International Taxation

A Report to the Treasurer

Volume 1

The Board of Taxation's Recommendations

The Board of Taxation

28 February 2003

ISBN 0 642 74186 7

Printer by CanPrint Communications Pty Ltd

MEMBERS, CHARTER OF THE BOARD OF TAXATION, CONFLICT OF INTEREST DECLARATION

Members

The members of the Board of Taxation are:

Chairman

Mr Richard F.E. Warburton

Members

Mr John Bronger
Mr Tony D'Aloisio
Mr John Harvey
Mr Brett Heading
Mr Chris Jordan
Ms Jane Schwager

Ex officio members

Mr Michael Carmody (Commissioner of Taxation)
Dr Ken Henry (Secretary to the Department of the Treasury)
Ms Hilary Penfold, QC (First Parliamentary Counsel)

Secretariat

Members of the Board's Secretariat are: Mr Gerry Antioch (Secretary), Mr Phil Bignell, Ms Byung-Hee Cho and Ms Kate Phipps.

Charter

Mission

Recognising the Government's responsibility for determining taxation policy, and the statutory role of the Commissioner of Taxation, to contribute a business and broader community perspective to improving the design of taxation laws and their operation.

Membership

The Board of Taxation will consist of up to ten members.

Up to seven members of the Board will be appointed, for a term of two years, on the basis of their personal capacity. It is expected that these members will be appointed from within the business and wider community having regard to their ability to contribute at the highest level to the development of the tax system. The Chairman will be appointed from among these members of the Board. Members may be reappointed for a further term.

The Secretary to the Department of the Treasury, the Commissioner of Taxation and the First Parliamentary Counsel will also be members of the Board. Each may be represented by a delegate.

Function

The Board will provide advice to the Treasurer on:

- the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.

Relationship to other boards and bodies

From time to time the Government or the Treasurer may establish other boards or bodies with set terms of reference to advise on particular aspects of the tax law. The Treasurer will advise the Board on a case by case basis of its responsibilities, if any, in respect of issues covered by other boards and bodies.

Report

The Chairman of the Board will report to the Treasurer, at least annually, on the operation of the Board during the year.

Secretariat

The Board will be supported by a secretariat provided by the Treasury, but may engage private sector consultants to assist it with its tasks.

Other

Members will meet regularly during the year as determined by the Board's work program and priorities.

Non-government members will receive daily sitting fees and allowances to cover travelling and other expenses, at rates in accordance with Remuneration Tribunal determinations for part-time public offices.

The Government will determine an annual budget allocation for the Board.

Conflict of interest declaration

All members of the Board are taxpayers in various capacities. Some members of the Board derive income from director's fees, company dividends, trust distributions or as a member of a partnership.

The Board's practice is to require members who have a material personal interest in a matter before the Board to disclose the interest to the Board and to absent themselves from the Board's discussion of the matter, including the making of a decision, unless otherwise determined by the Chairman (or if the Chairman has the interest, the other members of the Board).

The Board does not regard a member as having a material personal interest in a matter of tax policy that is before the Board merely because the member's personal interest may, in common with other taxpayers or members of the public, be affected by that tax policy or by any relevant Board recommendations.

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Volume 1: The Board of Taxation's Recommendations

Volume 2: The Board of Taxation's Consultations with the Community — Summary of Submissions

Volume 3: The Board of Taxation's Consultations with the Community — Summary of Confidential Submissions

This volume summarises the content of submissions which have been made in confidence to the Board. Under the terms in which the submissions were made to the Board, the Board is not permitted to disclose their contents beyond the Board (excluding the Commissioner of Taxation) and its advisers for the Review of International Taxation Arrangements, Treasury Ministers (the Treasurer and Minister for Revenue and Assistant Treasurer) and their advisers, the Department of the Treasury (excluding the ATO) and the persons who need to refer to the report for the purposes of Government consideration of the report.

FOREWORD

On 2 May 2002 the Treasurer announced details of a review by the Board of Taxation (the Board) of five main areas of our international taxation arrangements. Those areas were:

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

The Board's terms of reference for the review were set out in the Treasurer's letter of 22 August 2002 to the Board as follows:

> *'I am writing to confirm my request (as noted in my press release of 2 May 2002) that the Board of Taxation undertake public consultation on international tax issues in the second half of this year and provide the Government with a report by the end of the year.*
>
> *A copy of the Treasury paper, Review of International Taxation Arrangements, which I am about to release, is attached and should form the basis of consultations to be undertaken by the Board. I would encourage the Board to consult extensively, consider the views put forward, and provide its report on the outcome of the consultations and its recommendations to the Government.*
>
> *The review of Australia's international taxation arrangements is a key commitment of the Government to increase the attractiveness of Australia as a place for business. I look forward to receiving the Board's report and thank the Board for its assistance in undertaking this important consultation process.'*

The Board was asked to report by 31 December 2002. The timetable was very tight and despite the Board's best efforts, it was necessary to seek extensions to the end of January 2003 and then to 28 February 2003.

To assist the Board in its task, the Treasurer released the consultation paper titled *Review of International Taxation Arrangements*, prepared by the Commonwealth Department of the Treasury (Treasury Paper). The Treasury Paper sets out options for the consultations to be undertaken by the Board.

The Board's report

The Board's report is in 3 volumes:

- Volume 1: The Board of Taxation's Recommendations
- Volume 2: The Board of Taxation's Consultations with the Community — Summary of Submissions
- Volume 3: The Board of Taxation's Consultations with the Community — Summary of Confidential Submissions

Volume 3 summarises submissions which were made in confidence to the Board. On the terms on which the submissions were made, the Board is not permitted to disclose their contents beyond the Board (excluding the Commissioner of Taxation) and its advisers for the Review of International Taxation Arrangements, Treasury Ministers (Treasurer and Minister for Revenue and Assistant Treasurer) and their advisers, the Department of the Treasury (excluding the Australian Taxation Office) and the persons who need to refer to the report for the purposes of Government consideration of the report.

The Board's approach to its Terms of Reference

At the substantive level, the Board divided its tasks into two main elements:

- to conduct extensive consultations and to report on the outcome of those consultations; and
- based on the outcome of consultations and its own work, to formulate recommendations.

Volumes 2 and 3 summarise the outcome of the consultations. The full text of public submissions which it received are available on the Board's website. The submissions referred to in Volume 3 are confidential and available only as outlined in that volume. To help ensure the accuracy of the summaries in Volumes 2 and 3, the summaries were prepared by a team within the Board of Taxation Secretariat separate from that working on the Board's recommendations.

Volume 1 sets out the Board's own recommendations on the options canvassed in the Treasury Paper.

Procedurally, the Board went about its tasks in this way:

- The Board established a working group to have day-to-day carriage of the project. The Working Group met on numerous occasions from August 2002 to the date of this report.
- The Working Group was assisted by the Board's Secretariat and a number of tax, economic and industry experts retained for different aspects of the project.
- In advertisements placed in daily newspapers in all States and Territories, the Board called for submissions from the community by 31 October 2002 (the closing date set in the Treasury Paper).
- The Board's Working Group met with a number of representatives of corporate taxpayers on 2 September 2002 to explore key issues from the Treasury Paper.
- The Board held a consultative seminar on 30 September 2002 in Sydney. Invitations were sent to a very broad range of organisations covering all classes of taxpayers. About 100 participants attended. They included business representatives, tax practitioners, academics, industry bodies, community groups and practitioner organisations. The seminar included presentations from the Board's Working Group and representatives from the Department of the Treasury and the Australian Taxation Office.
- The Working Group also met with key stakeholders after the close of submissions on 31 October 2002. These stakeholders were principally those who provided detailed submissions to the Board. The purpose of the meetings was to help the Working Group better understand the submissions.

From August 2002 onwards the Board, met on a number of occasions (25 September 2002; 16 October 2002; 27 November 2002; 6 December 2002; 18 December 2002; and 3 February 2003) to discuss and give directions to the Working Group, leading to the Board's final approval.

In the course of its work, the Board received 'other options for consideration' not contained in the Treasury Paper. The Board addressed additional issues that it regarded as integral to those in the Treasury Paper. The remaining issues are contained in Volume 1, Chapter 6.

As part of its deliberations, the Board had the benefit of the views of its ex officio Board members:

- the Secretary to the Treasury (Dr Ken Henry);
- the Commissioner of Taxation (Mr Michael Carmody); and
- the Parliamentary Counsel (Ms Hilary Penfold, QC).

In addition, both the Treasury and the Australian Taxation Office provided assistance to the Board and its Working Group as required. The Treasury Paper itself provided an important outline of the issues and options and underpinned the Board's consultations. The ex-officio Government members, and the Treasury and the Australian Taxation Office, reserved their final views for advice to Government.

It is with great pleasure that I submit this three-volume Report to the Treasurer. Both I and the Board believe that, if implemented, the Board's recommendations will provide reforms which will greatly benefit Australia's ability to compete globally and, by doing so, increase Australia's GDP and national income. In particular, a number of the recommendations will make Australia a much more attractive place for business.

The Board recognises that some of the recommendations will have revenue implications which the Government would need to balance against other needs within the Australian budget.

Richard F.E. Warbuton
Chairman
The Board of Taxation

28 February 2003

ACKNOWLEDGMENTS

The preparation of the Report has involved:

- contributions (in the form of submissions) from 58 organisations (10 of which made submissions which were confidential in whole or part);
- consultations with organisations and interested persons; and
- a public seminar and a number of smaller group discussions.

On behalf of the Board of Taxation, we thank all those who have participated and contributed their time and assistance. The Board was impressed with the quality of the material put to it. This was more so as the material, because of the Board's tight timetable, needed to be prepared quickly. The parties who made submissions are listed at the end of these acknowledgments.

In addition, we thank:

The Board of Taxation Working Group

Mr Tony D'Aloisio (Chairman)

Mr Brett Heading

Mr Chris Jordan

Key Expert Advisers to the Board and the Working Group

Professor Richard Vann	Challis Professor of Law, University of Sydney, and Special Adviser to the Board
Mr John Brodie	Consultant
Professor Peter Butt	Professor of Law, University of Sydney
Mr Alf Capito	Partner, Ernst & Young
Dr Vince FitzGerald	Chairman, The Allen Consulting Group
Mr Richard Shaddick	Partner, Shaddick and Spence

The Board of Taxation Secretariat

Mr Gerry Antioch (Secretary)

Mr Phil Bignell

Ms Byung-Hee Cho

Ms Kate Phipps

Other Advisers and Assistance

A number of other advisers from industry and from the Board's Expert Panel and officials from the Treasury and ATO.

Richard F.E. Warburton
Chairman
The Board of Taxation

28 February 2003

Table 1: List of individuals and organisations providing submissions to the Board on the Review of International Taxation Arrangements

Submission Number	Organisation/Individual
1	Australian Custodial Services Association
2	Council of Small Business Organisations of Australia Ltd (COSBOA)
3	Barkoczy, Stephen & De Zilva, Aldrin
4	Lloyd-Smith, G
5	Australian Skandia Ltd
6	Ernst & Young
7	International Banks & Securities Association of Australia (IBSA)
8	Axiss Australia
9	Fernandez, Prafula
10	Institute of Chartered Accountants of New Zealand
11	Taxation Institute of Australia (TIA)
12	Deloitte & Touche LLP US
13	Deloitte Touche Tohmatsu New Zealand
14	Reach Services Australia Pty Ltd
15	British American Tobacco Australia Ltd
16	Anonymous
17	Mayo, Wayne
18	Vanguard Investments Australia Ltd
19	Boyd International Pty Ltd
20	Australian Bankers' Association (ABA)
21	Investment and Financial Services Association (IFSA)
22	Australian Institute of Company Directors (AICD)
23	Goodman Fielder International
24	PricewaterhouseCoopers
25	Deloitte Touche Tohmatsu
26	Taylor, John
27	Victorian Government, Department of Innovation, Industry and Regional Development

Table 1: List of individuals and organisations providing submissions to the Board on the Review of International Taxation Arrangements (continued)

Submission Number	Organisation/Individual
28	Clough Ltd
29	Corporate Super Association
30	AJ Baxter & Associates
31	CPA Australia
32	National Australia Bank Ltd (NAB)
33	Joint submission 10 companies (Joint 10 companies) (Amcor Ltd, AMP Ltd, BHP Billiton Ltd, BHP Steel Ltd, Brambles Industries Ltd, CSR Ltd, Lend Lease Corp Ltd, National Australia Bank Ltd, Orica Ltd, Telstra Corp Ltd)
34	BHP Billiton Ltd
35	Lam, Ada
36	Business Coalition for Tax Reform (BCTR)
37	KPMG
38	Institute of Chartered Accountants in Australia (ICAA)
39	Lend Lease Corp Ltd
40	Corporate Taxpayer Group, New Zealand
41	National Institute of Accountants (NIA)
42	Australian Chamber of Commerce and Industry (ACCI)
43	Westfield Holdings Ltd
44	Westfield Trust
45	Westfield America Trust
46	Association of Superannuation Funds of Australia (ASFA)
47	Rider, Cameron
48	Telstra Corp Ltd
49	Insurance Council of Australia
50	Export Finance and Insurance Corporation (EFIC)
51	Rio Tinto Ltd
52	Australian Stock Exchange Ltd (ASX)
53	Association of Grant Thornton Firms
54	Business Council of Australia and the Corporate Tax Association (BCA/CTA)

Table 1: List of individuals and organisations providing submissions to the Board on the Review of International Taxation (continued)

Submission Number	Organisation/Individual
55	Ernst & Young
56	Property Council of Australia
57	Government of Western Australia
58	Minerals Council of Australia

INTERNATIONAL TAXATION

Volume 1: The Board of Taxation's Recommendations

Attachments

List of Abbreviations

1936 Act	*Income Tax Assessment Act 1936*
1997 Act	*Income Tax Assessment Act 1997*
ABA	Australian Bankers' Association
ACCC	Australian Competition & Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ADF	Approved deposit fund
AICD	Australian Institute of Company Directors
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ASX	Australian Stock Exchange Ltd.
ATO	Australian Taxation Office
BCA	Business Council of Australia
BCTR	Business Coalition for Tax Reform
BELC	Broad-exemption listed country
CEN	Capital export neutrality
CER	Closer economic relations
CFC	Controlled foreign company
CGT	Capital gains tax
CIN	Capital import neutrality
COSBOA	Council of Small Business Organisations of Australia Ltd
CTA	Corporate Tax Association
DLC	Dual listed company
DRP	Dividend reinvestment plan
DTA	Double tax agreement
DWT	Dividend withholding tax
EDCI	Eligible designated concession income
EFIC	Export Finance and Insurance Corporation
ESO	Employee share option
EU	European Union
FBT	Fringe benefits tax
FDA	Foreign dividend account

FDI	Foreign direct investment
FIA	Foreign income account
FIF	Foreign investment fund
FSI	Foreign source income
GDP	Gross domestic product
GNI	Gross national income
IBSA	International Banks & Securities Association of Australia
ICAA	Institute of Chartered Accountants in Australia
IFSA	Investment and Financial Services Association
IRC	Internal Revenue Code
IT	Information technology
Joint 10 companies	Joint submission from 10 companies (Amcor Ltd, AMP Ltd, BHP Billiton Ltd, BHP Steel Ltd, Brambles Industries Ltd, CSR Ltd, Lend Lease Corp Ltd, National Australia Bank Ltd, Orica Ltd, Telstra Corp Ltd)
JV	Joint venture
LELC	Limited-exemption listed country
MFN	Most Favoured Nation
MIS	Managed investment scheme
NDA	Non discrimination article
NIA	National Institute of Accountants
NOHC	Non-operating holding company
NZ	New Zealand
OECD	Organisation for Economic Cooperation and Development
PE	Permanent establishment
PST	Pooled superannuation trust
R&D	Research & development
RBT	Review of Business Taxation, *A Tax System Redesigned,* Report, July 1999
REIT	Real estate investment trust
The Board	The Board of Taxation
TIA	Taxation Institute of Australia
Treasury Paper	Consultation Paper*: Review of International Taxation Arrangements*, August 2002, The Treasury
UK	United Kingdom
UN	United Nations
US	United States of America

The Board's Recommendations

Chapter 2: Attracting equity capital for offshore expansion

Recommendation 2.1(1):

The Board recommends:

(a) that domestic shareholder tax relief should be provided for unfranked dividends paid out of foreign source income derived after the commencement date; and

(b) that the relief should be provided by way of a non-refundable tax credit of 20 per cent and without any requirement to trace foreign tax paid or incurred.

Recommendation 2.1(2):

The Board recommends that the Government implement Option 2.1B to enable the streaming of foreign source income from an Australian parent company or through stapled stock arrangements from a foreign subsidiary, without adverse franking consequences (the Board does not recommend streaming between resident taxpayers).

Chapter 3: Promoting Australia as a location for internationally focused companies

Recommendation 3:

The Board recommends that where an attributable taxpayer holds an interest in a controlled foreign company that is resident in a broad-exemption listed country, the following income should not be attributed to the Australian resident:

(a) the income of the controlled foreign company (which would include its subsidiaries) that is sourced in that broad-exemption listed country or another broad-exemption listed country or is otherwise included in the tax base of a broad exemption listed country;

(b) the income of any subsidiaries of the broad-exemption listed country controlled foreign company where the subsidiaries are not resident in a broad-exemption listed country provided the broad-exemption listed country has a broadly comparable controlled foreign company regime to Australia's controlled foreign company regime.

In limited cases, income arising from specific features of a broad exemption listed country's tax system may be listed as subject to attribution.

This recommendation should be seen in conjunction with the Board's recommendations in 3.1(1) and (2), 3.2, 3.3, 3.4 and 3.10(1), (2) and (3) (below).

Recommendation 3.1(1):

The Board recommends that rollover relief should be available for corporate restructuring of controlled foreign companies not resident in a broad-exemption listed country, where the restructuring is covered by, and done in accordance with, the tax law of the country concerned.

Recommendation 3.1(2):

The Board recommends that rollover relief be extended to cover transfers of assets or interests between 100 per cent owned group companies, scrip for scrip transactions and demerger transactions in cases where relief would not otherwise be available as a result of recommendations 3, 3.1(1) and 3.10(2).

Recommendation 3.2:

The Board recommends that the tainted sales and services income rules be abandoned (except in relation to income or gains derived in designated tax havens that are not otherwise subject to tax in a broad-exemption listed country), and that services that are considered to raise particular integrity issues be dealt with expressly in the passive income rules under the controlled foreign company regime.

Recommendation 3.3:

The Board recommends that criteria for declaring further countries as broad exemption listed countries be developed and published as soon as practicable. Any further declarations of broad-exemption listed countries should be made on the basis of those published criteria. Existing broad-exemption listed countries should remain broad-exemption listed countries.

Recommendation 3.4:

The Board recommends that the policy position on the following issues in the controlled foreign company regime should be resolved by 31 December 2003:

(a) currency exchange fluctuations;

(b) limited liability companies and limited partnerships;

(c) all issues classified as urgent in the consultancy report commissioned by the Board not covered by other recommendations (see Attachment 1); and

(d) an ongoing speedy decision-making process to resolve other issues on the Controlled Foreign Company National Issues Register (see Attachment 2).

Recommendation 3.5:

The Board recommends a move towards a more residence-based treaty policy in substitution for the treaty model based on the source taxation of income.

Recommendation 3.6:

The Board recommends against proceeding with the Review of Business Taxation proposal to apply capital gains tax to the sale by non-residents of non-resident interposed entities with underlying Australian assets.

Recommendation 3.7:

The Board recommends that the Government set the following priorities:

(a) review and keep the key country treaties up to date and in line with Recommendation 3.5; and

(b) enter into treaty negotiations with other countries in the order of most important investment partners with Australia.

Recommendation 3.8:

The Board recommends that the consultation processes on negotiating tax treaties be improved by adopting processes similar to those of the Board's consultation report as adopted by the Government for domestic tax legislation.

Recommendation 3.9:

The Board recommends providing a general exemption for foreign non-portfolio dividends received by Australian companies and their controlled foreign companies and (subject to some existing exceptions) foreign branch profits.

Recommendation 3.10(1):

In view of the taxation relief available on certain dividends passing through Australia, and of the Board's recommendations in 3, 3.9, 3.10(2) and 3.11(2), the Board recommends that a separate conduit regime not be developed at this stage.

Recommendation 3.10(2):

The Board recommends that there should be a capital gains tax exemption for the sale by an Australian resident company or its controlled foreign companies of a non-portfolio interest in a foreign company that has an underlying active business.

Recommendation 3.10(3):

The Board recommends that any capital gain by an Australian resident company exempted as a result of Recommendation 3.10(2) would incur no withholding tax if passed to non-residents consistent with the policy intent of the Board's other recommendations on conduits.

Recommendation 3.11(1):

The Board recommends proceeding with the foreign income account rules recommended by the Review of Business Taxation as they apply to direct investment flows (such as non- portfolio dividends and branch profits but excluding capital gains, portfolio dividends or similar types of income such as interest and royalties).

Recommendation 3.11(2):

The Board recommends an exemption of capital gains made by non-residents on the disposal of shares comprising non-portfolio interests in Australian companies be provided by treaty, on a treaty by treaty basis. To the extent that these companies hold land in Australia, the same look through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.

Recommendation 3.12:

The Board recommends that a company should be regarded as resident in Australia only if it is incorporated in Australia.

Recommendation 3.13:

The Board recommends that a non-resident for treaty purposes should be treated as a non-resident for all purposes of income tax law, as an alternative to the current dual resident company provisions.

Chapter 4: Promoting Australia as a global financial services centre

Recommendation 4.1(1):

The Board recommends that, in the short to medium term, a fund registered as a managed investment scheme under the *Corporations Act 2001* or a company registered under the *Life Insurance Act 1995* should be exempted from the foreign investment fund rules where the fund is comprised of at least twenty diversified investments, at least 75 per cent of which are listed on an approved stock exchange.

Recommendation 4.1(2):

The Board recommends that, in the longer term (that is, within two years), the foreign investment fund rules be reviewed to provide a better balance between maintaining the integrity of the tax system and minimising compliance and other costs for taxpayers.

Recommendation 4.2:

The Board recommends that the 5 per cent balanced portfolio exemption threshold in the foreign investment fund rules should be increased for Australian managed funds that do not carry on a trading business as defined in Division 6C of the 1936 Act, to 10 per cent of the overall cost of the assets of the trust.

Recommendation 4.3:

The Board recommends that Australian managed funds that follow widely recognised indices be exempted from the foreign investment fund rules.

Recommendation 4.4:

The Board recommends that complying superannuation entities should be exempted from the foreign investment fund rules.

Recommendation 4.5:

The Board recommends that the foreign investment fund rules should be amended to allow fund management services to be an eligible activity for the purposes of the foreign investment fund rules.

Recommendation 4.6(1):

The Board recommends that non-resident investors who benefit under Australian trusts should be taken to be presently entitled only to so much of a capital gain as would be taxable if the trustee were non-resident.

Recommendation 4.6(2):

The Board recommends that the law be amended so that a non-resident investor in an Australian managed fund is not taken to be carrying on a business in Australia.

Recommendation 4.7:

The Board recommends an exemption of capital gains by non-residents on the disposal of non-portfolio interests in Australian managed funds in the form of unit trusts be provided by treaty, on a treaty by treaty basis. In the short term, an exemption should be provided to treaty partners who currently unilaterally exempt Australian residents in broadly similar circumstances. To the extent that managed funds hold land in Australia, the same look-through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.

Recommendation 4.8:

The Board recommends that capital gains tax rules be amended so that a distribution of foreign income to non-resident investors does not reduce the cost base of the investor in the Australian trusts that are subject to Division 6 of the 1936 Act.

Recommendation 4.8A:

The Board recommends that withholding tax on net rental income of property trusts be set at a flat rate of 30 per cent, subject to treaty reduction to 15 per cent on a reciprocal basis.

Recommendation 4.8B:

The Board recommends that withholding for other income of widely held Australian unit trusts that are subject to Division 6 of the 1936 Act be removed, except in relation to interest, dividends and royalties.

Recommendation 4.8C:

The Board recommends that exemption from interest withholding tax be available to widely held Australian unit trusts that are subject to Division 6 of the 1936 Act for widely distributed debentures issued to non-residents.

Recommendation 4.9:

The Board recommends the implementation of the Review of Business Taxation recommendations for simplifying the taxation of foreign trusts.

Recommendation 4.10:

The Board recommends that the taxation of transferor trusts should be amended as recommended by the Review of Business Taxation.

Recommendation 4.11(1):

The Board recommends that the separate entity approach be applied to branches of foreign banks and to other financial institutions, which are subject to similar treatment to banks under the thin capitalisation rules.

Recommendation 4.11(2):

The Board recommends that dividends received by branches of non-residents be subject to tax by assessment and not to withholding tax.

Chapter 5: Improving Australia's tax treatment of foreign expatriates

Recommendation 5.1:

The Board recommends against proceeding with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred capital gains tax liability.

Recommendation 5.2:

The Board recommends that the double taxation of employee share options should be addressed through immediate changes to Australia's domestic taxation laws to overcome double taxation, with subsequent bilateral tax treaty negotiations to ensure that the issue is dealt with comprehensively.

Recommendation 5.3:

The Board recommends against proceeding with the Review of Business Taxation recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A of the 1936 Act.

Recommendation 5.4:

The Board recommends that the Australian Taxation Office establish a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.

EXECUTIVE SUMMARY

Why a need for reform?

Up until the 1980s, Australian business was focused mainly on operations in Australia, with only a limited role in the ownership or management of foreign subsidiaries or businesses. Australia's current international taxation rules were largely formulated in that context.

Today, the situation is different. Over the last 20 years, successive Australian Governments have implemented a series of significant economic reforms aimed at boosting competitiveness and productivity (for example, by largely eliminating tariffs and deregulating financial markets). Australian businesses have responded. This has led to Australia's increased integration into the global economy, as can be seen from the increasing significance of trade, investment and income flows between Australia and the rest of the world. The benefits can be seen in the strong lift in productivity and income growth over the past decade, and Australia's exceptional performance in times of economic turbulence.

Looking ahead, the global integration of the last 20 years or so is likely to increase, not abate. In particular, investment is likely to become more and more international.

In the Board's view, however, our international taxation regime has not kept pace with these changes. This is in contrast to other areas of economic reform, where changes have helped integrate the Australian economy into the global economy. It is also in contrast to domestic tax reform — such as the introduction of a 30 per cent company tax rate, the introduction of the Goods and Services Tax, and reforms to capital gains tax (CGT) rollover relief.

While the priority afforded to domestic taxation is understandable, the failure to deal with the international taxation rules has left distortions and impediments. Unless removed, they could inhibit Australian companies from competing on the world stage with a strong Australian base. This in turn will reduce the benefits which could flow to Australia through further integration into the global economy. Those benefits come through in the form of increases in Gross Domestic Product (GDP) (income to Australians from the home economy) and in Gross National Income (GNI) (income from all Australian operations and investments worldwide). Moreover, the competitive environment is not static. Other countries are moving to reduce similar impediments. The Board believes that it is now time for Australia to tackle these distortions and impediments.

Chapter 1 expands on the benefits for Australia if these issues are tackled.

What are the Board's recommendations in overview?

International taxation is complex and technical. Because of this, the Board has been careful to approach its task issue by issue. Its approach has been to identify the tax issue of concern in consultation with a broad range of organisations, assess the alleged distortion or impediment, and then formulate its recommendation.

Put broadly, the Board's recommendations fall under the following 4 headings:

1. **Recommendations which ensure that Australia's dividend imputation system does not impede the ability of Australian companies to attract capital for offshore expansion.**

These recommendations are detailed in Chapter 2.

The Board believes that having strong globally relevant companies is fundamental to Australia's future prosperity.

The Board considers that the bias in the imputation system of restricting franking credits to Australian source income increases the cost of capital for Australian companies wishing to expand offshore — for example, to expand to achieve economies of scale to compete more globally or to grow overseas where they are constrained in Australia (such as for competition policy reasons).

The Board's recommendations are to:

- provide a credit of 20 per cent for unfranked dividends paid out of foreign-source income (FSI). This rate of credit is in contrast to the 30 per cent which now applies to Australian source income which has borne tax here; and

- allow streaming of FSI.

These changes will increase the integration of Australian companies into world class businesses. They will do so by:

- reducing capital cost for overseas expansion. Providing taxation relief to FSI removes the bias against investment by Australians in Australian companies deriving substantial profits overseas, and increases the after-tax returns to domestic investors (which include the value of imputation credits to shareholders). This will encourage Australian investors to invest where the rate of return on investment is the greatest;

- allowing the most efficient capital raising. Providing taxation relief to FSI removes the potential impact of the current imputation system in discouraging offshore investment relative to domestic investment by Australian multinationals or companies, by raising the cost of capital and lowering the returns for offshore expansion funded by Australian equity; and

- encouraging companies to repatriate profits to Australian shareholders rather than quarantining profits overseas.

2. Recommendations which remove impediments to Australia's attractiveness as a location for internationally-focused companies to operate global and regional business.

These recommendations are detailed in Chapter 3 and Attachments 1 and 2.

The Board considers that the current international taxation rules significantly constrain Australia from becoming an attractive location for global and regional business. Businesses ought to be encouraged both to remain in Australia and to set up new operations in Australia. Locating companies in Australia brings significant benefits to this country. They include attracting and retaining management and other high level skills. These areas are crucial in generating high-income jobs for Australians in an increasingly competitive international environment.

The Board's proposals include:

- changes to the controlled foreign company (CFC) rules. For example, dealing with the many technical issues that have been with the Foreign Source Income Subcommittee of the National Tax Liaison Group for a number of years (see Attachments 1 and 2);
- certain changes to the 'conduit' income rules; and
- changes to the residency test for companies.

These changes will make Australia a more attractive location for business. They will also reduce compliance costs (administrative, tax and legal) for companies and the Australian Taxation Office (ATO).

In addition, the Board endorses the direction the Government is taking in its tax treaty policy, in moving more to a residence-based approach.

3. Recommendations which remove impediments to Australia as a global financial services centre.

These recommendations are detailed in Chapter 4.

In particular, the Board has examined the so-called foreign investment fund (FIF) rules.

Australia is a highly attractive location within the Asia Pacific region for financial service providers. We have a large pool of highly talented labour. We also have a maturing funds management industry which helps generate clustering of other high-end service activities — for example, business and professional services, and IT.

However, the Board believes that:

- the operation of the FIF rules; and
- the capital gains treatment of investments by non-residents in managed funds (principally registered unit trusts),

inhibit Australia from realising its full potential as an attractive base for the managed funds industry. The FIF rules add significant compliance costs to an industry where cost reduction and efficiency are critical competitive factors.

The Board believes that the current FIF rules should be replaced by a system which better balances integrity with lower compliance costs.

The new rules may take time to formulate and enact. In the meantime, the Board believes that a number of changes should be made so as not to delay the benefits described above. These interim changes are:

- funds registered under the managed investment provisions of the *Corporations Act 2001* and life insurance companies should, as a general rule, be exempted from the application of the FIF rules;
- the 5 per cent balanced portfolio exemption should be increased to 10 per cent and applied to all trust assets; and
- limited exemptions from CGT should be granted for non-residents.

4. Recommendations which improve Australia's tax treatment of foreign expatriates to enhance Australia's attractiveness to overseas talent.

These recommendations are detailed in Chapter 5.

Skilled labour is mobile. To compete globally, Australia must attract and retain skilled labour to fill shortages and gain access to new ideas and skills. The current taxation rules in the treatment of foreign expatriates discourage companies from locating people in Australia. These issues affect both middle and senior management, as well as providers of traditional public sector services such as hospitals and educational establishments.

The Board proposes the following changes:

- addressing double taxation of employee share options (ESOs);

- establishing a specialist unit in the ATO to help advise on technical tax issues concerning foreign expatriates; and
- not proceeding with a number of Review of Business Taxation (RBT) proposals in the area.

What is the level of support of the Board's recommendations?

Fifty-eight submissions were made to the Board, of which 10 were confidential in whole or part. Overall, the submissions strongly supported the Board's recommendations. The Board took additional expert advice (both technical and economic) and had the benefit of input from the Treasury and the ATO.

Is taxation a real impediment or distortion in company decision-making?

The Board does not believe, nor was it argued in any significant way in the submissions, that tax is the sole reason behind company decisions. Clearly, there are important commercial drivers. Tax is, however, an important factor — increasingly so as our economy globalises — and certainly among the most important factors that government can directly influence. Its importance is reflected in most of the 58 submissions made to the Board.

Will the Board's proposals provide real benefits to Australia?

The Board considers (see Chapter 1) that its proposals will, in the medium to longer term, produce real benefits. These will be reflected in increases in GDP and national income. The Board believes that the benefits are comparable with the net benefits from microeconomic reforms implemented during the 1980s-1990s and designed to move companies from a domestic bias towards being better able to compete internationally. A typical estimate of benefits from such a reform is the 0.024 per cent lift (over some years) to GDP assessed to flow from reducing textile, clothing and footwear tariffs further after 2000-01 — and this was a relatively narrow reform.[1] The Board sees the likely long-term benefits as comparable to those benefits. This is because the Board's proposals similarly alter financial incentives in a material way so as to largely remove a bias in favour of domestically-oriented activity and investment. The result is to increasingly expose Australian companies in many sectors of the economy to the international marketplace.

It is true that the annual benefits of individual microeconomic reforms may be small fractions of GDP. However, the Board believes that only through continuing to

1 Productivity Commission, *The Textiles, Clothing and Footwear Industries – Inquiry Report*, Volume 2, Report Number 59, 9 September 1997, p. N16.

'harvest' such gains will Australia maintain the strong economic performance of recent years. The benefit will progressively build over a number of years.

What is the revenue cost of these changes?

In the limited time it has had, the Board has not been able to undertake a full analysis of revenue implications of the changes it proposes. However, from the advice received — principally from the Treasury — the expected revenue costs (in a full financial year when measures are in full effect) can be summarised as follows:

(a) for the Chapter 2 proposed changes:

- 20 per cent tax credit (Recommendation 2.1(1)) the estimate is $350 million to $400 million;
- streaming (Recommendation 2.1(2)) the estimate is $220 million to $240 million; and
- 20 per cent tax credit plus streaming (that is, both Recommendations 2.1(1) and 2.1(2)) the estimate is $520 million to $590 million.

The tax credit applies only to profits derived after the changes come into effect. The revenue cost of the credit will not impact fully on the forward estimates for one to two financial years after introduction.

The stated cost of the tax credit represents a gross amount that may be partly offset by two factors:

- top up tax collections from taxpayers who pay marginal rates higher than 20 per cent as companies repatriate offshore earnings and increase dividend distributions; and
- potential increases in CGT when shareholders dispose of shares that should, because of the changes, have a higher value.

Streaming would impact at the level set out above in the first financial year after introduction.

Combining the tax credit with streaming would entail a lower cost than is indicated by adding their separate costs. The lower combined cost arises because streaming would result in lower distributions of FSI to domestic shareholders, in turn reducing the cost of the tax credit.

(b) for the Chapter 3 proposed changes (other than Recommendations 3.5 and 3.11(2)) the estimate is $115 million to $160 million.

These costs are for a full financial year after the changes come into effect.

(c) for the recommendations on treaties (Recommendations 3.5 and 3.11(2)) the estimate is $250 million to $340 million.

The cost of revised tax treaties (Recommendation 3.5) will phase in over several years. Treaty estimates will run to $180 million to $220 million when fully implemented.

In relation to Recommendation 3.11(2), the impact will progress in the range of $70 million to $120 million when the program is fully implemented.

(d) for the Chapter 4 proposed changes the estimate is $50 million to $110 million. This impact would be in a full financial year after introduction.

(e) for the Chapter 5 proposed changes, the costs are negligible.

For the purpose of its assessment, the Board has accepted these Treasury estimates. The Board has not, in the time, conducted its own work. Nor has it examined the assumptions used for these estimates. As noted the impact of the costings will build up (generally) over 2 or 3 financial years before the full impact shown above. These estimates are being refined by the Treasury.

The Government has in its forward estimates funding related to the RBT which has been held in abeyance pending this report. These proposals related to providing franking credits for foreign dividend withholding tax and applying CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets. The Board is not recommending that these measures proceed (see Recommendation 3.6). The budget impact of proceeding with the Board's recommendations will therefore be lower than the costing ranges in this report indicate.

Notably, the Board does not propose using tax changes to provide incentives or handouts to achieve particular objectives. Its concern is to remove impediments and distortions. The change to imputation is designed to put companies wishing to expand offshore on much the same footing as those wishing to expand locally. The Board recognises, however, that removing these distortions and impediments comes at a cost.

Do the benefits of the proposed changes outweigh the revenue costs?

From the work it has done, the Board considers that the benefits outweigh the costs:

(a) the changes in Chapters 3 (excluding treaties), 4 and 5 should proceed. These reforms are overdue and can be achieved with relatively minimal costs. The costs will be outweighed by the benefits of:

- Australia as an attractive location for internationally focused businesses;
- Australia as a global financial services centre; and

- Australia's attractiveness for overseas talent.

(b) The Board recommends that the Government move more towards a more residence based treaty policy and notes that the revenue costs can be managed on a treaty-by-treaty basis.

(c) The changes in Chapter 2 should also be made. The Board has (on the material before it) come down with an on balance judgement that the benefits of these measures, particularly in the longer term, are significant and should be adopted. Those benefits outweigh their budgetary impact. Of the two changes in Chapter 2 (tax credit and streaming) the Board considers the tax credit to be the more important. If a choice were needed, because of budgetary constraints, the Board would favour priority being given to the tax credit over streaming.

What are the implementation and integrity issues?

The Board addressed costs of compliance, complexity and integrity and sought the views of the ATO. The Board's conclusions from that examination are:

- its recommendations, as a whole, will bring cost savings to business. These savings will occur, in particular, in relation to changes in CFCs and FIFs;

- its recommendations, as a whole, will reduce administrative costs of the ATO. According to the ATO, a lead time will be needed for the recommendations in Chapter 2. For this reason, the Board is recommending a start date of 1 July 2004 or 1 January 2005 for those changes; and

- its recommendations, as a whole, will deliver simplicity to the tax system. The recommendations remove complex areas and simplify others.

The Board has considered integrity issues. A balance is needed between integrity and removing impediments and distortions so as to deliver the benefits outlined. The Board believes that its proposals achieve the right balance.

The Board recognises, however, that more detailed work on its recommendations may uncover additional integrity issues. There is provision in the Government's tax design processes to deal with these. Specifically, the Board draws attention to the Board's Consultation Report (March 2002) which the Government has adopted. One of the steps in that process is 'road testing' draft legislation. Any additional integrity issues can be addressed when draft legislation is prepared.

Will these changes lead to greater use of tax havens?

In discussion with the ATO, the Board has been mindful to identify and deal with any potential abuse flowing from the proposed changes. For example, FSI could be channelled through tax havens to attract a foreign tax credit and domestic income could be connected to FSI to attract the 20 per cent credit. In the design phase, the Board expects rules to be developed to deal with a number of such issues.

These and other integrity measures are noted at the end of each chapter.

When should the changes come into effect?

The Board believes that the changes it is proposing should come into effect as quickly as possible. The Board's preference is that the changes for Chapters 3, 4 and 5 come into effect progressively from 1 July 2003. For Chapter 2, given the administrative issues which need to be addressed, the Board's preference is that the changes should come into effect from 1 July 2004 or 1 January 2005. The Board recognises that further consultations may be needed during the tax design phase on certain aspects of its recommendations but it would hope that these do not unduly delay implementation.

What should the priorities be?

From the evidence it has received, and in order to capture the growth in GDP outlined above, the Board believes that all the changes should be implemented as set out above. The issues have been around for a long time and essentially represent 'unfinished business' in tax reform. They should be dealt with as quickly as possible. The Board notes, however, that there are administrative issues which would warrant staggered start dates as set out in the previous paragraph.

Summary table

The following table will assist in understanding the Board's recommendations.

The table contains three columns:

- Column 1 — sets out the options in the Treasury Paper;
- Column 2 — sets out the Board's specific recommendations on each option; and
- Column 3 — sets out a summary of views in the submissions made to the Board on each option.

Summary table: Comparison of the Board's Recommendations (column 2) with the Treasury options in Treasury Paper (column 1) and the summary of views put in the submissions to the Board (column 3)

Chapter 1: Maintaining Australia's Competitiveness in a Global Economy

No options

Chapter 2: Attracting equity capital for offshore expansion

Treasury Options	Board Recommendations	Submissions
Option 2.1: After further considering the effect on Australian companies of the dividend imputation bias at the shareholder level, to consider three alternative options: A: providing domestic shareholder tax relief for unfranked dividends paid out of foreign source income; B: allowing dividend streaming of foreign source income; and C: providing franking credits for foreign dividend withholding taxes.	**Recommendation 2.1(1):** The Board recommends: (a) that domestic shareholder tax relief should be provided for unfranked dividends paid out of FSI derived after the commencement date; and (b) that the relief should be provided by way of a non-refundable tax credit of 20 per cent and without any requirement to trace foreign tax paid or incurred.	**Recommendation 2.1(1)**: The Board's recommendation to provide tax relief in the form of a tax credit to domestic shareholders reflects most of the submissions, which commented on this option. Most of these submissions considered that a credit of up to three-sevenths (30 per cent) would be needed to fully offset the existing bias in the imputation system.
	Recommendation 2.1(2): The Board recommends that the Government implement Option 2.1B to enable the streaming of FSI from an Australian parent company or through stapled stock arrangements from a foreign subsidiary, without adverse franking consequences (the Board does not recommend streaming between resident taxpayers).	**Recommendation 2.1(2):** The Board's recommendations broadly reflect the majority of views expressed in submissions. Few submissions directly commented on domestic streaming of tax preferred income. Option 2.1C Most submissions did not support option 2.1C. This is consistent with the absence of a recommendation on this issue by the Board.

Chapter 3: Promoting Australia as a location for internationally focused companies
Controlled Foreign Companies (CFCs)

Treasury Options	Board Recommendations	Submissions
	Recommendation 3: The Board recommends that where an attributable taxpayer holds an interest in a CFC that is resident in a BELC, the following income should not be attributed to the Australian resident: (a) the income of the CFC (which would include its subsidiaries) that is sourced in that BELC or another BELC or is otherwise included in the tax base of a BELC; (b) the income of any subsidiaries of the BELC CFC where the subsidiaries are not resident in a BELC provided the BELC has a broadly comparable CFC regime to Australia's CFC regime. In limited cases, income arising from specific features of a BELC's tax system may be listed as subject to attribution. This recommendation should be seen in conjunction with the Board's recommendations in 3.1(1) and (2), 3.2, 3.3, and 3.4 and 3.10(1), (2) and (3) (below).	**Recommendation 3**: The Board's recommendation is broadly consistent with a large number of submissions which proposed that attribution of income should not occur where a CFC is resident of a BELC. Generally these submissions did not outline a detailed method for implementing the exemption. However, several submissions proposed different forms of a 90 per cent threshold test above which attribution of CFC income should not occur.
Option 3.1: To consider options to expand rollover relief under the controlled foreign company rules, while maintaining the integrity of those rules.	**Recommendation 3.1(1)**: The Board recommends that rollover relief should be available for corporate restructuring of CFCs not resident in a BELC, where the restructuring is covered by, and done in accordance with, the tax law of the country concerned.	**Recommendation 3.1(1):** Expansion of rollover relief was supported in the majority of submissions.
	Recommendation 3.1(2): The Board recommends that rollover relief be extended to cover transfers of assets or interests	**Recommendation 3.1(2):** Many submissions raised the possibility of allowing general restructuring relief in accordance

Chapter 3: Promoting Australia as a location for internationally focused companies Controlled Foreign Companies (CFCs)		
Treasury Options	**Board Recommendations**	**Submissions**
	between 100 per cent owned group companies, scrip for scrip transactions and demerger transactions in cases where relief would not otherwise be available as a result of recommendations 3, 3.1(1) and 3.10(2).	with the law of the country concerned. Other possibilities raised included allowing any rollover in a BELC, any rollover between 100 per cent commonly owned companies, and scrip for scrip exchanges.
Option 3.2: To consider options to appropriately target the tainted services income rules, while maintaining the integrity of the controlled foreign company rules.	**Recommendation 3.2**: The Board recommends that the tainted sales and services income rules be abandoned (except in relation to income or gains derived in designated tax havens that are not otherwise subject to tax in a BELC), and that services that are considered to raise particular integrity issues be dealt with expressly in the passive income rules under the CFC regime.	**Recommendation 3.2**: Many submissions suggested confining the tainted services income rules to genuinely passive income. Other proposed methods for refining the scope include removing: services provided on an arms length basis; services provided by CFCs to non-resident associates; services without a direct connection to Australia.
Option 3.3: To consider whether additional countries should be included on the broad exemption country list, and to clarify the criteria for inclusion (or exclusion).	**Recommendation 3.3**: The Board recommends that criteria for declaring further countries as BELCs be developed and published as soon as practicable. Any further declarations of BELCs should be made on the basis of those published criteria. Existing BELCs should remain BELCs.	**Recommendation 3.3**: The Board's recommendation is consistent with the view of the majority of submissions that objective criteria be developed for determining BELC status. Some submissions made specific suggestions on countries to be included as BELCs.
Option 3.4: To identify technical and other remaining policy issues regarding the controlled foreign company rules, and consider options to resolve them either on a case-by-case basis or as part of a major rewrite of the provisions.	**Recommendation 3.4:** The Board recommends that the policy position on the following issues in the CFC regime should be resolved by 31 December 2003: (a) currency exchange fluctuations; (b) limited liability companies and limited partnerships; (c) all issues classified as	**Recommendation 3.4**: Submissions were broadly consistent with this recommendation. A number of submissions proposed a comprehensive review of the CFC regime in the longer term after specific problem areas had been addressed more immediately.

Chapter 3: Promoting Australia as a location for internationally focused companies Controlled Foreign Companies (CFCs)		
Treasury Options	**Board Recommendations**	**Submissions**
	urgent in the consultancy report commissioned by the Board not covered by other recommendations (see Attachment 1); and (d) an ongoing speedy decision making process to resolve other issues on the CFC National Issues Register (see Attachment 2).	
Treaties Option 3.5: To consider whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future treaty negotiations or whether alternative approaches are preferable.	**Recommendation 3.5**: The Board recommends a move towards a more residence-based treaty policy in substitution for the treaty model based on the source taxation of income.	**Recommendation 3.5**: The Board's recommendation is consistent with suggestions in some submissions. Other submissions made specific comments on the US Protocol and in particular on the benefits of reducing withholding tax rates.
Option 3.6: To consider whether or not to proceed with the Review of Business Taxation proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets.	**Recommendation 3.6**: The Board recommends against proceeding with the RBT proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets.	**Recommendation 3.6**: The Board's recommendation is consistent with submissions.
Option 3.7: To consider which countries should be given priority for tax treaty negotiations, taking into account negotiations underlay with the United Kingdom and Germany, the need to update pre-CGT treaties, and countries that Australia may be obliged to approach because of most favoured nation clauses in existing treaties.	**Recommendation 3.7**: The Board recommends that the Government set the following priorities: (a) review and keep the key country treaties up to date and in line with Recommendation 3.5; (b) enter into treaty negotiations with other countries in the order of most important investment partners with Australia.	**Recommendation 3.7**: Submissions generally sought that priority be given to treaty negotiations with Australia's most important trading partners, having regard also to the implications of Most Favoured Nation clauses in treaties.
Option 3.8: To consider options to improve consultation processes on negotiating tax	**Recommendation 3.8**: The Board recommends that the consultation processes on	**Recommendation 3.8**: Submissions were generally consistent with Board's

Chapter 3: Promoting Australia as a location for internationally focused companies Controlled Foreign Companies (CFCs)		
Treasury Options	**Board Recommendations**	**Submissions**
treaties.	negotiating tax treaties be improved by adopting processes similar to those of the Board's consultation report as adopted by the Government for domestic tax legislation.	recommendation, calling for more effective, transparent consultation processes.
'Conduit' Income Option 3.9: To consider abolishing the limited exemption country list and provide a general exemption for foreign non-portfolio dividends Australian companies receive and (subject to some existing exceptions) foreign branch profits.	**Recommendation 3.9:** The Board recommends providing a general exemption for foreign non-portfolio dividends received by Australian companies and their CFCs and (subject to some existing exceptions) foreign branch profits.	**Recommendation 3.9**: Submissions were generally consistent with the Board's recommendations.
Option 3.10: To consider options to provide conduit relief for Australian regional holding and joint-venture companies, including considering the benefits and costs of introducing a general conduit holding company regime; providing an exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business; and providing conduit restructure relief.	**Recommendation 3.10(1)**: In view of the taxation relief available on certain dividends passing through Australia and of the Board's recommendations in 3, 3.9, 3.10(2) and 3.11(2), the Board recommends that a separate conduit regime not be developed at this stage. **Recommendation 3.10(2)**: The Board recommends that there should be a CGT exemption for the sale by an Australian resident company or its CFCs of a non-portfolio interest in a foreign company that has an underlying active business. **Recommendation 3.10(3)**: The Board recommends that any capital gain by an Australian resident company exempted as a result of Recommendation 3.10(2) would incur no withholding tax if passed to non-residents consistent with the policy intent of the Board's other recommendations on conduits.	**Recommendation 3.10(1)**: Submissions generally supported a conduit holding company regime. **Recommendation 3.10(2):** Submissions generally supported the introduction of a CGT exemption for the sale by an Australian resident company or their CFCs of a non-portfolio interest in a foreign company that has an underlying active business.

Chapter 3: Promoting Australia as a location for internationally focused companies
Controlled Foreign Companies (CFCs)

Treasury Options	Board Recommendations	Submissions
Option 3.11: To consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1.	**Recommendation 3.11(1):** The Board recommends proceeding with the foreign income account rules recommended by the RBT as they apply to direct investment flows (such as non-portfolio dividends and branch profits a but excluding capital gains, portfolio dividends or similar types of income such as interest and royalties). **Recommendation 3.11(2)**: The Board recommends an exemption of capital gains made by non-residents on the disposal of shares comprising non-portfolio interests in Australian companies be provided by treaty, on a treaty by treaty basis. To the extent that these companies hold land in Australia, the same look through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.	**Recommendation 3.11(1)** Many submissions supported the introduction of the foreign income account rules. **Recommendation 3.11(2):** Submissions did not generally refer to providing an exemption for non-portfolio gains on shares in Australian companies for capital gains on a treaty-by-treaty basis.
Residency Option 3.12: To consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business.	**Recommendation 3.12**: The Board recommends that a company should be regarded as resident in Australia only if it is incorporated in Australia.	**Recommendation 3.12**: Submissions were generally consistent with the Board's recommendation.
Option 3.13: To consider whether a company that is a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of the income tax law, as an alternative to the current dual resident company provisions.	**Recommendation 3.13**: The Board recommends that a non-resident for treaty purposes should be treated as a non-resident for all purposes of income tax law, as an alternative to the current dual resident company provisions.	**Recommendation 3.13**: Parties who commented on Option 3.13 generally supported the Board's recommendation.

Chapter 4: Promoting Australia as a global financial services centre		
Treasury Options	**Board Recommendations**	**Submissions**
Option 4.1: To give longer-term consideration to a replacement of the current foreign investment fund rules to provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers.	**Recommendation 4.1(1):** The Board recommends that, in the short to medium term, a fund registered as a managed investment scheme under the *Corporations Act 2001* or a company registered under the *Life Insurance Act 1995* should be exempted from the FIF rules where the fund is comprised of at least 20 diversified investments, at least 75 per cent of which are listed on an approved stock exchange. **Recommendation 4.1(2):** The Board recommends that, in the longer term (i.e. within 2 years), the FIF rules be reviewed to provide a better balance between maintaining the integrity of the tax system and minimising compliance and other costs for taxpayers.	**Recommendation 4.1(1):** Submissions considered that there should be a long term replacement for the FIF regime. Several major submissions supported carving out managed funds from the regime. In contrast other submissions suggested that the FIF regime be more targeted to apply only to offshore accumulation of income. **Recommendation 4.1(2):** This recommendation is consistent with the majority of views in submissions.
Option 4.2: To consider, including undertaking detailed case studies in conjunction with industry, increasing the 5 per cent balanced portfolio exemption threshold in the foreign investment fund rules.	**Recommendation 4.2**: The Board recommends that the 5 per cent balanced portfolio exemption threshold in the FIF rules should be increased for Australian managed funds that do not carry on a trading business as defined in Division 6C of the 1936 Act, to 10 per cent of the overall cost of the assets of the trust.	**Recommendation 4.2**: This is broadly consistent with the views in submissions. However, several submissions noted that this exemption would not be needed if the FIF rules were more narrowly targeted or excluded managed funds.
Option 4.3: To consider exempting Australian managed funds that follow widely recognised indices from the foreign investment fund rules.	**Recommendation 4.3:** The Board recommends that Australian managed funds that follow widely recognised indices be exempted from the FIF rules.	**Recommendation 4.3**: This is broadly consistent with the views in submissions. However, several submissions noted that this exemption would not be needed if the FIF rules were more narrowly targeted or excluded managed funds.
Option 4.4: To consider exempting complying superannuation funds from the foreign investment fund rules.	**Recommendation 4.4**: The Board recommends that complying superannuation entities should be exempted	**Recommendation 4.4**: This is broadly consistent with the views in submissions, although several submissions noted that

Chapter 4: Promoting Australia as a global financial services centre		
Treasury Options	**Board Recommendations**	**Submissions**
	from the FIF rules.	this exemption would not been needed if the FIF rules were more narrowly targeted or excluded managed funds.
Option 4.5: To consider amending the foreign investment fund rules to allow fund management services to be an eligible activity for the purposes of the foreign investment fund rules.	**Recommendation 4.5:** The Board recommends that the FIF rules should be amended to allow fund management services to be an eligible activity for the purposes of the FIF rules.	**Recommendation 4.5**: The Board's recommendation is consistent with the views in submissions.
Option 4.6: To consider exempting from CGT gains to which non-resident beneficiaries are presently entitled that relate to assets without the necessary connection with Australia. Whether an asset has the necessary connection with Australia could be determined as if the trustee of the resident trust was a non-resident.	**Recommendation 4.6(1):** The Board recommends that non-resident investors who benefit under Australian trusts should be taken to be presently entitled only to so much of a capital gain as would be taxable if the trustee were non-resident. **Recommendation 4.6(2):** The Board recommends that the law be amended so that a non-resident investor in an Australian managed fund is not taken to be carrying on a business in Australia.	**Recommendation 4.6(1):** The Board's recommendations are broadly consistent with the views in submissions. **Recommendation 4.6(2):** The Board's recommendation was not generally raised in submissions.
Option 4.7: To consider the feasibility of exempting from CGT gains on the disposal of a non-portfolio interest in a unit trust that relate to unrealised gains on assets that do not have the necessary connection with Australia.	**Recommendation 4.7:** The Board recommends an exemption of capital gains by non-residents on the disposal of non-portfolio interests in Australian managed funds in the form of unit trusts be provided by treaty, on a treaty by treaty basis. In the short term, an exemption should be provided to treaty partners who currently unilaterally exempt Australian residents in broadly similar circumstances. To the extent that managed funds hold land in Australia, the same look-through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.	**Recommendation 4.7:** The Board's recommendation is broadly consistent with the views in submissions. Submission did not generally address the issue of whether a look-through test should apply to manage funds that hold land in Australia.

Chapter 4: Promoting Australia as a global financial services centre		
Treasury Options	**Board Recommendations**	**Submissions**
Option 4.8: To consider amending the CGT rules so that a distribution of income to which a non-resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain that arises from Option 4.6), does not reduce the non-resident investor's cost base in a unit trust.	**Recommendation 4.8**: The Board recommends that the CGT rules be amended so that a distribution of foreign income to non-resident investors does not reduce the cost base of the investor in the Australian trusts that are subject to Division 6 of the 1936 Act. **Recommendation 4.8A**: The Board recommends that withholding tax on net rental income of property trusts be set at a flat rate of 30 per cent subject to treaty reduction to 15 per cent on a reciprocal basis. **Recommendation 4.8B**: The Board recommends that withholding for other income of widely held Australian unit trusts that are subject to Division 6 of the 1936 Act be removed, except in relation to interest, dividends and royalties. **Recommendation 4.8C**: The Board recommends that exemption from interest withholding tax be available to widely held Australian unit trusts that are subject to Division 6 of the 1936 Act for widely distributed debentures issued to non-residents.	**Recommendations 4.8 – 4.8C**: The Board's recommendation is broadly consistent with the views in submissions.
Option 4.9: To consider proceeding with the recommendations of the Review of Business Taxation rationalising the application of current rules to foreign trusts.	**Recommendation 4.9**: The Board recommends the implementation of the RBT recommendations for simplifying the taxation of foreign trusts.	**Recommendation 4.9:** The Board's recommendation is broadly consistent with the views in submissions
Option 4.10: To consider proceeding with the recommendations of the Review of Business Taxation in relation to transferor trusts.	**Recommendation 4.10**: The Board recommends that the taxation of transferor trusts should be amended as recommended by the RBT.	**Recommendation 4.10**: Submissions expressed a range of views on this issue, with some calling for further consideration of the RBT recommendation and some expressing reservations.

Chapter 4: Promoting Australia as a global financial services centre		
Treasury Options	**Board Recommendations**	**Submissions**
Option 4.11: To consider specific tax issues outside the Government's current tax reform programme where the lack of separate entity treatment inappropriately impedes the use of branch structures.	**Recommendation 4.11(1):** The Board recommends that the separate entity approach be applied to branches of foreign banks and to other financial institutions, which are subject to similar treatment to banks under the thin capitalisation rules. **Recommendation 4.11(2):** The Board recommends that dividends received by branches of non-residents be subject to tax by assessment and not to withholding tax.	**Recommendation 4.11(1):** The Board's recommendation is broadly consistent with the views in submissions. **Recommendation 4.11(2):** Submissions did not generally deal with this issue.

Chapter 5: Improving Australia's tax treatment of foreign expatriates		
Treasury Options	**Board Recommendations**	**Submissions**
Option 5.1: To consider whether to proceed with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred CGT liability.	**Recommendation 5.1**: The Board recommends against proceeding with the RBT recommendation that residents departing Australia provide security for deferred CGT liability.	**Recommendation 5.1:** Submissions were consistent with the Board's recommendation.
Option 5.2: To consider addressing the double taxation of employee share options through bilateral tax treaty negotiations and possible consequential changes to Australia's domestic tax law treatment.	**Recommendation 5.2:** The Board recommends that the double taxation of ESOs should be addressed through immediate changes to Australia's domestic taxation laws to overcome double taxation, with subsequent bilateral tax treaty negotiations to ensure that the issue is dealt with comprehensively.	**Recommendation 5.2:** The majority of submissions were consistent with the Board's recommendation.
Option 5.3: To consider whether to proceed with the Review of Business Taxation recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A.	**Recommendation 5.3:** The Board recommends against proceeding with the RBT recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A of the 1936 Act.	**Recommendation 5.3**: Submissions were generally consistent with the Board's recommendation.
Option 5.4: To consider the Australian Taxation Office establishing a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.	**Recommendation 5.4**: The Board recommends that the ATO establish a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.	**Recommendation 5.4**: Submissions were generally consistent with the Board's recommendation.

CHAPTER 1: INTERNATIONAL TAX ARRANGEMENTS PROMOTING AUSTRALIA'S COMPETITIVENESS

Introduction

1.1 This chapter provides an overview of the Board of Taxation's (the Board) recommendations. It summarises the Board's recommendations and presents the basic principles that lie behind the Board's reasoning. The succeeding Chapters 2-5 deal with each of the Board's specific recommendations in more detail.

1.2 Competitiveness in an increasingly open and integrated global economy has become a central preoccupation of governments and companies around the world. The last 20 years has seen the weaving of national economies into a more integrated world economy. The Board approached its task of reviewing Australia's international taxation arrangements from the perspective that Australia's future prosperity depends on its capacity to engage competitively in the global economy.

1.3 The basic competitive unit in the global marketplace is the corporation. Hence, a key focus of the Board's consideration has been the ability of Australia's corporations to compete in that marketplace. Australia has a small population and limited capital. It must be able to attract capital from overseas, and its businesses must be able to earn the best possible return on Australians' savings. Indeed, businesses need to be able to earn the best possible return on all the capital they employ, including capital employed overseas. This is particularly so when their domestic opportunities become constrained, as to varying degrees is the case for most larger Australian companies.

1.4 As Australia has integrated into the global marketplace, investment by Australian firms in other countries has increased sharply. This is part of a worldwide trend. It is reflected in ever-rising trade and investment flows, rising labour mobility, and the rapid sharing of know-how and technology. Globally, foreign direct investment (FDI) has increased from 2 per cent of worldwide investment in the early 1980s to more than 8 per cent in the late 1990s.[1] This trend will continue. It is thus becoming increasingly important that the Australian domestic economy offer an attractive investment location for foreign companies. It is also becoming increasingly important that Australian companies are able to invest competitively in international markets. The taxation system should not impede either of these objectives. In this

1 Productivity Commission (2001), *Offshore Investment by Australian Firms: Survey Evidence*, p. xi.

regard, the competitive environment for Australia is not static. Other countries are making relevant changes to their taxation systems. Australia must do so too.

1.5 Australia must regularly review its taxation system to ensure that business competitiveness is not unduly hindered. Global integration provides business and individuals with greater freedom to take advantage of opportunities outside their home country. This includes the commercial reality that investment decisions take into account the level and complexity of taxation in different countries. While economic and commercial factors dominate, government also affects many aspects of the competitive environment notably via taxation regimes.

1.6 A recent Productivity Commission survey of Australian firms found that foreign and domestic taxation regimes were among the most important *government* factors influencing investment decisions.[2] About 55 per cent of firms considering whether to invest offshore in the next five years rated the Australian tax environment as 'important' to their decisions.

1.7 Furthermore, although few submissions made to the Board argued that tax was the primary reason behind companies' business decisions, most submissions did reflect the importance of Australia's taxation arrangements. Many submissions highlighted reforms that other countries have made to international or other relevant aspects of tax regimes to encourage investment flows. They also highlighted the risks which Australia faces if its existing international tax arrangements remain unchanged, and the opportunities which will be missed if Australia and Australian companies fall behind in integrating into the global economy. For example, in a joint letter dated 3 February 2003, the Australian Bankers' Association (ABA), the Business Council of Australia (BCA) and the Corporate Tax Association (CTA) highlighted the competitive boost that United States (US) companies would enjoy from the US Administration's proposals to end the double taxation of dividends. They said that

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

1.8 The Review of Business Taxation (RBT) examined a number of aspects of international taxation arrangements. However, due to their complexity, implementation of most reforms was deferred pending further consideration. Consideration of Australia's international tax arrangements is now overdue. It represents the completion of 'unfinished business' from the RBT.

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2 Productivity Commission (2001), *Offshore Investment by Australian Firms: Survey Evidence*, pp. 36–37.

1.9 Looking ahead, the increasing global integration of the last 20 years or so is not likely to abate. Despite growing cross-border investment flows, world capital markets are still far from fully integrated. Almost everywhere domestic saving typically funds most domestic investment, and equity portfolios are still heavily weighted toward the stocks of companies based in the investors' home country. Thus, the full gains from global integration have yet to be realised. In pursuit of those gains, economic, technological and regulatory factors will continue to propel foreign investment flows even higher. Unless Australia keeps pace, we will miss out on the benefits from further integration.

1.10 Therefore, the Board's recommendations, and any policy action that might emerge from them, need to be seen as part of a continuous process of ensuring that Australia's taxation system does not hinder business decisions, and that it promotes competitiveness and international integration. For example, the Board's recommendation on shareholder relief for dividends paid out of foreign source income (FSI) may need to be adjusted in light of any future significant movements in domestic and foreign taxation levels. Similarly, keeping our international tax treaties in step with commercial developments should be a continuous goal. A number of submissions stressed the importance of a continuous and holistic approach to examining Australia's international taxation arrangements. They emphasised the need for an ongoing process of review and reform of the tax system, rather than an uncoordinated, intermittent and piecemeal approach to reform as and when significant problems present themselves.

1.11 The Board's recommendations are designed to assist Australia, and Australian corporations, to compete on a neutral basis, by ensuring that Australia's tax system does not unduly hinder business decisions, but rather enhances Australia's status as an attractive place for business and investment. The Board has not sought to use tax as a mechanism either to buy inwards investment or to subsidise outwards investment.

1.12 In making its recommendations, the Board has applied the following widely-accepted tax policy design principles:

- *The efficiency principle*: in raising revenue, the business tax system should interfere as little as possible with the best use of existing national resources, with the efficient allocation of risk, and with long term economic growth. An internationally competitive economy requires, and is sustained by, the efficient use of its economic resources. To this end, a vital precondition for Australia's international competitiveness is that business decisions are not unduly constrained by the business tax system.
- *The neutrality principle:* (which complements the efficiency principle) a tax system should reflect the goals of (1) capital export neutrality (CEN), whereby all residents' income is taxed at the same rate, regardless of whether it is earned domestically or overseas; and (2) capital import neutrality (CIN), whereby the

income from domestically–owned and invested capital is taxed at the same rate as that from foreign inward investment.

- *The equity principle*: a tax system should reflect community concerns of fairness. Individuals in similar circumstances should be taxed similarly (horizontal equity), and tax burdens should depend upon ability to pay (vertical equity), the greater burden falling on those more able to pay.

- *The simplicity principle*: a tax system should be transparent, easily understood, and keep administrative and compliance costs to a minimum.

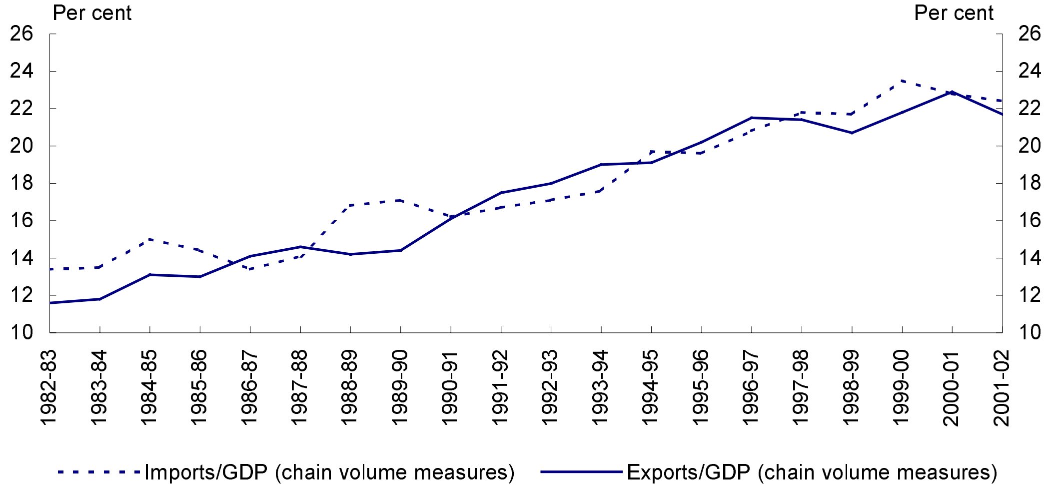
1.13 This chapter outlines what is at stake for Australia's international competitiveness and its international taxation arrangements. It summarises each group of the Board's recommendations, and discusses the benefits to be derived from implementing them.

How Australia benefits from integrating into the global economy

1.14 Over the last 20 years, Australian governments have implemented a series of significant economic reforms aimed at boosting the prospects of growth in Australians' living standards in a more open, competitive and global environment. This has involved removing external barriers and integrating both real and financial sectors into the global economy. Lower trade and foreign investment barriers, financial market deregulation, and pro–competition reforms, have all shown the need for Australian businesses to improve productivity by seeking out ways to become more specialised, to reduce costs, to develop ways to add value, and to access new markets.

1.15 The extent of Australia's increased integration into the global economy can be seen from the increasing significance of trade and income flows between Australia and the rest of the world. Figure 1.1 shows that the value of both exports and imports is now about 22 per cent of Australia's total gross domestic product (GDP) — about 10 percentage points higher than 20 years earlier. Similarly, as a proportion of GDP, the flow of income between Australian-resident firms and individuals and non–resident firms and individuals has increased significantly over the last 20 years (Figure 1.2).

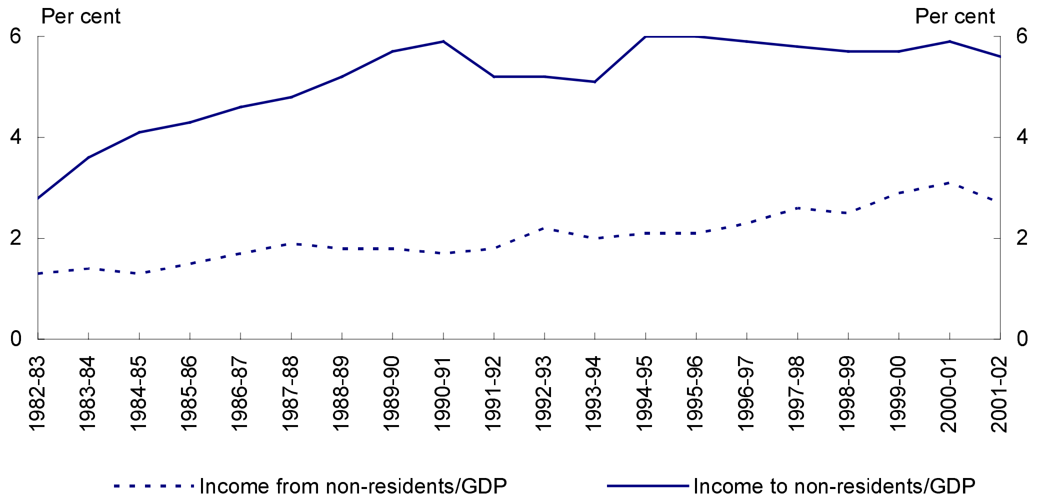
Figure 1.1: Exports and Imports as a proportion of GDP, chain volume measures, 1982-83 to 2001-02



Source: Australian Bureau of Statistics (2002), *Australian System of National Accounts,* Catalogue No. 5204.0, p. 14.

1.16 This increased integration of Australia's economy into the global stage is also highlighted by evidence showing that the number of companies declaring net foreign income increased by 40 per cent between 1994-95 and 1999-2000, to 7,465.[3]

Figure 1.2: Income to and from non-residents as a proportion of GDP, current prices, 1982–83 to 2001–02



Source: Australian Bureau of Statistics (2002), *National Income, Expenditure and Product, Australian National Accounts*, Catalogue No. 5206.0, pp. 42 and 54.

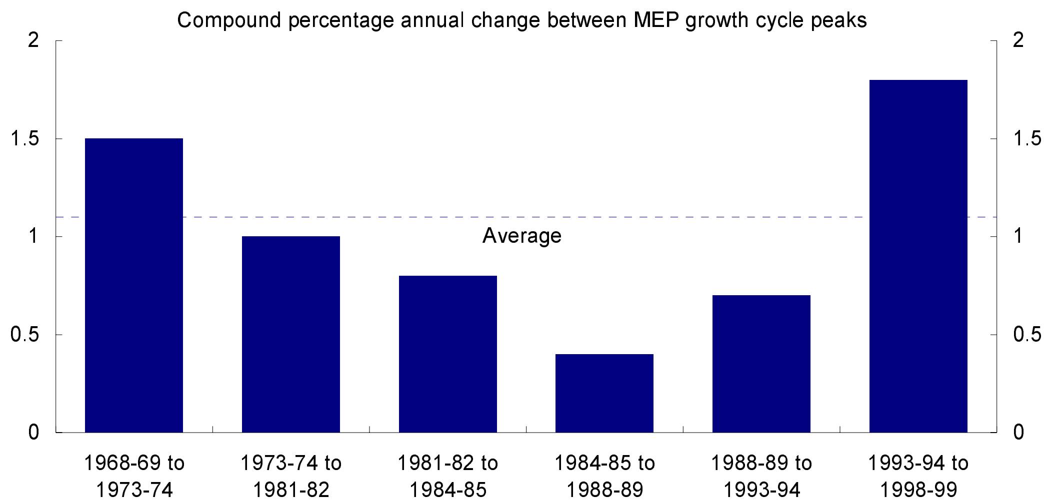
1.17 Australia's increased integration into the global economy has coincided with a surge in productivity growth, underpinning Australia's strong economic performance over the last decade. The Productivity Commission has shown that most of the key

3 Taxation Statistics 1999-2000, Table S4.6.

developments in productivity-related factors reflect the positive influence of reforms to promote efficiency and global competitiveness.[4]

1.18 Figure 1.3 shows the rates of multifactor productivity growth over productivity cycles in the market sector of the Australian economy. The 1.8 per cent annual average multifactor productivity growth reached in the 1990s cycle is a record high (albeit only marginally ahead of the rate in the late 1960s and early 1970s). The underlying rate of productivity growth accelerated a full percentage point in the 1990s, compared with the previous cycle.

Figure 1.3: Multifactor productivity over productivity cycles, 1968-69 to 1998-99



Source: Australian Bureau of Statistics (2002), *Australian System of National Accounts*, Catalogue No. 5204.0, p. 35.

Why impediments to continuing integration need to be removed

1.19 The Australian domestic market is small. This means that Australia's companies must continue to exploit expansion opportunities overseas if they are to:

- attain economies of scale;
- establish presence so as to access new markets;
- compete in larger markets;
- access new technologies and business systems;[5] and

4 Productivity Commission (1999), *Microeconomic Reform and Australian Productivity: Exploring the Links*, p. 81.

5 There is a view that companies operating in more sophisticated overseas markets are more able to quickly access new technologies and business systems, and to apply them at home.

- be rated by international credit agencies for the purposes of being listed on share markets.

1.20 Equally, Australia itself must offer a competitive environment for locating business activity particularly headquarters functions bringing strong demand for high value services. Even as they embark on a diverse range of business ventures, many Australian companies prefer to remain resident in Australia for a host of commercial, regulatory and other reasons. In particular, Australia's strong funds management industry offers a platform to develop a truly global financial services sector in Australia, and thereby attract other financial service companies wishing to locate their regional operations in Australia. In turn this promotes clustering of other high end service activities, such as business and professional services, telecommunications and information technology.

1.21 Removing impediments to Australia's continuing integration into the global economy will bring significant benefits. The Organisation for Economic Cooperation and Development (OECD) has found that attracting FDI lifts a country's economic performance and its living standards.[6] Foreign capital generates increased employment, increased incomes and improved infrastructure, thereby creating a stronger industrial and economic base. Inflows of foreign capital are also believed to improve a host country's productivity. For example, FDI can be a stimulus to indigenous research and development, stimulating expanded production or lower unit production costs. These developments, in turn, can be expected to attract additional investment, bringing with it technical efficiencies such as scale economies, and ultimately increasing a country's wealth. Australia is in direct competition for FDI with other centres in the Asia Pacific region and beyond. The strongest competition is in the finance sector and in other high–end services that can be sourced internationally.

1.22 A study undertaken by The Allen Consulting Group, in conjunction with Arthur Andersen, found that the taxation environment was an important factor influencing senior management decisions about where to locate regional financial headquarters.[7] The study also indicated that the level of Australian GDP could rise by about 1 per cent over ten years if Australia could make all the changes necessary to become a leading Asia Pacific regional financial centre.

1.23 The Board appreciates that its recommendations, particularly those set out in Chapter 2 under the heading *Attracting Equity Capital for Offshore Expansion*, involve a budgetary cost. It also appreciates the benefits to the Australian community of those recommendations will involve a *balance* of effects, and emerge over some time. The other recommendations set out in Chapters 3-5 have (collectively) more readily manageable budgetary costs and clearer and earlier benefits.

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6 OECD (2001) *Corporate Tax Incentives for Foreign Direct Investment*, OECD Tax Policy Studies No. 4, p. 19.

7 The Allen Consulting Group (1996) *Leader or Also-Ran? Australia's Competitive Position in Asia-Pacific Regional Financial Markets*, Report to Financial Services Steering Group.

1.24 However, the Board considers that the budgetary costs (which are in the first instance transfers within, rather than costs to, the nation as a whole[8]) of its recommendations are warranted by benefits flowing to the Australian community generally. In essence, those benefits will increase the national income and the nation's tax base over time. This view is supported by most of the 58 submissions made to the Board, outlining the need for reform to ensure that Australia's international tax arrangements further promote Australia's international competitiveness and future economic success.

1.25 It is difficult to quantify precisely the economic benefits from the Board's recommendations. However, based on advice from its consultants, the Board believes that they are comparable with the net benefits of some of the other microeconomic reforms implemented over the 1980s and 1990s and designed to move companies from a domestic bias towards being better able to compete internationally. A typical estimate of benefits from such a reform is the 0.024 per cent lift (over some years) to GDP estimated as flowing from reducing textile, clothing and footwear tariffs further after 2000-01 — and this was a relatively narrow reform.[9]

1.26 The Board sees the long run benefits of its proposals as likely to compare favourably with those of such a reform. Like that earlier reform, the Board's proposals:

- alter financial incentives in a material way so as to largely remove a bias in favour of domestically oriented activity and investment; and
- as a result, increasingly expose Australian companies in many sectors of the economy to the international marketplace.

1.27 Australian companies have 'lifted their game' in response to comparable reforms over the past two decades, as reflected in the nation's impressive economic performance. The Board acknowledges, however, that there are winners and losers from virtually any reform. In particular, the Board's proposal for tax relief for dividends paid out of FSI (see Chapter 2) may not benefit every company. Those that are and remain domestically-oriented will not be able to access equity capital as easily as they can under the current arrangements, and this could be reflected in their share prices. On the other hand, internationally-oriented Australian companies will benefit. The Board believes that overall, there will be net benefits to the Australian community, and that they will increase over time. The Board draws some comfort from the fact that

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8 This is because the beneficiaries of tax relief afforded under the Board's recommendations will be predominantly Australians, and the budget revenue forgone will be made up (in time) by adjustments either to other taxes, also paid predominantly by Australians, or to expenditures predominantly benefiting Australians. These adjustments are likely to be small and widely spread in the context of the budget as a whole, and their economic effects are also likely to be small and slow to emerge. The Board believes the emergence of benefits flowing directly from its proposals will outweigh such costs. Thus while there will be pluses and minuses within the Australian community, there should be no *net* cost initially, and ultimately a bigger overall 'cake'.

9 Productivity Commission, *The Textiles, Clothing and Footwear Industries — Inquiry Report*, Volume 2, Report Number 59, 9 September 1997, p. N16.

submissions made by the major representative bodies of business did not appear to be concerned with the potential impact of the changes on domestically-oriented companies.

1.28 Also, the Board considers the budgetary cost of its recommendations to be moderate in the context of the Commonwealth's total revenues of around $170 billion or 22.5 per cent of GDP.[10]

1.29 The following sections of this chapter outline the economic gains flowing from the Board's specific recommendations in relation to their revenue costs. An Addendum canvasses these aspects in detail in relation to the recommendation in Chapter 2 for tax relief on dividends paid out of FSI. For this proposed change the benefits are a balance of positives and negatives over time and the budgetary cost is significant. The conclusions of that Addendum are discussed further in the following discussion in this chapter.

Removing impediments to Australian investment abroad

1.30 Parts of the current tax imputation arrangements restrict Australia's ability to respond to emerging global trends, such as increased globalisation and the increasing importance to Australian companies of FSI. The current arrangements provide a credit to resident individual shareholders for company tax paid on Australian source income. However, FSI repatriated to Australian shareholders after it has been taxed overseas does not give rise to significant imputation credits; instead, if distributed to a resident shareholder, the foreign taxes are ignored and the distribution is subject to another layer of tax.

1.31 The Board considers that the current imputation arrangements impede Australian investment abroad. Given that Australian companies most readily raise equity capital from Australians,[11] the current system has the potential to discourage offshore investment relative to domestic investment by Australian multinationals or companies. This is because it raises the cost of capital and lowers the returns for offshore expansion funded by Australian equity. Conversely, it lowers the cost of capital for domestically-focused companies — that is, it could boost their share prices relative to those of internationally-focused companies.

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10 Excluding GST proceeds, passed to the States. The Commonwealth, in the *Mid-year Economic and Fiscal Outlook 2002-03* (MYEFO), projects its revenues to remain about the same percentage of GDP over the three Forward Estimates years, rising to approximately $200 billion per annum over that period.

11 As noted elsewhere, evidence of this is the market value placed on imputation credits, of 40-70 per cent of their face value.

Summary of recommendations

1.32 The Board's recommendations (see Chapter 2) are aimed at providing relief to shareholders from the taxation of FSI at the domestic level. The recommendations include:

- providing limited relief for unfranked dividends paid out of FSI in the form of a 20 per cent credit, and without any requirement that foreign tax has actually been paid or incurred; and
- allowing dividend streaming both for FSI of Australian parent companies and through stapled stock.

1.33 The recommendations are designed to mitigate the current disincentive for resident entities to invest offshore using Australian equity, emphasised as a key issue in many of the submissions, taken up in the Addendum to this chapter.[12] The BCA/CTA submission echoed the statements of many others in arguing that

> '… the current dividend imputation system means Australian based multi-national enterprises with significant overseas operations have to earn a higher pre-tax rate of return than their domestic competitors in order to attract investment.'

1.34 The Board's recommendations in this area are also consistent with promoting a simplified business tax system in Australia.

1.35 Of all the Board's recommendations, these two are estimated to have the greatest net revenue impact. While these revenue impacts are in the first instance transfers among Australians rather than costs to the Australian community as a whole, the Board acknowledges that some costs may flow from consequent budgetary adjustments. Moreover, while the Board judges that significant economic benefits will flow in time from the former change, in particular, it concedes that there will be negative effects as well. However, the Board believes that the balance will ultimately be favourable. The changes will bring significant *net* economic benefits to Australia over time, making it worthwhile to incur the budgetary impacts.

Rationale of recommendations

1.36 Australia's tax system must respond to globalisation, given the increasing importance to Australian companies of FSI. In 2000–01, Australia's top 15 listed companies earned approximately 26 per cent of their total revenues from overseas (Figure 1.4).[13] A Productivity Commission survey found that offshore production is

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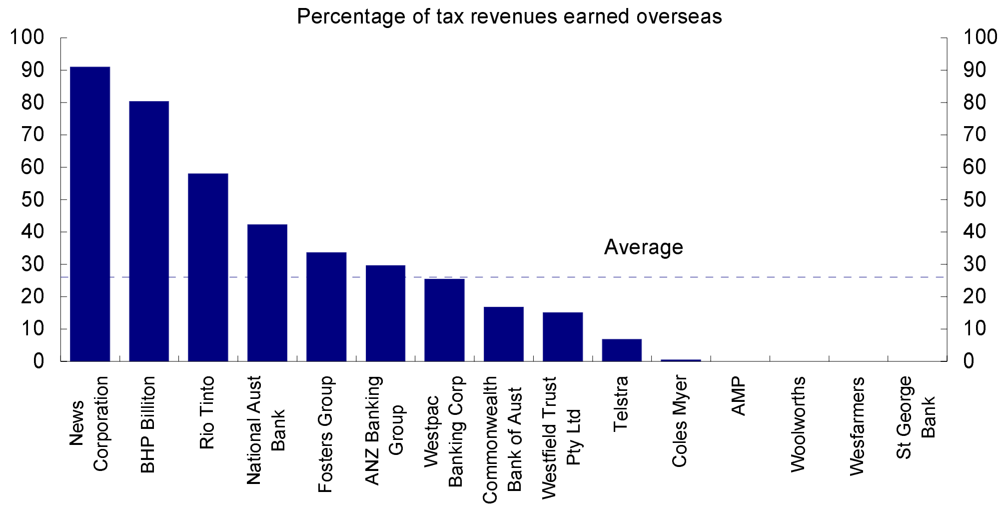
12 For example, those of ABA, the Australian Institute of Company Directors (AICD), The Australian Stock Exchange Ltd (ASX), BCA, CTA, the Institute of Chartered Accountants in Australia (ICAA), the Investment and Financial Services Association (IFSA), the Taxation Institute of Australia (TIA), several of the major accounting firms and a joint submission by ten of Australia's leading listed companies.

13 This is an unweighted average of revenues earned overseas by the top-15 ASX listed companies. This average is not weighted by the respective size of the sales of Australia's top fifteen companies.

becoming more prevalent: 50 per cent of Australia's largest businesses responded that they had actively engaged in offshore investment.[14] The Productivity Commission also found that 'consistent with the increase in FDI, income earned from offshore investments by Australian companies also increased' to around $8 billion in 1999-00.[15] In addition, the Commission found that foreign and domestic taxation regimes were the highest ranked *government* factors, and the second and third highest ranked factors overall, in influencing the decisions of Australian businesses whether to invest in offshore production. Respondents planning FDI in the next five years cited them as being particularly important.

Figure 1.4: Percentage of revenues earned overseas by top-15 ASX listed companies, 2000-01



Source: Compiled by The Allen Consulting Group.

1.37 Dividend relief will improve the ability of Australian companies with FSI to pay franked dividends to Australian shareholders. This will remove an existing barrier to Australian companies expanding overseas — the bias in the present arrangements raising the cost of capital for use in their international operations. The relative attractiveness to Australian shareholders of investments in Australian companies with substantial international operations will improve. Conversely, the relative share prices of domestically-focused companies may weaken. For foreign investors however investments in Australian companies with substantially domestic operations will become relatively more attractive.

1.38 As discussed in the Addendum to this chapter, there are clear advantages to Australia in Australian companies expanding overseas. They include facilitating access

14 90 of the 201 businesses surveyed responded that they had offshore investment, while half of the 90 and an additional 10 businesses responded they were planning new FDI in the next five years.

15 Foreign direct investment income includes dividends and similar payments, plus reinvested earnings attributable to direct investors. Productivity Commission (2002), *Offshore Investment by Australian Firms: Survey Evidence*, Commission Research Paper, p. 10.

to opportunities for expansion which are less constrained than at home, and the dynamic effects of increased integration of Australian companies into world-class business. The Board's recommendation will work towards these ends by:

- reducing capital cost for overseas expansion. Providing taxation relief to FSI income removes the bias against investment by Australians in Australian companies deriving substantial profits overseas. It also increases the after-tax returns to domestic investors (which include the value of imputation credits to shareholders). This will encourage Australian investors to invest where the rate of return on investment is the greatest; and
- allowing the most efficient capital raising. Providing taxation relief to FSI removes the potential that the current imputation system has for discouraging offshore investment relative to domestic investment by Australian multinationals or companies, by raising the cost of capital and lowering the returns for offshore expansion funded by Australian equity.

1.39 Many of the submissions and other inputs made to the Board[16] emphasised these kinds of benefits, and argued that they justified the budgetary costs, even though none were able to quantify aggregate net benefits for Australia. For example, in a letter dated 3 February the BCA argued that a 30 per cent credit will not

> '… come at an unrealistic cost to the revenue and in the longer term will generate increased economic benefits from investment in Australia. We believe the primary purpose of international tax reform in this area is to change investor behaviour in ways that generate more income to Australian residents and as a consequence, generate new tax revenue over time to offset any tax revenue losses arising from the initial effects of these reforms.'

1.40 The BCA further argued that the combination of that measure and dividend streaming

> '… would not represent an unsupportable cost to revenue. We believe that the expenditure would represent a worthwhile investment in mechanisms that would generate increased economic benefits from investment for Australia and improve the attractiveness of Australia as a place for business and investment.'

1.41 Reducing the cost of capital by removing the current investment distortion will, in the Board's view, allow Australian companies to more effectively deploy capital so that they can more easily achieve increased scale and the up-take of new technologies and business systems. By removing tax-induced distortions in investment decisions, the Board's recommendations will enable internationally-oriented Australian companies and investors in them to derive greater returns. Many submissions to the

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16 Including those footnoted earlier, that is, the submissions of ABA, AICD, ASX, BCA, CTA, ICAA, IFSA, TIA, three major accounting firms and ten major companies (in a joint submission).

Board supported that assessment. For example, the ABA submission argued that reform in this area would lead to

> '… increased capacity for Australian multinationals to raise cost effective capital in domestic and foreign capital markets, in order to fund global expansion and growth strategies, resulting in increased earnings …'

1.42 Lower yielding domestic investments will, on the other hand, not be so readily financed. Over time, this will force an increase in the productivity of Australian companies, flowing through to an increase in national income and the tax base. While the Board does not have precise advice on the relative contributions of individual measures to the overall benefits flowing from its recommendations, the advice available to it suggests that this measure will contribute significantly to the benefits. This is because it makes a substantial and direct change to the financial incentives facing companies and investors.

1.43 In addition, the Board's recommendations are designed to remove the current bias against the repatriation of overseas income to Australian shareholders. In its survey, the Productivity Commission found that only about one half of firms that repatriated profits repatriated less than 25 per cent of their profits; and around 40 per cent of respondents re–invested all offshore earnings.[17] This low rate of repatriation suggests that Australian businesses currently use a significant portion of foreign-sourced profits to build up international investments. By providing dividend relief, the Board's recommendations will remove the bias against repatriation and offshore investment relative to domestic investment by Australian business and shareholders. Again, a number of the submissions to the Board supported this assessment. For example, the joint submission by ten leading Australian listed companies[18] stated that

> 'In many cases, the shareholders will have a marginal tax rate that is higher than the corporate tax rate at which imputation and foreign divided account credits are granted. The repatriation and on-payment of the foreign profits will therefore actually **increase** the collections of Australian tax'.

1.44 The Treasury's estimate of the cost of the Board's recommendation to provide a 20 per cent credit for unfranked dividends paid out of FSI is set out in the Executive Summary. Although relatively large compared to the cost of most other individual recommendations, the Board considers this estimate to be the potential maximum cost. The ultimate net cost is likely to be lower due to:

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17 Productivity Commission, *Offshore Investment by Australian Firms: Survey Evidence,* Commission Research Paper, 2002, p. 28.

18 Amcor Ltd, AMP Ltd, BHP Billiton Ltd, BHP Steel Ltd, Brambles Industries Ltd, CSR Ltd, Lend Lease Corp Ltd, National Australia Bank Ltd, Orica Ltd, Telstra Corp Ltd.

- a possible permanent lift in the pay-out ratio of Australian companies as a result of the Board's recommendation and subsequent increase in the tax base; and
- an increase in the longer-term tax base as a result of the economic efficiencies achieved through this recommendation (reducing the cost of capital and providing the opportunities for companies to achieve critical mass and earn a higher return on their savings, so that GDP and GNI will increase over time).

1.45 IFSA articulated the benefits, in terms of efficiently raising foreign capital to use alongside Australian capital

> '… [while] streaming of dividends primarily benefits companies with existing foreign shareholder bases, it nevertheless recommends that it needs to be considered as a way of encouraging other resident companies to attract foreign shareholders. It also likely improves returns to non-resident shareholders and will accordingly attract them.'

1.46 On balance, the Board has come down to the view that the benefits of both the tax credit and streaming, particularly in the longer-term, are likely to be significant and should be adopted. However, of these two recommendations the Board considers the tax credit to be more universal in its impact. If a choice was needed, because of budgetary constraints, the Board would favour priority being given to the tax credit over streaming.

Competing for key investments, particularly headquarters

1.47 Australia has relatively few home-based global corporate competitors. To grow, Australia must continue to attract international investment into Australia, and accompanying inwards technology transfer. Headquarters operations promote clustering of high-end services. Competing for them must be a key concern.

1.48 Several aspects of Australia's current taxation arrangements add complexity and inhibit investment by corporations into Australia, notably:

- the controlled foreign company (CFC) rules;
- Australia's higher tax rate limits in treaties, relative to OECD norms, and other aspects of treaties (such as capital gains tax (CGT) treatment);
- Australian taxation of 'conduit income'; and
- company residency tests.

1.49 The role that tax plays in inhibiting businesses from retaining their headquarters in Australia is highlighted by the Productivity Commission's recent survey of Australia's 201 largest firms. The survey found that foreign and domestic taxation regimes were among the most important *government* factors influencing investment decisions.[19]

Summary of recommendations

1.50 In order to promote Australia as a location for internationally-focused companies, the Board's recommendations involve some changes to Australia's FSI rules.

1.51 The Board recommends (see Chapter 3):

- an exemption for attributable taxpayers holding interests in CFCs resident in broad exemption listed countries (BELCs) (subject to possible limited exceptions);
- an extension of rollover relief for corporate restructures;
- abandoning the tainted sales and services income rules (except in relation to certain tax havens);
- developing criteria for inclusion on the BELC list;
- reaching a policy position on outstanding issues in the CFC regime;
- substituting a more residence-based treaty policy for the previous policy based on source of income;
- improving consultation processes for negotiating tax treaties;
- setting government priorities for reviewing key country treaties;
- abolishing the limited exemption country list and providing a general exemption for foreign non-portfolio dividends that Australian companies receive and (subject to some existing exceptions) for foreign branch profits;
- against pursuing a conduit regime at this stage (in view of other relief provided);
- introducing a CGT exemption for the sale by an Australian resident of a non-portfolio interest in a foreign company with an underlying active business;
- proceeding with the foreign income account (FIA) rules as they apply to direct investment flows;
- providing a treaty exemption for capital gains made by non residents on the disposal of shares comprising non-portfolio interests in Australian companies; and

19 Productivity Commission (2002), *Offshore Investment by Australian Firms: Survey Evidence,* Commission Research Paper, pp. 28-30.

- clarifying the test for company residency and treating a non-resident for treaty purposes as a non-resident for all purposes of income tax law.

1.52 In addition, the Board recommends against proceeding with the RBT's proposals to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets.

Rationale of recommendations

1.53 The Board considers that a number of the current tax arrangements have increased the complexity of the tax system for internationally focused companies, and have materially inhibited investment into Australia. Companies made various submissions to the Board outlining examples of the way in which the current tax arrangements affect their decisions whether to invest in Australia. The complexity of the CFC regime received particular attention. Submissions noted that the current CFC regime has inhibited some companies from restructuring their organisations in response to their increased offshore earnings. Outdated and inflexible Australian taxation arrangements have resulted in companies retaining inefficient international operations.

1.54 The Board's recommendations are designed to ensure that globally-focused Australian companies maintain corporate structures and select headquarter location on the basis of commercial considerations rather than taxation considerations. The recommendations will give companies the incentive to adopt the most efficient corporate structure, enabling them more easily to achieve critical mass and more effectively to deploy their capital and compete on the global stage. The economic benefits of this group of changes are predominantly positive, rather than a balance of positives and negatives. The Board believes that the benefits would begin to flow relatively quickly.

1.55 The estimated gross cost of these measures is set out in the Executive Summary. The Board considers that the net revenue cost of implementing them will be modest, given:

- the cost of reforming Australia's treaties (if the Government follows the lead set by the new US Protocol) that may have occurred even without the Board's recommendations; and

- the way the Board's recommendations would spread the cost to government over a number of years.

1.56 The benefits of the Board's recommendations under this head are significant. They include promoting Australia's economic integration into the global economy by lifting the competitiveness of Australia's own domestic base for business activity, particularly when competing for headquarters on base activity (reducing 'branch economy' risks). The Board is confident that the benefits will clearly outweigh the revenue cost of the recommendations.

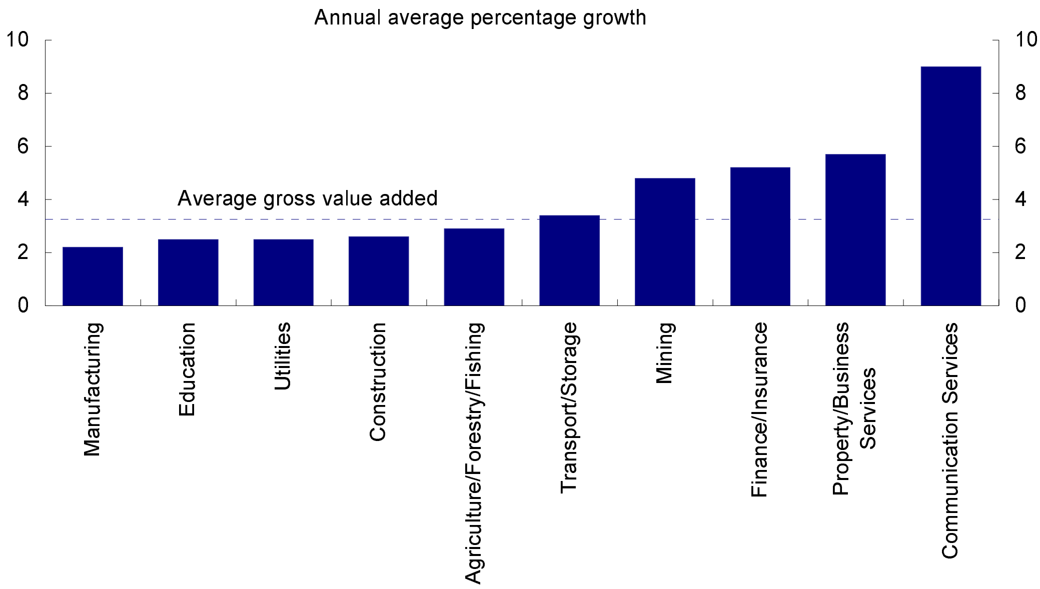
Competing in the financial sector

1.57 Australia's finance sector is a key arena. This is because:

- it is one of the fastest growing sectors of the Australian economy. Between 1986–87 and 2001-02, the financial sector recorded average annual growth of 5.2 per cent, the third fastest rate of industry growth, and well above the rate of growth for the economy itself (Figure 1.5);
- Australia has intrinsic comparative advantages here, in terms of advanced finance and capital markets and sophisticated skills. It also has a large and growing domestically-sourced managed funds pool. Of the 75 countries surveyed for the 2001-02 World Economic Forum Global Competitiveness report,
  - Australia's financial markets were rated as the sixth most sophisticated in the world; while
  - Australia was ranked first for the availability of financial skills, and fifth for availability of skilled labour overall;[20] and
- it plays a key role in providing high-skill jobs for Australians, in the sector itself and in associated high-end services.

20 World Economic Forum, *Global Competitiveness 2001-02*. Accessed from http://www.weforum.org/site/homepublic.nsf/Content/Global+Competitiveness+Programme on 15 December 2002.

**Figure 1.5: GDP Growth by Industry
1986-87 to 2001-02**



Source: Australian Bureau of Statistics (2002), *Catalogue 5206.0*, June Quarter 2002, Table 47, Industry Gross Value Added, Chain Volume measures.

1.58 As a result of Australia's intrinsic comparative advantage, leading companies are increasing their presence in the country's financial sector. Box 1.1 is one of many case studies highlighting the attractiveness of Australia's financial sector to premier overseas financial firms.

Box 1.1: Case Study — HSBC Centres Its Gold Trading in Australia

HSBC Bank USA, part of one of the world's largest financial services groups is to consolidate its global trading operations in Sydney, underlining Australia's status as a centre of excellence for many of the world's premier financial firms. Attracted by Australia's low-cost environment and standing as a precious metal producer, the centralisation is in line with the bank's move toward single trading hubs, and will involve closing the gold trading unit in Hong Kong.

The shift to Sydney continues HSBC's strengthening of its commitment to Australia.

Source: HSBC, Media Release, 25 September 2002. Accessed from www.http://us.hsbc.com/inside/news/pressreleases2002_nov_4.asp on 2 January 2003.

1.59 However, despite Australia's intrinsic comparative advantage, the Board has identified tax impediments to Australia's competitive position in global finance and capital markets. These impediments include:

- the application of foreign investment fund (FIF) provisions to funds management activity. This discourages possible efficiencies that could be generated by the use of offshore pools;
- the capital gains treatment of foreign investment in Australian funds. This discourages overseas investment into Australia; and
- various other provisions relating to trusts, branch structures, and the like.

1.60 Submissions to the Board provided many examples identifying how the current tax arrangements impede Australia from developing its funds management industry and limit Australia's potential to market products to foreign investors. In particular, submissions noted:

- that the FIF rules are too complex and impose very high compliance costs, including the requirement to keep an attribution account for each investment at the investor level; and
- that more onerous tax consequences arise for investments made by overseas investors in Australian-managed funds compared to direct Australian investments by overseas investors.

Summary of recommendations

1.61 To address these tax impediments, the Board has made recommendations (see Chapter 4) to reduce the adverse impact of the application of the current FIF rules on the Australian funds management industry. Specifically, the Board recommends exempting from the FIF rules:

- funds registered under the managed investment provisions of the *Corporations Act 2001* and companies registered under the *Life Insurance Act 1995* (in certain circumstances);
- funds applying widely-recognised indexes; and
- complying superannuation entities.

1.62 The Board also recommends:

- a general review of the FIF rules;
- increasing the 5 per cent balanced portfolio exemption threshold in the FIF rules to 10 per cent of the overall cost of the assets;
- amending the FIF rules to allow fund management services to be an eligible activity for the purposes of the rules;

- revising the CGT treatment of foreign investment in Australia; and
- revising other taxation arrangements for foreign trusts, transferor trusts, and branch structures.

Rationale of recommendations

1.63 The Board's reforms are designed to improve Australia's access to international capital markets and international capital markets' access to Australia. Improved access will increase the inflow of funds and will benefit Australia by:

- allowing Australian investors to benefit from lower-cost funds services arising from economies of scale (through increased inflow of funds); and
- generating additional GDP as a result of the spin-offs from enhancing Australia's reputation as a financial services centre and from increasing scale, particularly in the key area of funds management.

1.64 The recommendations will also provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers. The estimated revenue cost is set out in the Executive Summary. Again, the Board believes that the economic impacts of its recommendations in this area are predominantly positive and would begin to flow relatively quickly, and that they justify accepting that revenue cost.

Removing impediments to mobility of key personnel

1.65 Integral to the two-way process of Australian integration into the global economy is mobility of key personnel, within both home-based corporates with overseas operations and foreign-based corporates operating in Australia.

1.66 Taking Australia's personal income tax structure as given (because it is not a subject for this review), impediments identified by the Board include:

- the double taxation of employee share options (ESOs); and
- various other concerns over Australia's tax treatment of expatriates.

1.67 Submissions to the Board emphasised the importance of Australia's taxation arrangements allowing Australian businesses to attract educated and skilled foreign expatriates. There was a general view that Australia's current taxation arrangements regarding foreign expatriates present an unfriendly and unwelcoming tax environment compared to other developed countries.

1.68 Concerns about the unresponsiveness of the current tax system to the continuing integration of national economies and the increasing mobility of capital and skilled labour were reflected in a national survey of Australian business executives by PricewaterhouseCoopers in May 2002. This survey found that tax reform was the most important factor in boosting Australia's ability to attract overseas talent — see Box 1.2.

Box 1.2: Tax top of 'fix it' list for Australia's competitiveness

Tax, business innovation and immigration policy have been pegged as the top three issues impacting Australia's international competitiveness, according to a PricewaterhouseCoopers' national survey.

Tax was ranked top of the 'fix-it' list by business executives responding to PricewaterhouseCoopers' national survey entitled 'Australia's immigration policy — Does it work for business?'

More than 43 per cent of respondents ranked tax as the number one issue which needed to be addressed in terms of Australia's international competitiveness in attracting overseas talent.

'Business innovation (at 18 per cent) and immigration policy (at just under 17 per cent) ranked closely as second and third priorities, while employee remuneration and reward ranked fourth at 11 per cent) and economic stability (at just over five per cent) were seen as lesser concerns,' said Brendan Ryan, Asia Pacific Leader of PricewaterhouseCoopers' Global Visa Solutions.

'The survey respondents were well aware of the issues and obstacles involved in attracting skilled foreign labour to work in Australia — most (over 91 per cent) had sponsored overseas staff to work in Australia in the past 12 months, with 93 per cent planning to do so in the next 12 months,' Mr Ryan added.

The most important reason given for hiring overseas staff was that the relevant skills were not available in Australia or that overseas skills/experience were viewed as better (according to 72 per cent of respondents).

'Interestingly, though, 31 per cent cited cost considerations as the key deterrent to bringing in overseas staff. I would see this as an important acknowledgment of the additional difficulties Australian businesses face in competing for high quality overseas candidates', Mr Ryan commented.

PricewaterhouseCoopers' survey into 'Australia's immigration policy — Does it work for business?' was conducted during April 2002, surveying over 70 senior human resources and related executives in leading Australian businesses.

Source: PricewaterhouseCoopers (2002), 'Tax—top of 'fix-it' list for Australia's competitiveness', *Media Release*, May. Accessed from http;//www.pwc.com.au on 2 January 2003.

1.69 This same concern is supported by Wachtel and Capito (2001), who clearly illustrate how the taxation burden of a non-resident executive working in Australia is less favourable than if he or she were occupying an equivalent position in the United Kingdom, the US, Hong Kong or Singapore.[21]

Summary of recommendations

1.70 The Board's recommendations in this area (Chapter 5) are aimed at providing relief to foreign expatriates and departing residents from the current personal tax treatment of CGT liabilities and employee share options. The Board recommends:

- against proceeding with the RBT's recommendation that residents departing Australia provide security for deferred CGT liability;
- addressing the double taxation of ESOs; and
- against proceeding with the RBT's recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A of the 1936 Act.

1.71 In addition, the Board recommends creating a specialised Australian Taxation Office (ATO) cell, to enable the Australian Taxation Office to work with employers to deal with the tax administration concerns of foreign expatriate employees.

Rationale of recommendations

1.72 These recommendations are designed to remove current impediments to the free flow of ideas and skills, thereby increasing the mobility of personnel between Australia and the rest of the world, and ultimately attracting the human capital which Australian businesses require. The estimated revenue cost is expected to be quite small.

1.73 The benefits from increased personnel mobility include:

- the two-way transfer and development of skills and business ideas; and
- enhancing the ability of Australian companies and individuals to create income.

1.74 Ultimately, the benefits to Australia of removing these impediments include lower costs of obtaining key skills in Australia and the associated transfers of skills and ideas to Australia. This transfer will further contribute to Australia's competitive integration into the global economy, and well justifies the small cost.

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21 Wachtel, M. and Capito, A. (2001), *Removing Tax Barriers to International Growth: Positioning Australia's Tax System to Maximise the Potential Growth Opportunities from International Business*, Report to the Business Council of Australia.

Summing up: benefits and budgetary cost

1.75 The changes recommended by the Board have an estimated short to medium term gross budgetary cost as set out in the Executive Summary of around 0.6 per cent of total Commonwealth revenues or 0.14 per cent of GDP.

1.76 The Board believes that in the short to medium term these budgetary costs are worthwhile,[22] given the net benefits which the changes will generate over time to the Australian community as a whole. The recommended measures will:

- increase GDP (that is, domestic production) through their productivity-raising effects;
- increase national income, through increased returns on investment accruing to Australian shareholders.

The measures will thereby also, over time, increase the overall tax base.

1.77 The Board acknowledges that the balance of benefits and costs, and the time scales over which net benefits will emerge, are not as clear-cut for the proposals in Chapter 2 as for the proposals in other chapters

1.78 Nevertheless, based on the submissions and the Board's own assessment, the Board believes that the benefits outlined above will be achieved and hence the changes should be made (For further discussion see the Addendum to this Chapter). A prime design criterion for the Board's recommendations has been neutrality. The recommendations are intended to ensure that Australia's taxation system does not unduly hinder business decisions. In particular, the Board's recommendation on shareholder relief for dividends paid out of FSI is designed to alleviate the present bias against Australian investment offshore, and the related bias against offshore investment into Australia. While acknowledging that the effects of this change will be a mix of positives and negatives, the Board expects that the balance will, over time, be significantly positive. In the medium to longer term, it will result in higher productivity and growth within the Australian economy. This will come through scale economies and greater take-up of new technologies and business systems as well as through more efficient investment of Australian savings overall.

1.79 Typically, the largest asset class for Australian managed funds, particularly superannuation funds, are shares in Australian corporations. Through these, the benefits of the proposed changes will be widely distributed in the Australian community — particular to Australians (at all income levels) as they retire. The Board considers that this fact, and the relatively modest size of the net revenue effects, means

22 Although noting earlier that budgetary costs are in the first instance essentially transfers within the Australian community, the Board acknowledges that consequent budgetary readjustments may entail some net costs.

that implementing its recommendations will have minimal implications for the equity characteristics of the overall tax and transfer system.

1.80 The Board believes that the focus should be on the way in which its proposed changes will grow Australians' total incomes and Australia's overall tax base over time. The emphasis should be on the increased *size* of the 'cake' over time — not merely on the relatively small initial effects on *shares* of the 'cake'.

Addendum to Chapter 1

Short and longer-term impacts of providing limited dividend relief

This Addendum discusses the short and longer-term impacts of the Board's recommendation to provide limited relief for unfranked income paid out of FSI.

The Board considers that the revenue costs from the recommendation are outweighed by the benefits flowing from removing the current bias against offshore investment of Australian equity. Advice to the Board suggests that this change will contribute significantly to the benefits flowing from its proposed package as a whole — since it will have the most significant effect on the financial incentives facing companies and investors in respect of their future investment decisions. While its effects will be a balance of positives and negatives, the Board expects that this recommendation will help grow national income, the nation's economy and the overall Australian tax base over time.

Recommendation

The Board's recommendation, detailed in Chapter 2, is that limited shareholder relief should be provided for unfranked dividends paid out of FSI, at a rate of 20 per cent without any requirement that foreign tax has actually been paid or incurred. More specifically, the relief would apply to FSI, including non-portfolio dividends out of foreign profits and foreign branch profits of Australian companies, generated after the commencement date.

Short-term impacts

Since the shareholders of Australian companies are predominantly Australians, Australian tax arrangements are influential in the market valuation of Australian companies. Evidence of this is the fact that the market values imputation credits at 40-70 per cent of their face value. The dominance of domestic shareholders also reflects the reality that Australian companies are better understood, and can typically raise equity capital on better terms, in Australia than elsewhere. When it was first introduced, imputation removed a tax distortion (the 'double taxation of dividends') discouraging equity investment within Australia. But at the same time it raised a bias against overseas investment and towards domestic investment within Australia. The bias is illustrated by the numerical examples set out in Table 1 below.[23]

Table 1: Tax Treatment of Domestic Foreign Source Income on Companies, Shareholders and Gross National Income: Existing Position

	1. Australian source	2. Overseas source	3. Overseas source
Company			
Investment ($)	10,000	10,000	10,000
Rate of return (%)	10.5%	10.5%	15%
Pre tax income	1,050	1,050	1,500
Company tax - say 30 per cent	(315)	(315)	(450)
Dividend	735	735	1050
Shareholder			
Net dividend	735	735	1050
Gross-up	315	-	-
Taxable dividend	1,050	735	1050
Gross tax — say 50 per cent	(525)	(367.5)	(525)
Franking credit	315	-	-
Net tax	(210)	(367.5)	(525)
Post tax income	525	367.5	525
Gross National Income (GNI) contribution			
Post tax income	525	367.5	525
Company tax	315	-	-
Shareholder tax	210	367.5	525
GNI contribution	1,050	735	1,050

23 For simplicity, rates of return and tax rates are chosen to produce 'round figures' as far as possible. For example, the assumed company tax rate in the table is 30 per cent in both countries. Of course the lower the company tax rate abroad, the lower the bias created by imputation, but a company tax rate abroad similar to Australia's is nevertheless a realistic case. The example assumes a personal tax rate of 50 per cent, again for simplicity. Arguably the 'typical' Australian investor is a superannuation fund with a tax rate of 15 per cent, but qualitatively the picture in terms of comparison of investments is the same regardless of the shareholder's tax rate. Ultimately, of course, superannuation funds distribute benefits to individuals who pay personal tax.

The second and third columns of the table show two alternative overseas investments — one where pre-tax rate of return is the same as that of the Australian investment, and one where post-tax returns to an Australian shareholder are equal to those of the illustrative domestic investment.

Column 2 shows that an offshore investment whose *pre-tax* rate of return matches the domestic rate delivers a significantly lower post tax return. Something like column 3 is more likely to reflect reality: it shows that to deliver the same *after tax* return to an Australian equity investor, an overseas project must yield a (pre-tax) rate of return substantially higher than a domestic project. This is consistent with arguments put forward in a number of submissions, including that of BCA and CTA, as quoted in the body of this chapter.

In practice, different risk characteristics and portfolio diversification considerations may mean that post-tax returns are not fully equalised through the stock market valuation of companies. Nevertheless, the present significant bias in favour of companies with largely domestic investments is apparent and will be reflected to some extent in share prices now. In economic terms, domestic investment of somewhat lower intrinsic merit (rate of return) will tend to be funded ahead of higher-yielding investments available to Australian companies internationally.

An important aspect of this matter highlighted in many submissions, is that for many listed Australian companies, the limited size of the market constrains domestic opportunities for growth. Prospective returns diminish significantly as successive additional investments within Australia are considered. By contrast, the field for investment abroad is far wider. Companies' options for international growth are much less constrained, and the effect of diminishing prospective returns for additional tranches of investment is not so significant a factor.

Under the bias inherent in the present system, shares in Australian companies with largely domestic earnings are made relatively more expensive to foreign investors. For portfolio diversification and other reasons, foreign investors are presently willing to make equity investments in such companies, but are appreciably less willing than they would be without the bias.

The Board's recommendation will substantially reduce the present bias. Not only will companies derive more income from utilising Australian savings to invest internationally, but there should be increasing 'dynamic' effects on Australian companies and their behaviour. By expanding internationally, companies should achieve greater efficiency in all their operations, including within Australia through scale economies, more rapid transfer of technology and business ideas etc.

However, these effects will flow only over time. The Board's recommendations will not have an immediate effect on GDP or national income. GDP is defined as

- the total value of the production of goods and services in Australia; or

- the total value of factor incomes plus taxes; or
- the total value of expenditure on goods and services produced in Australia.

Nor will the Board's recommendations have any effect on the level of gross national income (GNI, or simply 'national income'), defined as GDP plus net primary income from non-residents.[24] The expected absence of a short-term GDP impact assumes that government does not change its budget programs (expenditure programs or other taxes) to offset the cost of the recommendation, and that the spending behaviour of investors does not change significantly in the short-term.

The short-term effects are therefore in the nature of a transfer, a reduction in revenue to the Budget equal to a reduction in tax paid by shareholders in respect of income from investments abroad. The economic effects (and thus the effects on the overall Australian tax base) over time flow from the substantial removal of the bias discouraging investors from investing in Australian companies' international operations, and conversely a reduction in the cost of capital to those companies for those purposes.

Table 2 below, drawing on the same numerical examples of domestic and overseas investments as in Table 1, illustrates the immediate effects of implementing the Board's recommendation on the returns to companies, shareholders, governments and national income.[25] As can be seen from column 2, an overseas investment whose *pre-tax* rate of return is the same as that of the Australian investment (column 1) would now yield after-tax income much closer to, although still below, that from the domestic investment.

Column 3 of the table shows the other (and probably more realistic) example, where *post-tax* returns were equal under present taxation arrangements. It shows that this investment yielding 15 per cent pre-tax now pays the investor $656 or 6.56 per cent after tax, compared with 5.25 per cent under present arrangements. This after tax return now exceeds the 5.25 per cent from the domestic investment, whose pre-tax return was 10.5 per cent. However the 6.56 per cent is still well below the after-tax return (7.5 per cent) which would be derived from a domestic investment[26] that matched the pre-tax return of 15 per cent here assumed for the overseas investment.

The nature and desirability of these outcomes is canvassed in a number of the submissions to the Board. For example, the Australian Stock Exchange Ltd (ASX) considered that this reform would:

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24 Net primary income is compensation of employees, property income and current transfers to Australian residents from non-residents, minus corresponding amounts from Australian residents to non-residents.

25 Dollar figures rounded to whole numbers.

26 Not shown as a specific example in the table.

- 'reduce the effective marginal tax rate imposed on that FSI, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies'; and
- 'reduce the cost of capital for those Australian companies with restricted access to international capital markets.'

Table 2: Immediate Effect of Providing a 20 per cent Credit on Dividends from Foreign Source Income

	1. Australian source	2. Overseas source	3. Overseas source
Company			
Investment ($)	10,000	10,000	10,000
Rate of return (%)	10.5%	10.5%	15%
Pre tax income	1,050	1,050	1,500
Company tax	(315)	(315)	(450)
Dividend	735	735	1050
Shareholder			
Net dividend	735	735	1050
Gross-up	315	184	263
Taxable dividend	1,050	919	1313
Gross tax — say 50 per cent	(525)	(459)	(656)
Franking credit	315	184	262
Net tax	(210)	(275)	(394)
Post tax income	525	460	656
Gross National Income (GNI) contribution			
Post tax income	525	460	656
Company tax	315	-	-
Shareholder tax	210	275	394
GNI contribution	1,050	735	1,050

Comparing Table 1 and Table 2 confirms that GNI (national income) does not change in the short-term. GDP (domestic economic activity) should not change either.[27] Less tax is collected, while Australian shareholders have more after-tax income. There may be some transitional positive effects on national income if the new arrangements lead to higher payout ratios to Australian investors from overseas income, temporary or ongoing. These would also bring forward and increase, at least in present value, Australian tax collections, as suggested in some of the submissions,[28] but the Board has no firm basis on which to estimate the magnitudes of such increases.

Consequent and longer-term impacts

The immediate effects illustrated in Table 2 will set in train other adjustments, including fairly quick adjustments to company valuations set in share markets. Australian companies which are domestically-focused and do not have plans, credible to the market, to pursue opportunities internationally, will be marked down. They will not be valued as highly *relative* to companies with substantial international operations and/or plans for expanding offshore. Companies in the former category will accordingly experience an increase in their cost of capital; they will need to apply higher return expectations (or hurdles) to domestic investment projects they are considering.

Companies with international operations and opportunities will, conversely, not have to restrict offshore investment to projects yielding well above domestic hurdle rates, as they must do now. The present gap between hurdle rates for domestic and offshore investment will be narrowed, and Australian capital will, through these adjustments, be utilised more efficiently by Australian companies. Especially given that for many companies domestic opportunities are significantly more constrained than overseas ones, the average effect on market valuations across all Australian companies is likely to be positive, increasingly so over time with dynamic effects on their scale and behaviour.

In the longer-term, therefore, the Board believes that the balance of benefits to be realised from its recommendation will be increasingly net positive over time, and will make the revenue costs worthwhile. The Board acknowledges that this is an 'on balance' judgement — in that investment within Australia by some companies will not be as great with the present bias removed as it would otherwise be, and there may be some economic costs as government finances are readjusted; and therefore, that it will take time for *net* benefits to come through that justify the budgetary costs. In reaching that on balance judgement, the Board sees as the key factors:

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27 This conclusion depends on the assumptions that investors do not change their spending behaviour and government does not change its budget programs in the short-run in response to the Board's recommendation. That is, it is assumed that government initially absorbs the cost of the Board's recommendation in its budget surplus/deficit with any readjustment occurring over time.

28 For example, that of the ten leading companies, as quoted in the body of this chapter.

- reduced cost of capital for Australian companies wishing to expand overseas, only partly offset by an increased cost of capital for those remaining focused on domestic opportunities;
- reduced cost of capital for internationally-oriented companies wishing more readily to combat overseas competitors, to gain scale, to speed up the adoption of new technology and business systems and generally to operate more efficiently, including at home;
- benefits to Australian shareholders from the growth of Australian companies which otherwise would have been unable to grow at comparable rates domestically (again, these positive shareholder gains being only partly offset by *relatively* negative effects on the share prices of domestically-focused companies);
- increased repatriation of profits to Australia, thereby increasing the wealth of Australians and taxes paid;
- increased foreign investment, as the bias which makes Australian domestic investments relatively expensive to foreign investors and relatively cheap to Australians is reduced; and
- reduced levels of borrowing by Australian companies to finance foreign investment, thereby reducing risks and potential credit rating downgrades.

Over the longer-term, the impact on GNI and GDP from the Board's recommendation to provide limited dividend relief depends essentially upon 'supply side' effects — that is, how much more efficiently capital is used, both domestically and internationally, by Australian companies using Australians' savings. Removing the investment distortion will reduce the cost of capital and enable Australian companies to deploy their capital more effectively and make investments based on their intrinsic risk/return commercial characteristics. There may also be a defensive aspect, as ICAA emphasised in its submission

> 'For Australian global companies to retain Australian bases, and raise capital in Australian markets, is an important element in protecting the relationship of those companies with their Australian investors, and their ongoing activity in Australia.'

The benefits in terms of productivity and innovation by Australian companies and ultimately the income they earned in both their Australian and overseas operations for their shareholders, and in turn the Australian tax base, will of course depend on how companies and investors respond to the change.

While the Board's recommendation may conceivably result in increased offshore investment by Australians at the expense of some domestic investment by Australians that might otherwise have occurred, the Board considers, that in economic terms such an effect would be outweighed by the other factors discussed above.

Long-term positive effects on GNI and GDP imply also long-term positive effects on the tax *base* available to Australian governments. In the near-term, however, the Board acknowledges that its recommendation will result in a cost to the Budget. This does not take into account:

- any one-off gain to tax revenues from companies bringing forward the repatriation of their current stock of retained earnings from abroad; and
- any permanent lift in the pay-out ratio of Australian companies out of foreign income.

Even without these factors, the Board considers that the budgetary cost is moderate and worthwhile in relation to the prospective positive net economic benefits flowing to the Australian community albeit over time.

CHAPTER 2: ATTRACTING EQUITY CAPITAL FOR OFFSHORE EXPANSION

Policy objectives

2.1 The Board's terms of reference included business concerns with the imputation 'bias' against foreign source income (FSI). In the Press Release of 22 August 2002, the Treasurer requested the Board to consult on whether change is necessary to ensure that Australia's dividend imputation system does not limit the ability of Australian companies to attract equity capital for offshore expansion.

Current law

2.2 Under current law, the imputation system is effectively confined to purely domestic situations. Tax credits under imputation are available only for dividends paid by resident companies to resident shareholders in respect of payment of Australian income tax. Confining imputation credits to Australian income tax paid by a company effectively covers only Australian-source profits. Very little or no Australian tax is paid on foreign profits, because of the operation of double tax relief mechanisms in relation to foreign tax. Australia either exempts foreign income from tax, or grants a foreign tax credit for foreign taxes paid.

The bias against direct foreign investment

2.3 The Treasury Paper acknowledges that an overall bias exists at the shareholder level against Australian companies investing offshore. It also concedes that this bias can affect the cost of capital for Australian multinationals or companies considering offshore expansion. However, the Treasury Paper notes the need to further explore the extent to which any bias actually affects the cost of capital for Australian business.

2.4 The Treasury Paper maintains that at the Australian company level, a bias against direct investment offshore is likely, only where a foreign country has higher company level taxes than Australia.

2.5 The Treasury Paper also suggests that world capital markets may set the required pre-tax rate of return for small open economies, and that in those circumstances, non-resident investors determine the cost of capital. As non-residents do not benefit from dividend imputation on domestic or offshore investments, they are unaffected by any tax bias. The Treasury Paper suggests that resident shareholders may be largely 'price-takers', and that to compensate them to reduce a bias would give them a strong windfall gain without reducing the cost of raising capital for offshore expansion.

2.6 Further, the Treasury Paper suggests that large internationally-recognised Australian multinationals may have sufficient access to international capital markets, so that the availability of tax credits for their resident shareholders may not significantly affect their cost of capital.

2.7 Most submissions argued strongly that:

- evidence shows a bias not only at the shareholder level but also at the corporate level;
- the bias affects the cost of capital for Australian multinationals and companies considering offshore expansion;
- Australian companies rely heavily on local markets for their equity raisings, and hence the cost of capital can be domestically determined;
- generally, Australian companies (including large internationally-recognised multinationals) do not register on foreign equity markets; and
- the bias drives behaviour that is not always in Australia's best interests.

Bias at the corporate level

2.8 In making investment decisions, companies look beyond the pure investment decision (hurdle rates, risk premiums, synergy benefits, non-financial aspects such as comparable legal systems, stable government). They look also at the impact the investment decision will have on shareholder value. The shareholder value component takes into account after-tax returns to shareholders, which in turn includes a value for imputation. Since major Australian companies with significant foreign earnings continue to have a disproportionate domestic shareholder base, the impact on shareholder value of any offshore investment decision is crucial. The submissions, therefore, dismiss the view expressed in the Treasury Paper that at the company level a tax bias is likely to occur only where a foreign country has higher company-level taxes than Australia.

That bias affects the cost of capital

2.9 The submissions maintain that even if the marginal price-setter for a stock is a non-resident, or if the cost of capital is found to be lower offshore, companies will necessarily consider the impact of the investment decision on the after-tax return on their existing shareholders. Where those rates of return are likely to be adversely affected, management will think twice about raising the capital offshore. Whether the equity is raised in the local market or overseas, a higher pre-tax rate of return will be needed to offset the bias, thereby driving up the cost of capital.

Australian companies rely heavily on local markets

2.10 The submissions rely on the research of academics, market commentators and a regulator to support the view that Australian investors lean heavily towards holding equities in Australian domestic companies and that imputation credits increase the value of equities. These findings are consistent with major Australian companies having a disproportionate domestic shareholder base. The findings are inconsistent with the view expressed in the Treasury Paper that the cost of capital in a small open economy is determined by global capital markets rather than by Australian investors.

2.11 Other matters support the active involvement of domestic investors in equity raisings. They include:

- the widespread use of dividend reinvestment plans (DRPs). These are more likely to attract an investment by an existing resident shareholder than by a theoretical price-setting non-resident investor, particularly as DRPs are often not offered to non-resident shareholders;
- rights issues, which access existing shareholders proportionately;
- domestic index investors, who will need to participate proportionally in capital raisings by domestic companies in order to maintain their relevant index weightings. They are, therefore, more likely than a non-resident to be the marginal investor;
- imputation funds that are purely domestic;
- government privatisations, such as Commonwealth Bank and Telstra, which have led to high levels of domestic shareholders and high levels of domestic share ownership throughout the economy. The active participation of large numbers of domestic residents in the capital markets indicates a strong likelihood that the marginal investor would be a resident; and
- the inflow of Superannuation Guarantee system funds, which provides a regular flow of investment capital ($15 billion and $20 billion for the years ended 31 March 2002 and 2001 respectively). It is estimated that 20 per cent of these monies are directed into equity markets. The availability of this money means that domestic investors are likely to be competing with non-resident investors when companies are raising capital from the market.

2.12 One submission cited the example of a major Australian financial services provider (a large multinational company) that could readily access (cheaper) offshore capital markets. That company undertook three recent capital raisings, all in Australia. Even though the company can access foreign capital markets, it considers that residents are the marginal price-setters of its shares.

2.13 For these reasons, the submissions conclude that domestic investors will always represent a major source of funds in new equity raisings, and that the Australian equities market clearly values franking credits. As a result, there is a domestically-determined cost of capital.

Australian companies do not register on foreign equity markets

2.14 Several submissions question whether many larger Australian companies have access to global capital markets as well as to the Australian market. They consider that only a few Australian-based multinationals can currently access global equity markets in any meaningful way. Further, as mentioned earlier, even they may not pursue that avenue, preferring instead to access the domestic market.

2.15 The submissions point out that the mismatch of Australian companies with significant foreign earnings and disproportionate domestic shareholder bases is a product of a number of factors. They include the relatively small size of Australian companies, the information costs associated with foreign investors assessing the prospects of such companies in what they perceive as a distant and unfamiliar market, and the simple fact that, with very few exceptions, Australian companies do not register on foreign equity markets.

The bias drives behaviour not always in Australia's best interests

2.16 Many public companies manage their distribution policies within the constraints of available imputation credits to partially compensate for the imputation bias. They do so by accelerating tax payments, deferring dividend payments, and deferring the repatriation of profits back to Australia. This behaviour is not always in Australia's best interests.

Problem

2.17 The submissions argue that the bias of the imputation system impedes expansion overseas by Australian companies. Companies need to expand for many reasons:

- larger companies are at their market limit in Australia because of competition law;

- large Australian multinationals need to maintain critical mass internationally, so that they can compete successfully with foreign multinationals both overseas and in Australian markets; and
- smaller Australian companies in niche areas need to tap foreign markets to make their businesses viable (given the relatively small size of Australian niche markets).

2.18 As noted above, the Treasury Paper raises the question whether the bias affects the cost of capital of Australian firms. The submissions argue that a variety of reasons affect the cost of capital, but even putting those reasons aside, companies consider they suffer in Australian markets when they are unable to fully or substantially frank dividends because of their FSI.

2.19 The imputation system was introduced to reduce the bias in the previous tax system for debt over equity. New concerns are that the imputation system's bias against foreign investment may lead to increased levels of borrowing to finance foreign investment. This increases risk and may downgrade the credit rating of Australian firms.

Evidence of the problem

2.20 The submissions argue that the imputation system penalises Australian firms expanding overseas, compared to firms deriving all their income from Australia. The penalty is demonstrated in a number of ways: for example, a higher cost of capital or lower share price (or price earnings multiple). At the extreme, the imputation system can become a significant factor in location decisions by Australian firms — not so much on the location of investment (as there is little choice beyond a certain firm size), but as to the company's residence.

2.21 It is difficult to do modelling work on this issue, so the submissions generally cite little direct evidence to support their view. However, they cite a number of indirect indications to establish the effect on the cost of capital. These include two sets of studies:

- studies on the value of imputation credits (indicating ranges generally of 40-60 per cent of face value); and
- studies on the predominance of investment in resident companies by individuals and institutional investors, contrary to modern portfolio theory (which is usually explained by the better knowledge of investors about local firms).

2.22 The second group of studies also supports the argument that Australian multinational firms effectively have to compete with other Australian firms for capital in Australia. This puts them at a disadvantage due to their lower franking capacity compared to firms whose market is primarily in Australia.

2.23 The Board considers that there is sufficient evidence to support the view that the Australian capital market significantly affects the cost of capital of Australian firms, and further, that the capacity to frank dividends affects the cost of capital in that market.

2.24 Hence, the Board considers that the current bias in the imputation system towards domestic investment by Australian firms impedes the ability of Australian companies to attract equity capital for offshore expansion.

Policy issues arising from the problem

2.25 The bias in the imputation system was not an accident. Australian policy on FSI in the 1980s ensured that national neutrality prevailed, so that Australia *as a country* would be better off from investment overseas only when the *after-foreign-tax* return on the foreign investment is greater than the *pre-Australian-tax* return on domestic investment. This policy was partly justified on the basis that Australian individuals should not be in any different position if they receive dividends from foreign companies directly or through Australian companies. As individuals do not get any credit for foreign corporate taxes under Australian law on dividends received directly from foreign companies, the same should apply to dividends received indirectly. This result is achieved by the dividend from the Australian company out of FSI being effectively unfranked.

2.26 In the 1980s, most Australian firms had room to grow in the Australian market. The issues of relative size of Australian firms to foreign multinationals and niche markets overseas had little impact on Australian firms. As Australian companies are increasingly expanding overseas, the current bias towards Australian firms raising capital domestically and investing in Australia instead of investing offshore has become a more significant issue of concern. Increasingly, the Capital Export Neutrality has become an important principle in the tax design of Australia's taxation arrangements.

2.27 The Treasury Paper questions whether change is necessary to ensure that Australia's imputation system does not limit the ability of Australian companies to attract equity capital for offshore expansion.

2.28 The Treasury Paper offers three options:

- providing domestic shareholder tax relief for unfranked dividends paid out of FSI (Option 2.1A);
- allowing dividend streaming of FSI (Option 2.1B); or

- providing franking credits for foreign dividend withholding taxes (DWTs) (Option 2.1C).

2.29 These options have different underlying policy-drivers. Options 2.1A and 2.1B effectively abandon the 1980s policy and substitute a policy (or at least a policy direction) with a different form of neutrality: a comparison at the shareholder level of *pre-foreign-tax* return on the foreign investment with *pre-Australian-tax* return on domestic investment. To achieve this result at the shareholder level, effectively the foreign tax is subject to foreign tax credit treatment. That is, the shareholder pays no Australian tax on foreign income derived to the extent of foreign tax paid on that income. Neither Option 2.1A nor 2.1B achieves this outcome directly, but indirectly as discussed below.

2.30 Option 2.1C deals with a different policy issue. As noted above, the 1980s policy was partly to achieve the same outcome for investment overseas by an Australian individual, whether the investment was in an Australian company or a foreign company. The current law does not fully achieve this policy because an individual gets a foreign tax credit for foreign withholding taxes on dividends received directly from foreign companies, but not from dividends received indirectly through an Australian company. By giving an imputation credit for foreign DWT, Option 2.1C would achieve equality of treatment.

Potential solutions

Option 2.1A

2.31 Option 2.1A provides domestic shareholder tax relief for unfranked dividends paid out of FSI by way of a non-refundable tax credit for 10 per cent of the dividend. Most submissions generally supported this option, although usually coupled with a view that the level of credit needs to be increased. Several submissions developed variants on the basic thrust of this proposal.

2.32 The benefits of Option 2.1A are that:

- it most closely reflects overseas trends;
- it most closely reflects the underlying policy for making changes to current arrangements;
- it has the most direct impact on the cost of capital of Australian firms expanding overseas;
- it enables Australian companies wishing to expand overseas to do so on the same basis as those choosing to invest in Australia;

- it facilitates Australian companies investing overseas using their brand name to raise capital in Australia, increasing their Australian shareholder base;
- it is likely to increase the repatriation of profits to Australia, along with the resulting benefits;
- it maintains the integrity benefits of the imputation system;
- it is more likely than Option 2.1B to encourage Australian shareholding in Australian companies; and
- it is more generally relevant than Option 2.1B to Australian companies expanding offshore.

2.33 As to overseas trends, Option 2.1A reflects the kinds of solutions that have recently appeared in the United Kingdom (UK) and Germany, and have been present for some time in other European Union countries such as Belgium, as well as Canada. The overseas mechanisms include credits for dividends paid by resident companies (Canada, and to some extent the UK), flat rate taxes on dividends (Belgium) and partial exclusion of dividends from income (Germany). The common feature is that the relief is available whether the company is distributing domestic or foreign income.

2.34 More recently, the United States of America (US) has introduced proposals to exempt from US tax, dividend income received by US residents from US companies, where the underlying profits have been subject to company tax. The proposals do not discriminate between US tax and foreign tax paid on the underlying profits. This proposed US reform re-enforces the need for Australia to reform its own international tax arrangements — in particular, to address the current bias in the tax system that discourages foreign investment by denying Australian shareholders any relief for foreign taxes paid.

2.35 However, Option 2.1A also differs from these systems. To attract a credit, it requires foreign income to be tracked through the foreign dividend account (FDA) or foreign income account (FIA), and then requires a distribution from those accounts. In the UK and Canada, the shareholder credit is to provide relief from double taxation with respect to both domestic and foreign income. Most submissions supported retaining the imputation system alongside Option 2.1A. They did not consider the use of different systems for relieving double tax on domestic and foreign income to be a significant disadvantage.

2.36 Adding Option 2.1A to the imputation system retains the advantages of imputation. The imputation system generally encourages Australian firms to pay Australian tax so that dividends can be franked. Hence, most firms are less likely to aggressively tax-plan away Australian tax payments (although they are encouraged to plan conversion of foreign tax to Australian tax).

2.37 Some submissions developed variants on this proposal, involving partial or full exemption of dividends. The main disadvantage of the variants is that they would give greater benefits to higher-income taxpayers. The credit method has less impact on the progressive nature of individual income tax. The advantage of the variants is that they would be simpler to implement.

2.38 The Treasury Paper suggests a relatively modest level of credit. It notes that higher levels of credit may require limiting the credit to tax on the relevant income, rather than tax on income generally, which would bring deduction allocation rules. On the other hand, many submissions argued for a higher level of credit if it is to have an appreciable impact on the cost of capital.

2.39 Ultimately, the appropriate level of credit will depend on modelling its effect on the cost of capital. Revenue considerations will also play a part in deciding the level. Given the current state of knowledge, the Board considers that a modest but meaningful level of automatic credit is most appropriate. It may be possible in the future to devise a workable system that allows credits for actual tax paid, which would most closely reflect the policy underlying this kind of proposal.

2.40 For ease of administration, the Board prefers a system that provides the relief without the need to trace foreign tax paid offshore.

2.41 The Board supports the view that the credit level would need to be set at a reasonably low rate. This is because it is provided without reference to foreign tax paid (which may be low in some cases); also, it would retain the benefits of imputation (noted above). However, the Board considers that a 10 per cent credit would be too low to have a significant impact on the cost of capital. Moreover, the Treasury Paper (Table 2.3) notes that virtually 80 per cent of Australia's direct foreign investment goes to the US, the UK and New Zealand (NZ), all of which have underlying tax rates (income tax plus state taxes plus withholding taxes) in excess of Australia's 30 per cent domestic rate.

2.42 On balance, the Board believes that relief should be provided by a non-refundable credit of 20 per cent without any requirement to trace foreign tax paid or incurred. An amount equal to the credit would be included in the taxpayer's assessable income.

2.43 The benefits and costs of this recommendation are discussed in more detail in Chapter 1 of this report.

2.44 To ensure that the level of relief remains relevant to future offshore expansion by Australian companies, the Treasury should conduct on-going modelling in conjunction with the business sector. The purpose would be to consider further developing the credit on the basis of its effect on the cost of capital of Australian companies that expand offshore.

2.45 The Board is conscious of the need to maintain the integrity of the Australian tax regime and to minimise the revenue cost of this recommendation. Accordingly, it believes that the following conditions are appropriate:

- the unfranked dividend would need to be paid out of a designated category of FSI;
- the relevant FSI would consist of non-portfolio dividends out of foreign source profits and foreign branch profits, where those profits are generated after the commencement date of the new measures;
- rules would identify the relevant FSI at the company level and allow it to be passed to shareholders. FSI subject to Australian company tax would not be included, as it would be franked, nor would untaxed foreign capital gains — see, for example, Recommendation 3.10(2). The same item of FSI could not give rise to a franking credit and a 20 per cent tax credit;
- an account, such as a FDA or FIAcould be used, and similar distribution rules as for franking credits could apply. This would include the ability to pass tax credits through a chain of companies. Chapter 3 of this report (see Option 3.11) contains further discussion on the potential use of these accounts;
- the 20 per cent credit would be available for offset against the total tax liability of the taxpayer, not merely the tax relating to the FSI; and
- the existing imputation system would continue to apply to Australian taxed income, while the credit would apply only to unfranked dividends paid out of FSI.

Option 2.1B

2.46 Option 2.1B allows the streaming of foreign income to foreign shareholders (and, as a consequence, streaming of imputation credits to Australian shareholders). This allows credit for foreign taxes to flow to foreign shareholders to the extent permitted under foreign systems (and may also eliminate foreign DWTs), and Australian imputation credits to flow to resident shareholders. By swapping credits between foreign and Australian shareholders, it indirectly achieves a result similar to giving Australian shareholders credit for foreign taxes.

2.47 The major impact of Option 2.1B is on Australian companies with significant levels of foreign shareholders. The impact is, therefore, more limited than Option 2.1A. The current policy underlying the imputation system is said to be that shareholders are entitled pro rata to credits and that wastage of credits in the hands of foreign shareholders is intended. However, this policy appears to be driven mainly by revenue concerns.

2.48 The benefits of the Option 2.1B are that:

- it allows Australian firms expanding overseas and with foreign shareholders to conserve imputation credits for Australian shareholders and overcome the disadvantage of lower franking of dividends;
- it allows Australian firms to provide foreign shareholders with benefits available under foreign systems, thereby encouraging foreign investment;
- it evens up the treatment of dual listed companies (which can already effectively stream foreign and domestic credits) with other Australian firms with foreign income and shareholders; and
- it helps Australian companies achieve critical mass in overseas markets by removing disadvantages in the current tax regime.

2.49 The Treasury Paper raised several methods to achieve streaming. The submissions generally considered that all methods should be allowed, as their effectiveness would vary depending on the overseas countries involved. Also, the submissions generally supported this option in combination with Option 2.1A.

2.50 The benefits and costs of this recommendation are discussed in more detail in Chapter 1 of this report.

Option 2.1C

2.51 Option 2.1C provides imputation tax credits for foreign DWTs, but not for foreign corporate taxes. This option has the benefit of treating dividends derived by individual shareholders in the same way, regardless of whether the shareholders receive dividends from foreign companies directly or indirectly via Australian resident companies.

2.52 The submissions argue that Option 2.1C will not effectively address the real issue raised by the bias of the imputation system towards domestic investment. They also point out that DWTs will become much less of an issue under renegotiated treaties.

The Board's recommendation

Option 2.1A

Recommendation 2.1(1):

The Board recommends:

(a) that domestic shareholder tax relief should be provided for unfranked dividends paid out of foreign source income derived after the commencement date; and

(b) that the relief should be provided by way of a non-refundable tax credit of 20 per cent and without any requirement to trace foreign tax paid or incurred.

Option 2.1B

Recommendation 2.1(2):

The Board recommends that the Government implement Option 2.1B to enable the streaming of foreign source income from an Australian parent company or through stapled stock arrangements from a foreign subsidiary, without adverse franking consequences (the Board does not recommend streaming between resident taxpayers).

Option 2.1C

The Board does not recommend Option 2.1C.

Administration and integrity issues

2.53 This recommendation will have a significant administration impact, and would require at least nine months lead time before implementation. During the legislative tax design phase, consideration will need to be given to, for example, preventing conversion of domestic income to FSI to inappropriately access the 20 per cent credit, or channelling FSI through tax havens to attract the foreign tax credit in Australia.

CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

Controlled Foreign Company (CFC) Rules

Policy objectives

3.1 The Treasurer's Press Release of 22 August 2002 identified a high-level aim of improving Australia's attractiveness as a location for internationally focused companies to operate global and regional businesses. Reform of the CFC rules will contribute to this.

3.2 The Treasurer's Press Release of 2 May 2002 specifically outlined the aim of the review in relation to CFCs. The review's task is to examine claims that the rules:

- are complex and impose significant compliance costs on business;
- are out of step with modern business practice; and
- negatively affect decisions to locate in Australia as against countries with less stringent rules or no such rules.

Current law

3.3 The aim of the CFC regime is to prevent residents accumulating 'tainted income' taxed at low or zero rates in foreign companies controlled by Australian residents. A variety of methods and concepts have been developed over time to achieve this aim. They include:

- *Active income test*: If a CFC passes an active income test (that is, the large majority of its income is not tainted income), its income is generally not taxed on a current basis. If it fails the active income test, Australian owners may be taxed on tainted income on a current basis.
- *Tainted income:* This is foreign passive income and certain (mainly related party) sales and services income. Broadly, it arises from investments and arrangements that could be significantly influenced by taxation considerations in the source country.

- *Listed countries:* In the original regime, countries were divided into two categories: 'comparable tax countries' and 'tax havens'. In 1997, the comparable tax countries were subdivided into two lists: broad-exemption listed countries (BELCs), whose tax regimes were closely comparable to the Australian tax system; and limited-exemption listed countries (LELCs), whose regimes were less comparable to Australia, but were not tax havens. There are currently seven BELCs: Canada, France, Germany, Japan, New Zealand (NZ), United Kingdom (UK), and the United States (US).

- *Eligible Designated Concession Income (EDCI):* This is tainted income that is concessionally taxed in a BELC and therefore subject to tax in Australia. Types of EDCI are listed in the Income Tax Regulations. There are two categories — generic and specific. In the generic category are capital gains not subject to tax. In the specific category are usually 'types of entities' which are concessionally taxed in specific jurisdictions.

3.4 These are only a few examples of the tests and definitions within the CFC rules. There is significant complexity and compliance costs for business in applying these rules.

Problem

3.5 The submissions made to the Board supported the basic underlying policy of the CFC rules. Submissions agreed that rules are necessary to prevent Australian-controlled companies from deliberately accumulating passive income in a low tax jurisdiction. However, there are two major problems with the current CFC regime:

- the complexity of the rules leads to high compliance costs; and

- the operation of the rules often impedes genuine business transactions and decisions.

3.6 Specific problems include:

- restructuring is difficult because of insufficient rollover relief for capital gains tax (CGT);

- the interaction of Australia's transfer pricing rules and the CFC regime leads to duplication;

- under the tainted services income rules, Australian-owned businesses providing services into Australia from overseas pay Australian levels of tax on that income. Foreign-owned competitors providing the same services do not. Further, foreign subsidiaries of Australian companies are discouraged from providing services among themselves, as the income produced is usually attributed to the Australian parent; and

- a long list of technical and policy options produced by the foreign-source income (FSI) subcommittee of the Australian Taxation Office (ATO) National Tax Liaison Group has remained virtually unactioned.

3.7 The following case studies are representative of the views echoed in numerous submissions about the impediments that Australian companies face when dealing with Australia's international tax regime. They also provide indicators of further behavioural effects that might arise from reforms — namely, that Australia might see an increased volume of inbound employment-creating investment into headquarter activities which are currently being located in Europe or Asian countries.

Box 3.1: Case Study — Malaysia preferred to Australia as headquarters

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

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

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

Option 1 — Malaysia as a hub

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

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

Option 2 — Australia as a hub

Dividends from China and Malaysia would flow free of DWT to the Australian joint venture company. The Thai dividends would attract 10 per cent DWT, the same as if Malaysia were the hub.

The dividends received by the joint venture Australian company would be exempt from Australian tax. These dividends could be paid on to the Netherlands free of DWT by utilising the foreign dividend account (FDA). However, Company Y would have to pay Australian tax on the unfranked dividends received from the joint venture Australian company.

Australian CGT would be payable in respect of any gain on disposal of the foreign subsidiaries.

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

Conclusion

Owing to Australia's tax on unfranked dividends (albeit sourced from previously taxed foreign income and which was previously tax exempt in Australia), its capital gains tax on sales of foreign subsidiaries, and its CFC laws that top-up taxes to the Australian rate on passive and tainted income, a hub in Malaysia is recommended.[1]

Box 3.2: Case Study — Observation of a multinational

Company Z has provided this background based on its own observations as a multinational. The comments are focused on the tax considerations of holding/owning assets. They do not purport to address other investment considerations such as sovereign risk; nor do they address the question of where headquarters should ultimately reside. (Headquarters can reside separately from the location where assets are held or owned.)

1 Case Study provided in a supplementary submission by BCA/CTA/ABA.

A key question for Company Z, when new businesses are acquired or to be established, is the ongoing ownership structure. A related and important issue is the implications of any ultimate disposal of the investment. The taxation implications of these matters may influence a decision one way or another when weighing up country ownership comparisons. Both these issues bring into sharp focus the extent of DWT and the implications of any CFC regime relating to holding/ownership, and the extent of CGT on exit.

Company Z notes that offshore multinationals have a structuring choice. This potentially allows access to more favourable international tax regimes than in Australia — for example, UK where there is no CGT on the sale of foreign businesses (that is, disposals of shares or assets).

Although Australia has an excellent record of economic growth, its taxes on foreign profits and on the sale of foreign assets make it unattractive as a regional holding centre, and largely isolated in the eyes of global investors. As a result, Australia is generally unattractive for 'flow through' investment, which of itself generates positive economic outcomes from service-related activity and Australian-bound personnel transfers. Company Z is aware that in the UK and the US, Australia's taxation regime is a key reason why companies seeking to conduct businesses in the Asia/Pacific region are advised not to consider Australia as a location for the regional holding company. As a result, business and multiplier effects flow instead to places such as Singapore and Hong Kong. Australia is not considered to be a suitable base from which to establish regional headquarters; for the most part it tends to attract only Australian-focused subsidiaries of multinationals.

Company Z is concerned that the international tax debate has focused on outbound investment. Perhaps this is not surprising, from the perspective of Australian companies attempting to grow globally. However, Australia's international tax regime should also be viewed from the perspective of inbound investors, including multinational companies seeking to invest offshore through Australian-based holding companies. While it would be impossible to quantify the amount of international investment that by-passes Australia, Company Z remains concerned that unless Australia makes its international tax regime more attractive, multinational companies in similar positions will continue to locate their regional service businesses (and consequently, their regional holding companies) outside Australia. This will be due, in part, to other countries' competitive on-going tax regimes on annual profits, combined with their minimal exit tax on foreign investments.

Company Z disagrees with arguments that there is no need for reform in this area. It disagrees that other structures (including the dual listed company structure) deal adequately with the tax problems. Those structures do not benefit Australia in the sense of attracting inbound or 'flow-through' investment. Moreover, Australian companies with outbound investments may have no choice but to adhere to an uncompetitive regime.

Inbound multinationals have a choice concerning ownership of offshore assets. With the current Australian tax regime, they are likely (in all but exceptional circumstances) to favour establishing ownership structures under more attractive regimes outside Australia — places such as the UK. (It seems that the US Administration is likely to propose substantial changes to its CFC and foreign tax credit regimes precisely because of a perception that the nature of its international tax rules makes the US (much like Australia) not a preferred tax regime. This compares with the situation in the UK, which recently sought to relax its rules to attract companies holding foreign assets.)

Therefore, Company Z considers it is crucial that reforms be considered not only to encourage companies to locate their headquarters/regional headquarters in Australia, but also to assure them that Australia will not seek to tax gains on investments held through Australia.[2]

Evidence of the problem

3.8 Australian multinationals often wish to restructure, for various reasons. The lack of CGT rollover relief can make this difficult. Australia has a number of rollover rules for capital gains, and many are incorporated into the CFC regime. However, the CFC provisions sometimes modify the rules. For instance, rollover relief is denied for certain transfers between BELCs (for example, from the US to the UK) and from non-comparably taxed jurisdictions to comparably taxed jurisdictions (for example, Hong Kong to US), and vice versa.

3.9 Submissions noted that the general business environment has changed since the introduction of the tainted sales and services rules. The ATO's enforcement of Australia's transfer pricing rules has improved dramatically. This has led to overlap between the transfer pricing rules and the CFC regime. Originally, taxation under the CFC regime of services provided by CFCs to unrelated parties in Australia was originally on the view that such activity should be discouraged. But the effect in the modern economy is to impede Australian businesses from providing services to Australia in the most economic way. This gives a competitive advantage to foreign-owned business providing the same services.

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2 Case Study provided in a supplementary submission by BCA/CTA/ABA.

3.10 Submissions proffered the National Tax Liaison Group's list of issues as strong evidence that the CFC regime is overly complex. The list of issues is extensive. In the Board's view, the list highlights technical and policy issues which have arisen since the introduction of the CFC regime, and which remain unresolved.

Policy issues arising from the problem

3.11 A central concept in the CFC rules is the active income test. It is aimed at ensuring that only passive and certain sales and services income is affected by the CFC rules. This reflects the general policy that an Australian company's foreign subsidiaries should be subject only to the same tax as their local competitors. Australia does not wish to impose additional tax on active income, regardless of whether the foreign country is a high or low taxing country. This policy is generally referred to as 'capital import neutrality' (CIN), meaning that Australian capital deployed overseas should be subject to the same tax burden as foreign capital.

3.12 Under this principle, the CFC regime is applied in two circumstances only:

- to highly mobile income that can be shifted out of Australia more or less at the taxpayer's choice without involving the movement of real activities (passive and services income); and
- to passive sales and services income which is subject to transfer pricing.

3.13 The CFC provisions define notional assessable income. In some areas, particularly tainted services, perceived risk of abuse leads to a broad inclusion of income. This results in high compliance costs, as the regime attempts to pick up all forms of untaxed or lightly taxed income.

3.14 Important changes have occurred in the world economy since the CFC regime was introduced. Relevantly, they include the following:

- many Australian firms have reached the limits of possible growth in Australia. Expansion overseas is driven by business considerations, not merely to find a more favourable tax regime;
- the Organisation for Economic Cooperation and Development (OECD) Tax Competition project is identifying harmful tax practices in some countries and taking steps to remove their harmful features. This facilitates making judgments based on countries' systems overall rather than dissecting all the features of their tax regimes;
- international trade has increased between related parties compared to unrelated parties. This has led to coordinated international action against, and a much higher profile for, transfer pricing. (The OECD produced its Guidelines on Transfer Pricing in 1995 and has updated them several times.) The CFC regime

means that Australian-owned companies (but generally not foreign-owned companies) must deal with two sets of rules, involving high compliance costs in the transfer pricing area; and

- international trade in services is growing much faster than international trade in goods. This has led to international coordination of policy on the taxation of services. The general policy response is to tax services on the same principles as goods; in contrast, the CFC regime treats services significantly differently from goods.

3.15 Submissions universally concluded that the complexity and compliance costs involved in applying the CFC rules, as well as the changes in the international environment, demonstrate the need for urgent reform. Considerations relevant to reforming the CFC rules include:

- developing criteria to assess whether another jurisdiction has a reliable tax system, and then relying on the foreign system rather than trying to assess all its features in detail. Specifically, where a country has a rigorous tax system with features similar to Australia's, then it should be possible to rely on that country's tax system to deal with tax problems, without overlaying Australia's CFC rules;

- identifying changes in international business practices that affect the operation of the CFC rules, and their implications;

- identifying specific situations that constitute genuine and significant risks to revenue to be dealt with by the CFC regime, rather than excluding the regime only where there is no risk to revenue; and

- removing the bias inherent in current tax arrangements so that globally-focused Australian companies maintain corporate structures and select headquarter location on the basis of commercial considerations rather than taxation considerations.

Potential solutions

Exemption for BELCs

3.16 The Treasury Paper proposes a number of options aimed at simplifying the CFC regime and reducing compliance costs. However, many submissions went further and raised the possibility of exempting BELCs from the CFC regime, given that BELCs are countries with broadly similar tax regimes. They argued that the CFC provisions add an unnecessary complex layer of tax compliance. It should be possible to rely on a comparably taxing country without enforcing the CFC rules. Other attributable income not dealt with by the BELC's CFC regime (for example, foreign investment fund (FIF) income) could possibly be included in passive income. In specific situations it may be necessary to list features of a BELC system that should be subject to attribution. For example, NZ does not have a CGT regime; untaxed capital gains of defined types arising in NZ could be a listed feature. These situations would be specific and much narrower than the current listing.

3.17 The logic that Australia should 'trust' comparably taxed countries applies to income of the CFC sourced in the relevant BELC, or in any BELC. However, a CFC may have income that is sourced outside the BELC, in a jurisdiction that is not comparably taxing. This creates issues that need to be addressed. Possibilities include:

- limiting the BELC exclusion to income sourced in the BELC or otherwise included in its tax base (or sourced in or otherwise included in the tax base of any other BELC); and
- limiting the BELC exemption to CFCs deriving income mainly from a BELC. For example, a de minimis rule could allow a small percentage of income sourced outside the BELC.

Advantages and disadvantages

3.18 The majority of Australia's outbound investment is with BELCs. A virtual exemption for BELCs would substantially reduce overall CFC compliance costs for business.

3.19 A possible disadvantage is that Australia would become more dependent on the tax administration and laws of other jurisdictions, as the CFC rules would no longer provide a backstop to BELCs. Overseas regimes would need to be regularly monitored. The behavioural response of business would also need to be monitored, to ensure that the CFC rules are not undermined by the general exemption. On the other hand, the changes in 1997-1998, which were partly driven by the problem of monitoring overseas systems, have resulted in substantial CFC compliance costs in the private sector, far exceeding the monitoring costs for the public sector.

3.20 While the above comments relate to income and gains derived by the CFC resident in the BELC, a residual issue is the treatment of income and gains of a subsidiary of that BELC where that subsidiary is resident in a non-BELC (including for these purposes, subsidiaries not resident in any jurisdiction).

3.21 An approach would be to rely on the CFC regime of the BELC to prevent diversion of passive income to low tax jurisdictions. The effect would be to exclude from Australia's CFC measures a CFC resident in a BELC and all its subsidiaries wherever resident. Conceptually this option is attractive and would limit the compliance burden of dealing with more than one CFC regime. Some submissions emphasised this existing compliance burden and favoured this approach to limiting the CFC measures.

3.22 The practical problems with this approach are similar to those discussed above. As pointed out in the Treasury Paper, even where a country has a CFC system policies vary regarding the type of income to be attributed. Therefore, there is a risk that exempting from Australia's CFC measures all subsidiaries held by a CFC resident of a BELC may leave scope for BELC 'shopping'.

3.23 Also, once a country is listed as a BELC, that BELC's CFC measures would need to be monitored. There is increased potential for countries to be taken off the BELC list depending on changes to their CFC rules.

3.24 On balance, although the compliance saving is attractive, it would inevitably lead to a restriction of the number of countries that could be listed as BELCs.

3.25 In the Board's view, it is important to balance minimising the overall compliance burden of the CFC measures with maximising the number of countries treated as BELCs. For this reason, the Board considers that subsidiaries in non-BELCs should be exempted from the CFC regime only where the BELC has a comprehensive CFC regime broadly equivalent to that of Australia.

Recommendation 3:

The Board recommends that where an attributable taxpayer holds an interest in a controlled foreign company that is resident in a broad-exemption listed country, the following income should not be attributed to the Australian resident:

(a) the income of the controlled foreign company (which would include its subsidiaries) that is sourced in that broad-exemption listed country or another broad-exemption listed country or is otherwise included in the tax base of a broad exemption listed country;

(b) the income of any subsidiaries of the broad-exemption listed country controlled foreign company where the subsidiaries are not resident in a broad-exemption listed country provided the broad-exemption listed country has a broadly comparable controlled foreign company regime to Australia's controlled foreign company regime.

In limited cases, income arising from specific features of a broad exemption listed country's tax system may be listed as subject to attribution.

This recommendation should be seen in conjunction with the Board's recommendations in 3.1(1) and (2), 3.2, 3.3, 3.4 and 3.10(1), (2) and (3) (below).

Option 3.1: To consider options to expand rollover relief under the controlled foreign company rules, while maintaining the integrity of those rules

3.26 The Treasury Paper suggests the extension of rollover relief under the CFC rules. Suggestions in submissions include extending relief to:

- all forms of corporate reorganisations available under the domestic CGT provisions;
- any rollover relief available under the laws of the relevant foreign jurisdiction;
- any rollover in a BELC;
- any gain of a CFC on disposal of a non-portfolio interest in a non-resident company with underlying active assets (for corporate reorganisations, merger or demerger);
- any rollover between 100 per cent commonly-owned companies; and
- transfer of shares from one CFC to another in exchange for shares.

3.27 Another suggestion is to allow the use of Australian capital losses to offset attributable capital gains of CFCs.

Advantages and disadvantages

3.28 Submissions emphasised that any extension of CGT rollover relief would facilitate corporate reorganisations and other business decisions in relation to foreign jurisdictions-matters, which are currently impeded or prevented by the CFC regime.

3.29 Although extension of Australian rollover relief will solve some problems, it will not meet all the cases where there is no clear policy against rollover. This is because of the wide variety of overseas tax systems to which the rules would have to relate.

3.30 A more targeted overall strategy would involve less complexity and deal with virtually all cases. The strategy would involve three elements, two of which arise from other recommendations of the Board. The first is to virtually exempt BELCs from the CFC rules (see Exemption for BELCs, above). Many submissions suggested this kind of approach as a possible alternative to extending CGT rollover relief. Of course, this will solve problems for BELCs only. For non-BELCS, a second and similar approach is possible — namely, permitting restructures which are specifically permitted under the law of the non-BELC concerned. Thirdly, the Board's recommendations in relation to Option 3.10(2) would effectively permit many corporate restructures in non-BELCs where the restructure involves the transfer of certain non-portfolio shareholdings in CFCs.

3.31 This still leaves some residual restrictions for the restructure of foreign subsidiaries, mainly in non-BELCs. For instance, rollover relief would not be allowed under the CFC measures where the foreign jurisdiction does not generally impose CGT and therefore does not have rollover relief. Therefore, additional rollover relief for companies may be necessary (in certain cases, scrip for scrip rollover relief may be appropriate). Moreover, if recommendation 3.10(2) were not accepted, such additional rollover relief would be critical for both BELC and non-BELC cases. For example, this extended rollover relief would also need to cover the disposal of assets by a CFC resident of a jurisdiction that did not have a CGT regime. Another example would be countries with capital gains and rollover provisions, where the rollover relief was narrow.

3.32 It is arguable this additional rollover relief should be restricted to relief available in Australia. That is, the relief should be restricted to transfers between 100 per cent owned group companies, scrip for scrip rollover, and de-merger relief. This would ensure neutrality between restructures onshore and offshore.

3.33 However, the argument against this restriction is that rollover relief is intended to place the Australian multinational on a consistent footing with the foreign multinational competitor. Since the foreign competitor may not be subject to any tax impediment or restructuring in the country of residence of the CFC, rollover relief should be as broad as possible while maintaining the integrity of the CFC measures.

3.34 The Board prefers the second approach because it gives an Australian multinational greater ability to restructure its business offshore for maximum efficiency. However, this measure will inevitably take some time to design and implement. In the meantime, the existing constraints on the restructure of an Australian multinational's offshore operations would remain. However, in the interim, the Board recommends that in addition to the relief recommended above, rollover relief be provided for transfers between 100 per cent owned group companies and for scrip for scrip and de-merger transactions.

Option 3.1: Extending CGT rollover relief

Recommendation 3.1(1):

The Board recommends that rollover relief should be available for corporate restructuring of controlled foreign companies not resident in a broad-exemption listed country, where the restructuring is covered by, and done in accordance with, the tax law of the country concerned.

Recommendation 3.1(2):

The Board recommends that rollover relief be extended to cover transfers of assets or interests between 100 per cent owned group companies, scrip for scrip transactions and demerger transactions in cases where relief would not otherwise be available as a result of recommendations 3, 3.1(1) and 3.10(2).

Option 3.2: To consider options to appropriately target the tainted services income rules, while maintaining the integrity of the controlled foreign company rules

3.35 There is general agreement that the tainted services income rules need to be reformed. While many submissions suggested the need to narrow the scope of both the tainted sales and services income rules, services were the main focus. Suggestions included that:

- provision of services between CFCs on an 'arms length basis' should be outside the scope of the CFC rules;
- consistent with the tainted sales income rules, provision of services that do not have a direct connection with Australia should be excluded;
- the scope of the rules should be confined to genuinely passive income;
- the scope of the rules should be confined to services which CFCs provide to resident associates; and
- CFCs undertaking an active business of providing services should be excluded.

Advantages and disadvantages

3.36 The Board accepts the need to reform the tainted-income rules. A number of submissions suggested handling the problem by distinguishing between active and passive businesses of providing services. However, rapid developments in the high-value services area make enduring definitions difficult. Further tinkering with the definitions of tainted sales and tainted services income is likely to add to complexity and compliance costs without fully solving the problems. Where the concern is transfer pricing out of Australia, the Board considers that Australia's transfer pricing regime is sufficient and reliance could be placed solely on the transfer pricing rules, not the CFC regime. Where the concern is the movement of service capacity from Australia, the issue for taxation of income from services under the CFC rules is in essence no different to that for sales income. Different treatment would disadvantage companies deriving services income internationally compared to others.

3.37 An overall strategy to deal with concerns is to remove altogether the concepts of tainted services and tainted sales income. However, the Board recognises that there may be a narrow range of services the location of which are generally accepted as more likely to be motivated by tax minimisation than by commercial considerations. Captive insurance companies may fall into this category; they can be dealt with expressly in the passive income rules.

3.38 A concern remains about the use of tax havens, particularly in view of other changes recommended in this report. For example, those other changes create the potential to more easily establish the residence of a company offshore (Recommendation 3.12), including in tax havens, to generate tainted services or tainted sales income and take advantage of nil or low tax rates to distribute dividends to an Australian parent in a tax-free form (Recommendation 3.9) and to entitle the shareholders of the Australian parent to a 20 per cent tax credit (Recommendation 2.1(1).

3.39 Accordingly, the Board's recommendation in relation to this option does not extend to tainted services income or tainted sales income derived in designated tax havens unless, consistent with Recommendation 3, the income is subject to tax under the tax regime of a BELC (including its CFC regime). In other words, unless the income is subject to tax in a BELC it will continue to be subject to Australia's CFC measures. Care needs to be taken in determining what is a designated tax haven for this purpose, and the Board suggests using the criteria adopted by the OECD to identify tax havens.[3]

Option 3.2: Reforming the tainted services income rules

Recommendation 3.2:

The Board recommends that the tainted sales and services income rules be abandoned (except in relation to income or gains derived in designated tax havens that are not otherwise subject to tax in a broad-exemption listed country), and that services that are considered to raise particular integrity issues be dealt with expressly in the passive income rules under the controlled foreign company regime.

3 Harmful Tax Competition: An Emerging Global Issue — 1998.

Option 3.3: To consider whether additional countries should be included on the broad exemption country list, and to clarify the criteria for inclusion (or exclusion)

3.40 Many submissions called for clear criteria to determine BELC status. Developing such criteria will become crucial if the Board's recommendation to exempt BELCs from the CFC regime is adopted. This is because:

- Australia will be relying more heavily on the tax laws and administration of the BELC; and
- the favourable treatment will result in more pressure to expand the list.

3.41 Submissions suggested including the Scandinavian countries, and some southern European and Asian countries on the BELC list. This would double the current list to approximately 15 members. Until criteria are developed, the Board does not support specific recommendations on countries for inclusion.

Option 3.3: Adding to the list of BELCs, and clarifying criteria for inclusion

Recommendation 3.3:

The Board recommends that criteria for declaring further countries as broad exemption listed countries be developed and published as soon as practicable. Any further declarations of broad-exemption listed countries should be made on the basis of those published criteria. Existing broad-exemption listed countries should remain broad-exemption listed countries.

Option 3.4: To identify technical and other remaining policy issues regarding the controlled foreign company rules, and consider options to resolve them either on a case-by-case basis or as part of a major rewrite of the provision

3.42 The current CFC rules are lengthy, highly technical and complex. There are many compliance problems and unintended consequences (even though, when enacted in 1990, the rules had been subject to very extensive consultation).

3.43 The FSI Subcommittee of the National Tax Liaison Group has maintained a list of CFC issues (CFC issues register) for a decade. A large number of submissions referred to this list, and called for immediate action. The submissions pointed out that the issues have remained unresolved for many years, even though CFC issues had been raised in two major reviews (the 1997 CFC review[4] and the RBT).

3.44 The Board commissioned a report to examine the issues and to prioritise them: see Attachment 1. On the basis of this report and the submissions, the Board considers that these issues should be resolved as a matter of urgency.

3.45 Many issues may be resolved if other recommendations of the Board in this report are adopted. For example, the issues relating to EDCI will not be relevant if BELCs are exempted from the CFC rules. As noted in the Treasury Paper, one issue in particular is already the subject of consideration and should be resolved swiftly — namely, the treatment of hybrid entities such as limited partnerships and US limited liability companies.

3.46 The Treasury Paper also raised the possibility of a complete rewrite of the CFC provisions. Submissions were divided on whether a rewrite is the best solution. There is concern that a complete rewrite would:

- take some years to complete;
- create other unintended consequences and compliance problems; and
- impose considerable costs of re-learning the rules and re-engineering compliance systems in an environment where tax reform fatigue is already a significant problem.

3.47 Conversely, there is concern that marginal tinkering:

- would deal only with some of the problems and not address systemic issues;
- would receive only a low priority in government business and be drawn-out over time; and
- may lead to greater complexity by merely modifying or qualifying existing rules, not removing them.

Advantages and disadvantages

3.48 As the benefits of a complete rewrite are difficult to demonstrate, a more targeted strategy is likely to be more effective, at least in the short-term. The Board is satisfied that the major CFC recommendations in this report will substantially improve the operation of the CFC provisions and significantly reduce compliance costs. It recognises, however, the need also to work on other technical issues.

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4 *Information Paper: Proposed changes to the taxation of foreign source income*, December 1996.

Option 3.4: Identify technical and remaining policy issues, and consider options to resolve them either on a case-by-case basis or as part of a major rewrite

Recommendation 3.4:

The Board recommends that the policy position on the following issues in the controlled foreign company regime should be resolved by 31 December 2003:

(a) currency exchange fluctuations;

(b) limited liability companies and limited partnerships;

(c) all issues classified as urgent in the consultancy report commissioned by the Board not covered by other recommendations (see Attachment 1); and

(d) an ongoing speedy decision-making process to resolve other issues on the Controlled Foreign Company National Issues Register (see Attachment 2).

Tax Treaties

Policy objectives

3.49 A policy objective of the current Review is to promote Australia as a location for internationally-focused companies. Double tax agreements (DTAs) are a significant element in international tax arrangements and need to be considered alongside domestic tax law. As DTAs are the result of detailed negotiations based on the tax systems of the two countries concerned, general DTA policy necessarily must be concerned with high-level issues and processes. A major policy question is the balance between residence and source taxation, and whether the balance struck in the recent Protocol to the US treaty should be the basis of future policy.

Current position

3.50 DTAs allocate taxing rights between Australia and other countries. They ensure that the same income or capital gain is not subject to double taxation, or to double non-taxation (or exemption). Until recently, Australia's DTAs have generally given greater emphasis to source taxation than to residence taxation. This is reflected in a number of features, such as:

- a wide definition of permanent establishment (PE), which increases Australia's taxing rights over non-residents' business operations in Australia; and

- relatively high withholding tax rate ceilings for dividends, interest and royalties derived by non-residents from Australia.

3.51 When Australia introduced its CGT in 1985, two important issues arose for DTAs: (1) how did existing DTAs apply to the CGT, and (2) how would future DTAs deal with it? Consistent with Australia's broad-source taxing policy, the ATO has taken the position that pre-CGT treaties do not limit CGT taxing rights (see Taxation Ruling TR 2001/12). It has also preserved domestic law source taxing rights over capital gains in treaties negotiated since them. In the case of investment in companies, the CGT taxes non-residents on gains on shares in resident private companies and non-portfolio interests in public companies. The CGT does not extend to shares in non-resident companies which hold Australian assets. The RBT recommended that the CGT be extended to non-portfolio interests in non-resident companies having their principal assets in Australia.

3.52 Australia's DTA with the US dating from the early 1980s had given away more source taxing rights than other DTAs, with a narrower definition of permanent establishment (PE) and a partial non-discrimination article (NDA). A NDA deals only with source taxation rights. In the recently-negotiated Protocol to the US DTA, Australia moved further away from source taxation by significantly reducing withholding tax rates on dividends, interest and royalties, and to a small degree qualifying Australia's levy of CGT on US residents. These changes reflected the RBT's recommendations that Australia renegotiate its treaties with its major trading partners and in particular reduce withholding tax rates on dividends paid from subsidiaries of Australian companies operating in those countries.

3.53 The emphasis of treaty negotiations over recent decades has been on extending Australia's DTA network to new countries, while updating the most important treaties on about a 20-year cycle.

3.54 Like many other contracts entered into by governments, DTAs are negotiated largely in secret. To some extent, this is changing: in Australia in recent years the negotiation process has been partly opened to consultation, through the ATO's Tax Treaties Advisory Panel and direct dealing with specific taxpayers on particular issues. But the balance is still very much on the side of secrecy.

Problems

3.55 The source-based DTA policy has detrimental impacts on Australian firms investing offshore, because it exposes them to high taxes in tax treaty partner countries. Yet Australia has unilaterally given up significant areas of source taxation under domestic law, such as DWT on franked dividends and interest withholding tax on widely-issued debentures.

3.56 Further, the treatment of capital gains has been a vexed issue under pre-CGT treaties for over a decade. The overwhelming private sector view is that pre-CGT treaties override the domestic CGT rules. However, the ATO view is that they do not. This standoff has detrimental effects on investment decisions by non-residents in relation to Australia, as the CGT treatment of the investment is uncertain. While the position under more recent DTAs is clear, the broad CGT jurisdiction claimed by Australia is out of line with international norms and also affects investment decisions by non-residents under these treaties.

3.57 Extending the CGT to shares in non-resident companies as proposed by the RBT will give even greater emphasis to source taxing rights. Further, the extension would add significant complexities to the tax law and would be very difficult to administer. Although the issue has been well understood internationally for many years, very few countries have sought to extend their CGT to shares in foreign companies. Indeed, apart from land rich companies, the international norm is not to levy CGT on non-residents when they dispose of shares in domestic companies, whether portfolio or non-portfolio interests. In some countries this result follows under domestic tax law; in other countries it follows as a result of DTAs.

3.58 In recent decades, the source emphasis in Australia's DTAs had made updating some major treaties problematical. Several major treaties have now run for more than 20 years without any significant updating (UK, 1967; Japan, 1969; Germany, 1972; several other European countries in the 1970s). The RBT has led to a shift of emphasis towards updating the major treaties. However, the DTA negotiation agenda is large, due to earlier inactivity and the practice of giving priority to extending the DTA network to investment partners that are relatively minor (at least, from Australia's point of view). Political and economic events may also affect negotiation priorities at particular times.

3.59 As Australia's overseas investment is concentrated in a few countries, extending the tax treaty network to countries with which Australia has little trade or investment is less important than revising existing major treaties.

3.60 The submissions suggest that the Tax Treaties Advisory Panel has had mixed success. In recent and current tax treaty negotiations, major companies have found it necessary to bypass this forum to make sure that their concerns receive a proper hearing.

Evidence of the problems

3.61 The evidence on change in investment flows in and out of Australia is now well known, although its implications went largely unnoticed before the RBT. The need to protect source taxation is now far less significant than 20 years ago, when inbound investment was four times the level of outbound investment. The emphasis on source taxation creates significant tax obstacles to foreign investment by Australian-based multinationals, and leads to collection of tax in foreign countries rather than in Australia. The problem of foreign withholding taxes on dividends was a significant element in one major company's recent decision to move out of Australia.

3.62 The standoff in the application of pre-CGT treaties in the CGT context is the subject of many published articles and many disputes with the ATO. No test case has yet been run to settle the issue, despite the ATO's significant general test case activity in recent years. Australia's international treatment of CGT on shares is a recurring theme in the problems of establishing Australia as a base for internationally-focused companies.

3.63 The majority of submissions stated that while the Tax Treaties Advisory Panel has given advice on a number of technical issues, it meets infrequently compared to other Panels, is often presented with proposed treaty texts where there is little or no room for change, and has little input into major policy matters. Also, its practice does not conform to the new consultation processes recently established for tax legislation. Major OECD countries are much more open than Australia in this regard. For example, more information is publicly available in the US on the 1983 DTA with Australia than is available in Australia.

Policy issues arising from the problems

3.64 Two main models are used in international negotiations of DTAs: the OECD Model Tax Convention, and the United Nations (UN) Model Double Tax Convention between Developed and Developing Countries. The OECD Model was designed for treaties between developed countries whose investment and trade flows over time tend to be in balance among themselves. This Model gives more emphasis to residence taxing rights, because when flows are in approximate balance the same division of revenue is achieved whatever the division of source and residence taxing rights. As one country gives up source taxing rights over residents of the other country, it acquires greater taxing rights over its own residents who can no longer be taxed in the other country through that country giving up its source taxing rights.

3.65 The OECD Model prefers residence taxation to source taxation. This is partly because it is administratively easier and partly because of economic distortions caused by source-based taxes:

- gross basis withholding taxes at source often exceed net basis tax in the residence country, resulting either in unrelieved double taxation, or (more commonly) in charging the withholding tax back to the source country through gross-up provisions in loan and licensing agreements; and

- profits in one source country do not effectively offset losses in other source countries, so that companies get taxed even when they are suffering substantial losses.

3.66 The UN Model Double Tax Convention between Developed and Developing Countries was designed for situations where investment and trade flows are not in balance. This is the typical situation between a developed and a developing country. It gives greater emphasis to source basis taxation to ensure that revenue from trade and investment is shared fairly between the two countries.

3.67 Historically, Australia has been a significant capital importer. Hence its DTA position currently departs from the OECD Model, even though it has been a member of the OECD since 1971. Australia gives greater emphasis to source taxation in a way which is often closer to the UN Model than to the OECD Model.

3.68 As Australia moves towards balance in investment inflows and outflows, the revenue need for source taxation recedes. Even though Australia may remain a net capital importer for many years to come, there will be significant levels of investment outflows as well as inflows. The distorting effects of source based taxes may mean that resulting economic efficiency gains for both inbound and outbound investment will exceed revenue foregone by moving to a residence-based policy for DTAs.

3.69 The recent Protocol with the US has moved more to residence based taxing rights, but still has a considerably greater source-taxing emphasis than the OECD Model.

Potential solutions

Option 3.5: To consider whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future negotiations or whether alternative approaches are preferable

3.70 The Treasury Paper recognised that higher levels of withholding tax may disadvantage Australian companies operating offshore against local competitors, and against competitors resident in countries which negotiate lower withholding tax rates. The rapid growth in Australian direct investment offshore has highlighted the increasing importance of this disadvantage.

3.71 High levels of withholding tax may also detract from Australia's conduit arrangements, as discussed in the 'Conduit income' section in this chapter. The Treasury Paper suggested that Australia might need to change its tax treaty practice to reflect the increasing level of direct investment offshore and the limited use of its withholding tax rights.

3.72 Most submissions which addressed this issue agreed with some or all of the major changes made under the recent Protocol with the US. They included:

- eliminating the DWT for most franked and unfranked non-portfolio dividends;
- reducing the royalty withholding tax rate; and
- reducing the interest withholding tax rate to zero for financial institutions.

Those changes would reduce tax paid by non-residents on Australian-source income, but at the same time reduce the cost to Australian businesses of foreign capital or of accessing foreign technology. They would also mean that when Australian businesses invest in the US, Australia would collect more tax than it currently does on the income they earn.

3.73 As many submissions stated, this approach would facilitate outward and inward investment from and to Australia. A tax treaty policy based on residence taxation, like the OECD Model, would achieve this goal and make renegotiation of major treaties much easier. A tax treaty in OECD form would also override the CGT extension. This should help Australia proceed more speedily with renegotiations of major treaties. However, the Board acknowledges that treaties are bilateral negotiations requiring time and observance of international protocols, and that it is not always possible to reach a speedy conclusion.

Option 3.5: Australia's future treaty practice

Recommendation 3.5:

The Board recommends a move towards a more residence-based treaty policy in substitution for the treaty model based on the source taxation of income.

Option 3.6: To consider whether or not to proceed with the Review of Business Taxation proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets

3.74 Almost all submissions addressing this issue overwhelmingly opposed the proposal that Australia should extend its source taxing rights to gains made by non-residents on the sale of non-resident interposed entities with underlying Australian assets.

3.75 Such a measure would be difficult to comply with and hard to enforce. It would cause inadvertent breaches by creating hidden tax exposure for overseas investors for relatively small revenue gain. It would also harm Australia's international competitiveness by making Australia a less attractive investment destination. Targeting the measure properly would also increase the complexity of the tax law.

3.76 The uncertainty surrounding the operation of pre-CGT treaties also has detrimental effects on investment in Australia.

Option 3.6: Extending capital gains tax to sale of shares in non-resident companies

Recommendation 3.6:

The Board recommends against proceeding with the Review of Business Taxation proposal to apply capital gains tax to the sale by non-residents of non-resident interposed entities with underlying Australian assets.

Option 3.7: To consider which countries should be given priority for tax treaty negotiations, taking into account negotiations underway with the United Kingdom and Germany, the need to update pre-CGT treaties, and countries that Australia may be obliged to approach because of most favoured nation clauses in existing treaties

3.77 Once the US Protocol takes effect, Australia will be obliged by its tax treaty with eight countries to enter into negotiations with a view to treating them in the same way as those countries with which Australia has a most favoured nation (MFN) clause on rates of withholding tax. The countries are the Netherlands, France, Switzerland, Italy, Norway, Finland, Austria and the Republic of Korea.

3.78 Australia is currently negotiating tax treaties with several countries, including the UK and Germany. If these treaties include a non-discrimination article, then Australia will be obliged to enter into negotiations for a similar article with France, Finland, Republic of Korea, Spain and South Africa, and also in relation to the agreement between the Australian Commerce and Industry Office and the Taipei Economic and Cultural Office. Australia has a MFN clause on a NDA with these countries.

3.79 The obligation to enter into negotiations presents an opportunity to quickly negotiate new treaties or protocols which would clarify Australia's right to apply capital gains tax. It would also be possible to include elements of the US Protocol, such as zero or low rates of tax for permitted dividend withholding.

3.80 The submissions noted that most favoured nation clauses in many of Australia's important DTAs would influence priorities, and that Australia should swiftly seek to renegotiate these DTAs along lines consistent with the recommendations concerning Australia's future DTA policy. Most submissions considered that Australia's priority for tax treaty negotiation should be its major investment partners. Generally, the most important countries are covered by existing negotiations or obligations likely to be triggered by those negotiations. Those negotiations would also deal with most of Australia's pre-CGT treaties, so that uncertainties in this area could be resolved for the future.

Option 3.7: Priorities in negotiation

Recommendation 3.7:

The Board recommends that the Government set the following priorities:

(a) review and keep the key country treaties up to date and in line with Recommendation 3.5; and

(b) enter into treaty negotiations with other countries in the order of most important investment partners with Australia.

Option 3.8: To consider options to improve consultation processes on negotiating tax treaties

3.81 Most submissions agreed that effective consultation arrangements between Australian business, other interested parties and Treasury are important in achieving successful and timely DTA negotiations, and in improving the transparency and effectiveness of the current processes.

3.82 Many submissions noted that stakeholders are invited to comment only after the negotiation process is almost complete, and that the discussions are often about technical wording rather than policy issues.

3.83 The Board agrees that Australia would benefit from following best practice on consultation in the DTA area, in the same way as it does for tax legislation and as other countries do for treaties. Although the way in which such a process will operate in individual cases will always vary, it is important to establish clear guidelines. The Tax Treaties Advisory Panel could be maintained as the forum for such consultation. However, the Panel would be improved by:

- more frequent meetings;
- input into formation of basic policy as well as technical details;
- flexible membership, to allow affected taxpayers to be consulted on relevant treaties; and
- publishing Australia's model tax treaty.

Option 3.8: Improving consultation arrangements

Recommendation 3.8:

The Board recommends that the consultation processes on negotiating tax treaties be improved by adopting processes similar to those of the Board's consultation report as adopted by the Government for domestic tax legislation.

Conduit income

Policy objectives

3.84 Conduit income raises two related policy issues:

- whether the CFC and foreign tax credit/exemption rules are too complex and impose unduly onerous compliance costs on business, are out of step with modern business practice, and negatively affect decisions to locate in Australia; and
- the adequacy of the current conduit rules and their impact on the establishment of regional holding companies in Australia.

Current law

3.85 The current treatment of dividends from foreign companies is very complex, depending on the following factors:

- whether the dividends are portfolio or non-portfolio;
- whether the dividends are received by a company or other taxpayer;
- whether the dividends are received from a company resident in an unlisted country or a listed country;
- whether the dividends are paid out of income that has been attributed under the CFC regime; and
- whether the dividends are subject to withholding tax in the foreign country.

3.86 Depending on these factors, the dividends may be exempt, partially exempt, subject to a foreign tax credit in whole or part (and relating to underlying corporate tax, or dividend withholding tax, or both), or simply taxable. Most dividends paid to Australia are received by Australian companies from non-portfolio interests in foreign companies. They are generally exempt from tax if they are paid by companies resident in either BELCs or LELCs. The exemption does not generally apply to dividends received directly (or in some cases indirectly) from unlisted countries.

3.87 On the inbound side into Australia, unfranked dividends paid to non-resident owners are generally subject to DWT (usually reduced by treaty to 15 per cent). Some recent treaties adopt lower rates of tax on non-portfolio dividends paid to companies, most notably zero in certain cases under the US Protocol. The withholding tax on unfranked dividends is not payable if the dividend can be traced through an accounting mechanism contained in the tax legislation — foreign dividend account (FDA) — to non-portfolio dividends received by the Australian company from offshore. The FDA currently records only non-portfolio dividends. The purpose of the account is to allow an Australian company to pay unfranked dividends to non-resident shareholders without the imposition of withholding tax, subject to rules which prevent streaming of the account only to such shareholders.

3.88 Capital gains derived by resident companies from disposal of non-portfolio interests in foreign companies are subject to tax; so are gains by non-residents on non-portfolio interests in Australian companies.

3.89 In a broad sense, these treatments of dividends and capital gains are replicated offshore under Australia's CFC regime.

Problems

3.90 The complexity of the current rules for dividends from foreign companies is obvious even from this brief description. Where possible, companies respond by paying dividends which are exempt in Australia from countries which do not levy withholding tax on the dividends; otherwise, dividends are unlikely to be paid to Australia. Where a company's financial position forces it to pay substantial amounts of dividends to Australia from foreign subsidiaries which are subject to significant levels of withholding tax, then it may consider moving offshore. This is because the withholding tax generally operates as an additional tax impost on the company and ultimately on shareholders arising simply from residence in Australia. For similar reasons, companies may be reluctant to locate in Australia.

3.91 Because Australia potentially taxes incoming and outgoing dividends, Australian tax may be levied on conduit income passing from offshore through an Australian company to a non-resident. Interposing the Australian conduit affects the tax outcome. For some dividends, this problem is overcome through the exemption for non-portfolio dividends and the FDA. However, this is not the result in some potentially common cases. For example, if a US company were to set up a JV company in Australia with an Australian company for investing in the Asia-Pacific region, dividends from a Hong Kong subsidiary of the JV would be subject to corporate tax in Australia. Dividends paid by the Australian JV company which were franked would not be subject to withholding tax, and would give rise to franking credits for the

Australian participant in the JV company. Dividends paid out of the FDA would also not be subject to withholding tax, but would be unfranked dividends for the Australian participant and subject to corporate tax at that level. Other dividends paid by the JV company (for example, out of profits of a branch in Hong Kong) would be subject to dividend withholding tax in the hands of the US joint venturer.

3.92 For capital gains on shares in either an offshore subsidiary of an Australian company, or an Australian subsidiary of a foreign parent, there is no attempt to provide any tax relief. Capital gains on shares in controlled companies often represent retained income. To the extent that the profits are paid out as dividends from a foreign company resident in a listed country, or by an Australian subsidiary to a US parent, the profits would not be subject to tax in Australia. This differential treatment of dividends and capital gains is difficult to justify.

3.93 As a result of the treatment of dividends and capital gains on non-portfolio interests in companies into or out of Australia, Australia has not developed as a favoured conduit or headquarter location.

3.94 While the dividend situation is to a degree dealt with in the tax law, conduit treatment does not apply to exit from investments (either offshore subsidiaries of the Australian conduit, or the foreign parent from the Australian conduit).

3.95 In the CFC regime, the complexity of the treatment of dividends and capital gains was considered necessary to prevent movement of profits from companies resident in unlisted countries to companies resident in listed countries.

Evidence of the problems

3.96 The LELC category was created in 1997 when listed countries were separated into BELCs and LELCs. Approximately 88 percent of non-portfolio dividends currently paid to Australia are from BELCs, 9 percent from LELCs, and 3 percent from unlisted countries.

3.97 Very little revenue is thus collected on dividends repatriated to Australia from unlisted countries. In addition, the amount of dividend income from LELCs is small — even though it is exempt. Yet Australian companies and their offshore CFCs incur large compliance costs in tracking the various kinds of dividends and in making deduction allocation and foreign tax credit calculations.

3.98 Many large companies with significant amounts of foreign income have examined their dividend position under the system for relief of double taxation in combination with their imputation position. The prevalence of exempt dividends indicates how they approach dividend policy. The result is a considerable constraint on capital management by Australian-based companies. In extreme cases, companies may move out of Australia.

3.99 Australia has had little success in attracting holding companies and regional headquarters. In the late 1980s and early 1990s, the private sector made a concerted push to make Australia an attractive location. The government gave some ground to the push and introduced a number of tax measures, including some relating to offshore banking units, regional headquarters, and the FDA. However, the private sector regarded the measures as inadequate.

Policy issues arising from the problems

3.100 In common with most countries, Australia levies tax on a source and residence basis. This is relatively easy to apply in the case of individuals. However, in the case of entities such as companies the application becomes complex, for two reasons. The first is the problem of double taxation of dividends. The second is that determining the residence of companies is not as simple as for individuals. For the first problem, mechanisms are put in place such as imputation, and the exemption of dividends from foreign subsidiaries, or underlying tax credit for such dividends. For the second problem, the appropriate policy would be to base the residence of a company on that of its ultimate owners; but to trace ownership through many tiers of entities is not practical, and in any event the ultimate owners will often be resident in several countries.

3.101 Hence, it is common to use a 'management' or 'place of incorporation test'. As these tests can be manipulated, they are backed up by measures such as CFC and FIF regimes. Where FSI is derived by a company resident in Australia under these tests, but the owners of the company are non-residents, Australia is generally considered to have no real tax claim.

3.102 Partly for this reason, the OECD Model tax treaty ensures that little or no tax is levied on dividends or capital gains on non-portfolio interests in companies held by non-residents.

3.103 In addition, many countries in their tax law or treaties provide an exemption for the foreign-source dividends and capital gains received by their residents. The purpose is to avoid international double taxation (given that the underlying profits will have been subject to corporate tax). These measures are supported on the policy basis of CIN — that is, that the company should be subject to the same tax level as its competitors in the countries where it operates, either through branches or subsidiaries. As noted previously, this is the general policy basis underlying Australia's CFC regime.

3.104 The combination of these policies also produces a conduit situation — that is, foreign income passes through a country to non-resident owners without tax in a direct investment situation. Unless appropriate policies are adopted, it becomes necessary to create special rules to deal with conduit situations. The FDA serves this purpose in current law for outgoing dividends (there is no relief for capital gains). But the FDA covers only incoming dividends; it does not cover other FSI. The RBT recommended that other income be covered by the account, so that conduit treatment is also possible for other types of foreign income such as foreign branches.

Potential solutions

Option 3.9: To consider abolishing the limited exemption country list and provide a general exemption for foreign non-portfolio dividends Australian companies receive and (subject to some existing exceptions) for foreign branch profits

3.105 Clearly, any simplification of the current maze regulating the taxation of foreign dividends will be an advantage. In view of the small amount of tax collected on dividends from companies resident in unlisted countries, and the small amount of dividends received from LELCs, there is a strong case on compliance grounds alone for exempting all non-portfolio dividends received by Australian companies. In policy terms, such a change would also produce greater consistency for foreign income. Active income would be subject to CIN at the corporate level — that is, it would be taxed only in the country of source. Low taxed passive income would be subject to attribution under the CFC regime.

3.106 This policy and compliance approach could greatly simplify the system. Non-portfolio dividends received by Australian companies from foreign companies would be exempt from tax in all cases, with no credit for DWT. All other dividends would be subject to tax, with credit for foreign DWT only.

3.107 This change would also greatly simplify the CFC regime. It would lead to abolition of the LELCs, the only listed countries would be BELCs. Complex rules dealing with disguised distributions from CFCs resident in unlisted countries would no longer be necessary. Further, the exemption would be extended to offshore dividends under the CFC regime, as concerns about moving profits from unlisted to listed countries would no longer arise. Non-portfolio dividends received by CFCs would also be exempt from attribution. Finally, it would no longer be necessary to record and track (through tiers of companies) dividends that are paid out of attributed income under the CFC regime.

3.108 As the treatment of foreign branch profits largely parallels the treatment of CFC income, all foreign branch income would similarly become exempt, except for low taxed passive income.

Option 3.9: General exemption for non-portfolio dividends

Recommendation 3.9:

The Board recommends providing a general exemption for foreign non-portfolio dividends received by Australian companies and their controlled foreign companies and (subject to some existing exceptions) foreign branch profits.

Option 3.10: To consider options to provide conduit relief for Australian regional holding and joint venture companies, including considering the benefits and costs of introducing a general conduit regime providing an exemption from the sale of non-portfolio interests in a foreign company with an underlying active business; and providing conduit restructure relief

3.109 Constructing a targeted conduit regime is fraught with difficulties:

- if not limited to wholly-owned situations, there are significant problems of complexity and risks of leakage;
- if limited to wholly-owned situations, not all the necessary cases will be covered; and
- in either event, there may be problems in meeting forthcoming OECD guidelines on harmful tax practices for what is an acceptable conduit or headquarter regime.

3.110 Also, conduit restructure relief represents a complex and backdoor solution to the problem of conduit income. It would require parties to enter into additional transactions which, though effective under Australian domestic law (as amended under this proposal), may create tax problems under foreign law.

3.111 A systemic solution is therefore to be preferred. Such a solution is possible, consistent with policy developments discussed elsewhere in this report. The solution would also significantly simplify the CFC and related rules.

3.112 The following measures, for example, would in essence achieve a conduit regime without undue complexity:

- exempting certain dividends paid into Australia — see Recommendation 3.9 and exemption available under section 23AJ;
- exempting dividends paid out of Australia — DWT and foreign income account (FIA);

- CGT exemption for sale by an Australian resident of a non-portfolio interest in a foreign company that has an underlying active business — see Recommendation 3.10(2);
- simplifying the CFC regime (exemption for CFCs in relation to income from BELC) — see Recommendation 3; and
- exempting non-portfolio gains on shares in Australian companies — see Recommendation 3.11(2).

3.113 On the CGT side, the solution involves exempting capital gains on direct investment in foreign companies, whether in listed countries or not. Along with this, any capital gain so exempted would then qualify for FIA treatment. This change would parallel the solution in relation to the previous option of exempting all non-portfolio dividends received from foreign companies. The potential simplifying power of these two changes is very significant. They would allow the removal of a significant part of the CFC and associated legislation: potentially sections 23AI, 23AJ, 47A, 422, 423, 457, 458, 459, 459A, Part X Divisions 4, 5, 6, 10 of the 1936 Act. Exemptions would also need to be inserted for capital gains offshore between CFCs in a similar way for dividends. Simplification would flow into the underlying foreign tax credit (FTC) provisions and other parts of the legislation.

3.114 The Treasury paper canvasses whether the CGT exemption should be limited to shares in companies which pass the active income test. The Board considers that this is necessary, but that it should be done on a time-apportionment basis. That is, shares would be regarded as active assets so long as the CFCs effectively disposed of in the sale passed the active income test for at least half of the time they were held by the taxpayer or its associates. This limitation should not prevent the removal of the provisions above (which at the moment do contribute to the CGT calculation where companies do not pass the active income test). Rather, a provision should be inserted that, if the capital gain is taxable, CGT applies only to the extent that it reasonably reflects gains on the assets producing the income which caused failure of the active income test, and reduced by any foreign tax liability in respect of those assets. The interaction of Recommendation 3.10(2) and other recommendations contained in this report, for example Recommendation 2.1, will need to be further considered.

Option 3.10: Conduit relief for Australian regional holding and joint venture companies

Recommendation 3.10(1):

In view of the taxation relief available on certain dividends passing through Australia, and of the Board's recommendations in 3, 3.9, 3.10(2) and 3.11(2), the Board recommends that a separate conduit regime not be developed at this stage.

Recommendation 3.10(2):

The Board recommends that there should be a capital gains tax exemption for the sale by an Australian resident company or its controlled foreign companies of a non-portfolio interest in a foreign company that has an underlying active business.

Recommendation 3.10(3):

The Board recommends that any capital gain by an Australian resident company exempted as a result of Recommendation 3.10(2) would incur no withholding tax if passed to non-residents consistent with the policy intent of the Board's other recommendations on conduits.

Option 3.11: To consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1

3.115 The discussion of this option has to be considered in the light of Recommendations 3.9 and 3.10(1) to (3). The nature of a FDA or FIA will depend on the purpose or purposes to which it is being put. Chapter 2 recommended that a 20 per cent tax credit be attached to dividends paid out of foreign income and that companies be allowed to stream dividends out of foreign income to foreign shareholders. So far as the FIA is used to support a credit for Australian resident shareholders, it is not appropriate to include such types of income as royalties or interest received from unrelated parties. This is because the account deals with income from direct investment.

3.116 The FDA currently is part of limited conduit arrangements. In the form of an FIA, it will still be used for conduit type treatment of dividends under the streaming proposal in Chapter 2 (see paragraph 2.45). However, Australia is moving to a treaty policy of exempting non-portfolio dividends from Australian withholding tax, as in the recent US Protocol. This treatment goes beyond conduit relief (as it also covers dividends out of Australian source profits). But the adoption of the previous two recommendations will effectively provide conduit relief for non-portfolio dividends from foreign companies (Recommendation 3.9) and capital gains on non-portfolio interests in foreign companies conducting an active business (Recommendations 3.10(2) and 3.10(3)). Again, the Board considers that broader systemic measures of this kind are more effective than a specific regime to achieve conduit relief. Therefore, it was not considered necessary to include any other form of foreign income in this recommendation. With respect to allowing the tax free flow through of foreign income amounts along a chain of Australian companies, the Board has had insufficient evidence put to it on whether the benefits outweigh the revenue cost and other integrity issues for it to determine whether it should make a recommendation. The Board believes that further work should be undertaken to establish the viability of such a proposal.

3.117 Consistent with the principle underlying conduit income flows, consideration of conduit capital gains is also necessary. There is a strong argument supportive of an exemption of the capital gains on direct investments. This is in fact the international standard under tax treaties. It recognises that any income generated by non-resident investment in Australia should be taxed here, being the country of source, as and when the income is derived. However, any capital gain accruing to the investor reflective of possible future income flows, more appropriately falls to be taxed in the investor's home country. A consequence of such a policy avoids imposing local tax impediments to both the initial investment commitment as well as to future ownership changes that may in fact prove favourable from a local efficiency, technology and management perspective.

3.118 There are questions about how such treatment should be achieved. One possibility is through future tax treaties. The treatment would be available only for treaty partners, and only on condition that Australian companies receive reciprocal treatment in the foreign country. As it would take some time for the treaty network to cover the main countries from which conduit investment into Australia is sourced, in the short term the treatment could be legislated into domestic law for investors resident in BELCs. The purpose would be to ensure that Australia is not used as a conduit to lend respectability to pure tax haven activities. The CFC regime and other features of the tax system of the BELC would be relied upon to ensure continuing integrity in the system.

3.119 While this solution in relation to non-resident investors achieves conduit treatment, it also goes further. It exempts the investor for capital gains generated by the Australian activities of the Australian company. As noted above, it is already possible to achieve this by disposing of shares in a foreign company which holds the Australian assets directly or indirectly. The Board recommends on practical grounds against extending the CGT to such cases. Viewed from this broader perspective, Australia would be relying on its corporate tax system to ensure that Australian activities of the direct investor are appropriately taxed, just as it relies on the tainted income rules in the CFC system to ensure that low taxed passive foreign income does not escape Australian taxation.

3.120 The interaction between the consolidation regime and this option may need further consideration in order to ensure that any capital gain on the Australian assets is ultimately taxed on disposal of the assets (as compared to the company in which the shares are held).

3.121 In addition, the exemption of sales of shares in CFCs held by residents and sales of shares in Australian companies held by non-residents would require measures to prevent Australian residents acquiring Australian companies through CFCs (that is, by looping the investment through a foreign company). This can be achieved by denying the exemption for sales of shares in CFCs operating active businesses in Australia (where the Australian assets form a significant part of the CFC's assets). Further, if a CFC sold directly or indirectly a non-portfolio interest in an Australian resident company, the profit or gain on the sale would be subject to tax in the hands of the Australian controllers, provided the Australian assets form a significant part of the value of the shares sold.

Option 3.11: Adoption of a foreign income account as recommended by the Ralph Review

Recommendation 3.11(1):

The Board recommends proceeding with the foreign income account rules recommended by the Review of Business Taxation as they apply to direct investment flows (such as non- portfolio dividends and branch profits but excluding capital gains, portfolio dividends or similar types of income such as interest and royalties).

Recommendation 3.11(2):

The Board recommends an exemption of capital gains made by non-residents on the disposal of shares comprising non-portfolio interests in Australian companies be provided by treaty, on a treaty by treaty basis. To the extent that these companies hold land in Australia, the same look through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.

Company residence

Policy objectives

3.122 To assist in establishing Australia as a centre for internationally-focused companies, it is necessary to have clear, practical and internationally-acceptable rules for company residence. It is also necessary to resolve issues that arise when a company is a dual resident, that is, treated as a resident in two or more countries under the respective countries' tax laws.

Current law

3.123 Under current law, there are three alternative tests of Australian residence for companies:

- incorporation in Australia;
- central management and control and carrying on business in Australia; and
- majority ownership of shares by Australian residents and carrying on business in Australia.

3.124 It is possible for a company to be resident in more than one country where countries have different tests or a multiplicity of tests — for example, incorporation in one country, and management in another country. Tax treaties solve the problem of dual residence (but only for the purposes of the treaty) by a tie-breaker which allocates the company to one or other country. The OECD Model uses the place of effective management for this purpose; so does Australian law. In addition, Australia has several rules in domestic law for dealing with dual resident companies in specific situations, such as the CFC regime and doubling up on interest deductions.

Problems

3.125 Many submissions argued that the 'central management and control' test creates uncertainty. Under this test, residency could depend on where the board of directors makes its decisions. This leads to stage-management of board meetings of companies which operate in a number of countries and have top management distributed among those countries.

3.126 Another complication is introduced by an early High Court case which held that a company which is managed in Australia is likely to carry on business here. This has the potential to make foreign subsidiaries of Australian companies resident in Australia, even though the subsidiaries are incorporated and operate outside Australia. To prevent this possibility, Australian companies may deliberately seek to appoint a majority of directors resident in the country of incorporation of the subsidiary and hold board meetings there. In practice, however, these directors are likely to closely follow the views of the Australian parent company, thus leaving the place of management unclear.

3.127 The 'treaty' test will not clarify the problem of foreign subsidiaries if they are regarded as managed in Australia. Further, even a treaty tie-breaker applies for the purpose of the treaty only, and so does not deal with all potential cases involving residence of companies. The OECD is currently seeking a solution to the uncertainty inherent in the test. The additional Australian rules on these and other issues result in a complex mosaic of corporate residence tests under Australian tax law.

Evidence of the problems

3.128 Some prominent Australian multinational groups indicated the difficulties they encounter over management-residence issues, particularly in relation to the board of the parent. The residence of subsidiaries is also an ongoing problem for companies, even where no problem exists at the parent level in Australia. The management test imposes considerable rigidity on dual listed company (DLC) structures also.

Policy issues arising from the problems

3.129 As noted above in relation to conduit income, residence tests for companies necessarily represent a departure from the policy ideal — an ideal which would be based on ultimate ownership of companies. As a result, countries generally adopt residence tests based on incorporation and/or management and then use various other measures to deal with problems to which these tests give rise. The main objective of the company residence test should be to produce certainty and ease of operation.

Potential solutions

Option 3.12: To consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business

3.130 The simplest solution would be to adopt the place of incorporation as the sole residence test in Australia. The recommendations in the earlier part of this chapter, and in other chapters make the test of corporate residence much less of a concern in ensuring the proper operation of the international tax system. The US adopts a place of incorporation test, but it is currently having some concerns as a result of corporate inversions — tax motivated transactions which substitute a tax haven incorporated parent for the US incorporated listed parent company, often at some tax cost. The result is to move residence of the parent out of the US even though it is still managed there and its operations otherwise remain unchanged.

3.131 The place of incorporation test would equally apply to the initial incorporation of a company outside Australia where the company is managed and controlled from Australia.

3.132 The problem arises in the US for three key reasons. First, foreign branch profits and dividends derived by the US parent from its foreign subsidiaries are subject to US tax (with a credit for foreign taxes paid). Second, the US has a comprehensive CFC regime. Third, because the US has no imputation system, the dividends paid by the US parent to its US individual shareholders are taxed. Factors one and three do not exist in Australia.

3.133 The shareholders of the Australian parent currently gain imputation benefits for Australian tax paid by the Australian parent. If the Australian parent company is moved offshore, the shareholders will lose those benefits.

3.134 Finally, many of the Board's other recommendations will remove residual tax impediments for both the Australian companies and their shareholders. For example, credits are recommended in Chapter 2 for certain foreign profits and Australia's existing CFC regime is to be simplified.

3.135 On balance, there would be little incentive to moving offshore. There would also be substantial disincentive in the form of loss of imputation benefits. Thus, for Australian based companies the US concerns with "inversions" are largely unfounded. For this reason, the Board recommends that in the interests of certainty for taxpayers and ease of administration, the test for residency be based solely on incorporation.

Option 3.12: Residence of companies

Recommendation 3.12:

The Board recommends that a company should be regarded as resident in Australia only if it is incorporated in Australia.

Option 3.13: To consider whether a company that is a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of the income tax law, as an alternative to the current dual residency provisions

3.136 Various tax-planning possibilities arise when a treaty tie-breaker applies to a dual resident company. Australian law currently deals with a number of these through specific provisions in domestic law. A number of other countries deal with the issues by projecting the treaty tie-breaker into domestic law — that is, a dual resident company ceases to be a resident under domestic law if a treaty allocates it to another country. This is a simpler and more comprehensive solution than Australia's current law provides.

3.137 However, as the tie-breaker is based on a management test, it can create the same kind of uncertainty mentioned above for DLCs and listed companies with directors distributed around the world. The OECD is currently working on a solution for this problem, which Australia should consider in due course. In the meantime, problems arising from the management test for DLCs and other listed companies could be dealt with by treaty as necessary. At the moment, the problem arises mainly in relation to the UK.

3.138 The submissions made very few comments on this issue. However, those submissions which did discuss the issue favoured excluding dual resident companies from resident status if the tax treaty allocated their residency to the other country. Given the Board's Recommendation 3.12, this is likely to be an issue mainly where an Australian incorporated company is managed from offshore. Such circumstances tend to be rare in practice and may often be motivated by the tax advantages of obtaining Australian tax residency. In these circumstances, if the relevant tax treaty treats the entity as a non-resident of Australia, it would seem appropriate to do so for all income tax purposes. Moreover, this is generally consistent with the intent of the existing dual residency rules.

Option 3.13: Dual residents

Recommendation 3.13:

The Board recommends that a non-resident for treaty purposes should be treated as a non-resident for all purposes of income tax law, as an alternative to the current dual resident company provisions.

Administration and integrity issues

3.139 Exemption for BELCs from the CFC rules would lessen complexity by removing a number of taxpayers from the CFC rules. During the legislative design phase consideration may need to be given to certain integrity issues.

3.140 Removing tainted services from the CFC regime would generally bring compliance and tax benefits. However, there could be some compliance and administration costs associated with the need to identify and address services that raise integrity issues. The extent to which these services can be practically identified and addressed will determine the impact of the recommendation on the integrity of the tax system.

3.141 The recommendation not to proceed with the conduit regime would have no impact on tax administration.

3.142 The incorporation test would provide greater certainty and reduce complexity. Integrity issues associated with this recommendation are expected to be minimal. Of course, any change will need transitional measures.

3.143 The recommendation that rollover relief be available for corporate restructuring of CFCs not resident in a BELC, where the restructuring is covered by, and done in accordance with, the tax law of the country concerned, will present administration difficulties because it will be based on the tax laws of other countries.

The recommendation may also require integrity measures to ensure the appropriate gain is captured when the asset leaves the economic group.

3.144 The recommendation to develop and publish criteria for declaring further countries as BELCs will entail monitoring a BELC's compliance with the criteria. Recommendation 3 concerning non-attribution in BELCs will increase the relevance of ensuring that the BELC list consists of tax-comparable countries.

CHAPTER 4: PROMOTING AUSTRALIA AS A GLOBAL FINANCIAL SERVICES CENTRE

Foreign investment funds

Policy objectives

4.1 The Board's review examined claims that the foreign investment fund (FIF) rules are complex and impose significant compliance costs on business, are out of step with modern business practice, and negatively affect decisions to locate in Australia compared to countries with less stringent rules or no such rules.

Current law

4.2 The FIF rules apply to Australian residents that invest in certain foreign companies, trusts and life policies. They are structured so as to initially include all such investments, and then carve out a large number of exemptions. The relevant exemptions are:

- controlled foreign companies (CFCs);
- companies carrying on active businesses (defined in such a way to leave a number of active businesses within the regime);
- foreign banks and insurance companies;
- certain foreign real property companies;
- certain United States (US) mutual funds;
- investments worth less than $50,000;
- investments of certain expatriates;
- foreign employer-sponsored superannuation funds;
- share traders;
- certain foreign conglomerates;

- interests which are less than 5 per cent of the investor's overall FIF portfolio (the balanced portfolio exemption); and
- certain interests in Lloyd's syndicates.

4.3 Most offshore portfolio investments by Australian resident individuals are not held directly but indirectly through Australian retail or wholesale unit trusts or superannuation entities. This fact, combined with the $50,000 de minimis exemption, means that the major impact of the FIF measures in Australia is on the funds management (including superannuation) industry. The rules are also projected into the measurement of attributable income of CFCs. Hence, if a CFC enters into a joint venture where it has less than a 50 per cent interest, it must also navigate the FIF rules; this is a common situation especially in the property industry.

4.4 An investment that is caught by the FIF rules is taxed on an attribution basis — that is, Australian residents are taxed whether or not they receive any income distribution from the FIF. There are three methods of taxation: the mark to market method, which is commonly used for marketable securities; the calculation method, which is a simplified version of the CFC calculation of income; and the deemed rate of return, where a high rate of return is simply deemed to have been derived.

4.5 Investors caught by the regime must keep complex records for each FIF in which they are invested, in order to prevent double taxation of income when they sell their investments in the FIF. Australian fund managers must keep a separate account for each investor in the Australian fund in respect of each FIF investment held by the fund. For tax purposes, income from FIF investments is accounted for at the level of each investor in the Australian fund (or if the investor is itself another Australian fund, at the level of investors in that fund, and so on through further levels of trusts and partnerships).

Problems

4.6 The FIF rules suffer from a major structural problem as well as a myriad of specific problems.

4.7 The major structural problem is that they include everything within their ambit, and then carve out certain activities. This gives rise to a number of unintended consequences.

4.8 The specific problems include:

- the desired portfolio mix of many fund managers in Australia has higher proportions of FIF interests with attributable income under the FIF regime than the balanced portfolio exemption permits. This is often a reflection of the FIF regime's over-broad coverage. Rather than experience attribution on the entire portfolio, the fund managers rebalance the portfolio at the end of each financial year solely to meet the balanced portfolio exemption;

- there is no provision for removing from the regime funds that track stock market indices;
- for offshore superannuation funds, only employer-sponsored funds are exempt from being FIFs. Industry funds, do it yourself funds, and rollover entities are not exempt, even though in their home country they may be subject to the same kinds of rules as our rules to prevent abuse of the tax system (vesting, preservation, and the like);
- the FIF regime taxes unrealised foreign capital gains without the capital gains tax (CGT) discount, whereas this does not occur for domestic investments;
- complex loss rules leave many investors with income taxed and no offset for losses; and
- very high compliance costs arise from the complex rules for characterising investments, calculating FIF income, and the separate accounting required.

Evidence of the problems

4.9 Most fund managers (including superannuation entities) adjust foreign investment portfolios significantly just before relevant year-ends to meet the balanced portfolio exemption, and reverse the transactions shortly thereafter. This incurs significant transaction costs and so lowers returns for investors. The tax and other costs of doing this are substantial, but they are less than complying with a massive record-keeping burden which the application of the FIF regime would impose on funds.

4.10 The FIF regime makes certain investment strategies very difficult (such as tracking foreign indices). It becomes necessary to set up mirror funds in Australia to try to overcome the problems, thereby increasing costs or discouraging particular investments. Australia is not usually a large enough market to support a mirror fund economically. Hence, returns are reduced by unnecessary costs, or investments are simply not made.

4.11 The government found it necessary to amend the rules to remove certain US mutual funds and Real Estate Investment Trusts (REITs) from the regime. This was because the regime was making it impossible to manage substantial investments by Australian funds in the property sector (in particular, in the US), putting Australian companies at a substantial competitive disadvantage in the US. The result now is a bias in favour of investment in US funds rather than funds in other countries, particularly the UK. Apart from the advantage this gives to US fund managers, it leaves investments in other countries with similar problems as previously applied in the US.

Policy issues arising from the problems

4.12 The FIF regime is intended to target passive income of foreign entities which Australian residents do not control and which accumulate their income. Investment of this kind can produce two tax benefits: (1) deferral, as foreign income of foreign entities is not taxed on a current basis in Australia; and (2) conversion of income to capital gains by sale of the investment in the foreign fund rather than distribution of the accumulated income. The FIF rules remove these benefits by taxing increases in value of the foreign investments as income on an annual basis.

4.13 The rules target two kinds of situations, rather than one. This gives rise to problems of over-inclusiveness, flowing partly from trying to achieve differing policy objectives:

- taxation of direct investment which falls below the control threshold of the CFC rules — that is, as a backup CFC regime; and
- taxation of portfolio investment in accumulation funds.

4.14 Further, the rules do not attack accumulation of passive income directly, but seek to exclude cases where accumulation is not a possibility. This is a policy failure similar to that discussed above for the CFC regime. Rather than identify and target specifically what is intended to be caught, the rules cover everything and then create exclusions based on situations where no potential abuse is possible. The effect is to catch investment strategies that often have little to do with accumulation of income. Tracking foreign indices is an increasingly popular investment strategy for balancing risk and return, as studies suggest that no fund manager can outperform the market long-term. It is hard to see any mischief in such accumulation funds.

4.15 Finally, the rules are based on the paradigm investor being a high income individual with much to gain through deferral and conversion to capital gains. But superannuation entities in particular do not fit this paradigm — they are taxed at a low rate and receive only a one third discount on capital gains. Also, companies do not enjoy the CGT discount, and indexation is frozen as of 30 September 1999; hence, the only benefit available to companies is deferral.

4.16 Since the FIF rules were introduced, fundamental shifts have occurred in the Australian economy. The amount of funds under management, especially in superannuation, has increased exponentially — certainly more than the growth in the Australian equity markets. Australia offers fewer investment choices than international markets, relative to the large amount of funds available. Further, portfolio management of Australian-sourced funds is now viewed globally rather than in the

Australian context only. The enormous growth in portfolio investment overseas, noted in Chapter 1 of the Treasury Paper, reflects this trend. Australia cannot afford rules that are biased against investment overseas. Taxation of unrealised gains under the FIF rules should be confined to cases where it is absolutely necessary to remove a tax bias that would otherwise favour investment overseas. Though intended to remove a tax bias in favour of overseas investment, the rules in fact end up going much further.

4.17 Australia is not alone in experiencing the trends mentioned above. While the explosive growth in offshore funds (that is, funds that encourage investment from residents of other countries) is partly explained by tax motivations of deferral and conversion, it is equally explained by the growth and globalisation of funds available for investment. The location of offshore funds in tax havens or in jurisdictions with favourable regimes does not of itself indicate a growth in tax avoidance. Often, only by such a conduit can tax-neutral treatment of foreign portfolio investment be achieved.

4.18 Australia operates a flow-through regime for collective investment at the domestic level (that is, no tax is levied on the fund). Often the only way to achieve the same outcome offshore (where problems are experienced with different characterisation of entities, taxes on the investment funds and withholding taxes), is to locate the fund in a favourable jurisdiction.

4.19 Nonetheless, a number of offshore funds are clearly designed to accumulate income and convert it to capital gains. Thus, it is necessary for tax purposes to formulate criteria for distinguishing funds.

Potential solutions

4.20 In describing potential solutions, the Board is conscious that some of the terms it has employed do not precisely reflect the terminology of the tax law. Some of the Board's terms may need to be refined during the legislative development process.

Option 4.1: To give longer term consideration to a replacement of the current foreign investment fund rules to provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers

4.21 The submissions argue strongly for an urgent rewriting of the FIF rules.

4.22 As for the CFC regime, more immediate solutions are possible — solutions that leave certain elements of the current FIF regime generally intact, but greatly simplify or remove parts of it. Suggestions made in submissions to this end include:

- limiting coverage to an offshore accumulation entity — that is, to a fund that does not carry on a trading business, pays tax on its worldwide income at a rate less than 20 per cent, and distributes less than 50 per cent of income and realised gains over a three-year period;

- removing from the FIF regime Australian funds managers who meet the following criteria that are in part the requirements under the *Corporations Act 2001* for managed investment schemes (MISs):

  – the taxpayer is a registered MIS or a life company registered by Australian Prudential Regulation Authority (APRA);

  – if the taxpayer is not a life company, it is a fixed trust;

  – the entity is a resident of Australia for tax purposes. Further, if the entity is a MIS, its Responsible Entity is also an Australian resident, and trust administration is performed in Australia;

  – if the entity is a trust, it is not subject to tax as a company; and

  – the Australian Taxation Office (ATO) has not issued a notice to the entity to the effect that the trust or life company product is not considered to be a genuine public offer vehicle;

- exempting investments into broad-exemption listed countries (BELCs). As these countries have comparable tax rates, a comparable tax base and their own attribution regimes, there is little scope for an offshore accumulation entity to be resident there. An exception to this exemption would apply where the entity invested into is exempt from tax in the BELC and does not have a requirement to distribute its income and realised gains. This is an extension of the current exception for investments in certain US entities; and

- exempting investment in an entity that is bound to distribute its income and realised gains, whether by its constitution, its offer documents, the laws of any country, or any other means.

4.23 Measures of these kinds would largely remove the Australian funds management industry from the FIF regime, while protecting the Australian tax system from exploitation in the form of foreign pure accumulation funds. The benefits would significantly boost the funds management industry, by removing several disadvantages, which at present reduce the global competitiveness of funds management. In particular, the measures would:

- eliminate the wastage associated with year-end sales;

- eliminate the classification costs in relation to FIF interests;

- eliminate the custody costs associated with year-end checking to ensure compliance with the 5 per cent balanced portfolio exemption;
- eliminate the costs of attempting to maintain attribution accounts for individual investors;
- maintain parity between direct and indirect investment into overseas equities;
- eliminate the unintended FIF issues that can arise from direct investment into overseas-listed entities;
- eliminate the need to maintain costly 'mirror' funds; and
- provide a framework for investment into overseas hedge funds. There is a growing demand for investment funds which adopt a 'manager of managers' approach for hedge funds. This approach cannot be efficiently performed from Australia under the existing FIF rules.

Option 4.1: Longer term consideration of FIF replacement regime

Recommendation 4.1(1):

The Board recommends that, in the short to medium term, a fund registered as a managed investment scheme under the *Corporations Act 2001* or a company registered under the *Life Insurance Act 1995* should be exempted from the foreign investment fund rules where the fund is comprised of at least twenty diversified investments, at least 75 per cent of which are listed on an approved stock exchange.

Recommendation 4.1(2):

The Board recommends that, in the longer term (that is, within two years), the foreign investment fund rules be reviewed to provide a better balance between maintaining the integrity of the tax system and minimising compliance and other costs for taxpayers.

Option 4.2: To consider, including undertaking detailed case studies in conjunction with industry, increasing the 5 per cent balanced portfolio exemption threshold in the foreign investment fund rules

4.24 Several possible approaches can help reduce the problems of the current balanced portfolio exemption. However, they are unlikely to eliminate the problems. For non-tax reasons, some funds will have levels of interests that are higher than the level of the balanced portfolio exemption (which is likely always to be an average of some kind).

4.25 The most obvious solution is to increase the percentage threshold for the purposes of the exemption. Option 4.2 proposes consultation to that end. Though a sound idea, it should be possible to: (1) raise the threshold immediately to, say, 10 per cent (or other appropriate higher figure), and then (2) give the Treasury/ATO administrative power to further increase that threshold as investment patterns change and render the existing threshold inappropriate. An ongoing solution is required if the threshold continues to be expressed by way of some percentage of the portfolio.

4.26 In addition, the exemption should be expressed in terms of the overall investments of the relevant fund, not merely its interests in offshore investments. For example, an Australian fund which has 90 per cent of its portfolio invested in Australia is clearly not being established to accumulate income offshore.

4.27 Other ways of shaping the exemption could also be considered. One is by adopting more qualitative criteria (for example, types of investments) rather than a simple figure. Another approach (suggested in submissions) is as follows: The balanced portfolio exemption would be rewritten, so that if the investor has a portfolio of more than twenty different investments, at least 75 per cent of which are listed on approved stock exchanges, then the investor is taken to have a diversified portfolio. This measurement would include the investor's Australian investments as well as its foreign investments. If the taxpayer had a diversified portfolio, then all investments in the portfolio (other than those that fail a concentration test) would be exempted from attribution. If the portfolio were too weighted to a particular investment, then that investment would not get the benefit of the exemption. The concentration threshold could be 10 per cent of the total value of the portfolio.

4.28 It may even be possible to formulate an agreed system of attributing average foreign investment returns along the lines of the special rules for funds in the qualifying shareholder rules of the imputation system. These rules allow fund managers to rely on the average dividend return and franking of the Australian Stock Exchange index to calculate the imputation credits claimable by investors in the funds.

4.29 While some of these approaches might be considered in the longer-term rewrite of the rules, submissions strongly favoured the simplest short-term solution to be by way of increasing the threshold to 10 per cent of the overall fund.

Option 4.2: Balanced portfolio exemption threshold

Recommendation 4.2:

The Board recommends that the 5 per cent balanced portfolio exemption threshold in the foreign investment fund rules should be increased for Australian managed funds that do not carry on a trading business as defined in Division 6C of the 1936 Act, to 10 per cent of the overall cost of the assets of the trust.

Option 4.3: To consider exempting Australian managed funds that follow widely recognised indices from the foreign investment fund rules

4.30 This option proposes that Australian funds that track appropriate indices be added to the exempt category. Clearly, this would be a useful addition to the exemptions, particularly if the balanced portfolio exemption were based on broad averages. While some submissions supported this exemption, other submissions argued the need for much more extensive exemptions of the kinds discussed above.

Option 4.3: Exemption for managed funds

Recommendation 4.3:

The Board recommends that Australian managed funds that follow widely recognised indices be exempted from the foreign investment fund rules.

Option 4.4: To consider exempting complying superannuation funds from the foreign investment fund rules

4.31 The removal of resident superannuation entities from the FIF regime as canvassed in the Treasury Paper is justified, given the relatively small benefits available from accumulation of income in this sector. Submissions pointed out, however, that most superannuation entities invest into other Australian funds rather than directly offshore. Of itself, therefore, this exemption will not significantly simplify the FIF regime. Nonetheless, some submissions supported the measure. However, any advantage created for the sector will be very small compared to the other tax concessions for superannuation, which are designed to increase savings in the sector. Complying superannuation entities referred to in the following recommendation should include complying superannuation funds, complying approved deposit funds and virtual pooled superannuation trusts (PSTs) as defined in section 267 of the *Income Tax Assessment Act 1936* (1936 Act) as well as PSTs of life companies as defined in section 995-1 of the *Income Tax Assessment Act 1997*.

Option 4.4: Exemption for complying superannuation entities

Recommendation 4.4:

The Board recommends that complying superannuation entities should be exempted from the foreign investment fund rules.

Option 4.5: To consider amending the foreign investment fund rules to allow fund management services to be an eligible activity for the purposes of the foreign investment fund rules

4.32 When the FIF regime was introduced ten years ago, it was less common for funds management companies to be a separately available investment for portfolio investors. A number of such companies are now listed and should enjoy the same treatment as other financial institutions.

Option 4.5: Exemption for fund management activities

Recommendation 4.5:

The Board recommends that the foreign investment fund rules should be amended to allow fund management services to be an eligible activity for the purposes of the foreign investment fund rules.

Managed funds and trusts

Policy objectives

4.33 This section concerns two policy issues raised in the review:

- conduit taxation rules (the treatment of foreign source income (FSI) flowing through an Australian managed fund) applying to non-resident investors, in particular the adequacy of the current conduit rules and their impact on the establishment of managed funds (with an international clientele) in Australia; and

- claims that the rules on FSI are complex and impose significant compliance costs on business, are out of step with modern business practice, and negatively affect decisions to locate in Australia compared to countries with less stringent rules or no such rules.

Current position

4.34 The income of trusts is calculated as if they are residents (wherever their actual residence is). Residence and source rules are then used at the beneficiary level to ensure that non-resident beneficiaries are not taxed on FSI. However, for capital gains there are different rules for resident and non-resident trusts. Resident trusts include world-wide net capital gains in net income, while non-resident trusts include only capital gains which have the necessary connection with Australia (for example, land in Australia, or direct non-portfolio investment in Australian listed companies).

4.35 Further, tax treaties can have an impact on funds management activities conducted by Australian funds with foreign unitholders and foreign income. Where a tax treaty exists between Australia and the unitholder's country of residence, arguably non-residents become taxable in Australia on foreign income of the Australian unit trust.

4.36 Non-resident direct investors with non-portfolio investment (10 per cent or more) in Australian public unit trusts are subject to Australian CGT when they dispose of their units, regardless of whether they would be taxable under the CGT international rules if they held trusts assets directly. For example, if the Australian unit trust holds portfolio interests in Australian companies, non-resident unit holders would not be taxable if they held the shares directly. Further, for such non-portfolio interests under the CGT, cost base write downs of units apply to distributions of trust income which are in excess of the taxable income of the trust, with the result that such income is effectively taxed when the units are disposed of. Foreign income of the trust distributed to non-resident 10 per cent or more unitholders is non-taxable, leading to a cost base write down of the units. Hence for non-resident direct investors in unit trusts, this foreign income is effectively taxed on sale. Similarly, they are effectively taxed on unrealised foreign gains of the trust.

4.37 Under current law, interest, royalties (rare), and the unfranked part of dividends distributed by Australian or foreign unit trusts to non-resident beneficiaries, is subject to flat rate final Australian withholding tax (usually 10 per cent, 10 per cent and 15 per cent respectively in a treaty case, or 10 per cent, 30 per cent, 30 per cent in a non-treaty case). The withholding tax applies when the interest, royalties or dividends are paid by Australian residents — that is, has a source in Australia — not to FSI (which has been dealt with under previous headings). Australian trusts do not benefit from the publicly offered debentures exception to interest withholding tax available to companies. For Australian property trusts, there is also a withholding tax mechanism for distributions of rent from real estate in Australia. The tax rate for individual unit holders is that applicable for non-residents, meaning a rate of 29 per cent for distributions up to $20,000 and the usual progressive rates thereafter (with no Medicare levy). This regime also applies to other miscellaneous categories of income derived by trusts, such as foreign exchange gains.

4.38 The current law has several regimes for dealing with foreign trusts:

- controlled foreign trust measures in the CFC regime;
- FIF rules;
- transferor trust rules designed to prevent private trusts being used for international tax avoidance;
- special rules for foreign trusts in Division 6 of the 1936 Act, which contains the general rules for taxation of trusts and beneficiaries; and
- Division 6 of the 1936 Act in its normal operation.

4.39 Current law treats foreign trusts settled before April 1989, or settled by non-residents, differently to trusts settled by Australian residents under the transferor trust provisions. Before income can be attributed to an Australian resident settlor of the trust, it is necessary to show that the settlor controls the trust under these exceptions. It is not necessary to show control for settlements by Australian residents after April 1989.

Problems

4.40 The result of the rules for calculating trust income and tax treaties is that non-resident investors in foreign funds are taxed more favourably than non-resident investors in Australian funds. For example, non-resident investors in foreign funds are not taxed on capital gains on portfolio interests in Australian listed companies, nor on any interests in foreign companies.

4.41 Similarly, the cost base write down mechanism favours foreign trusts over Australian trusts. Many examples of inappropriate write downs have been identified over the years and progressively eliminated from the write down mechanism. To date no such exclusion has occurred for foreign income distributed to non-residents. The same kinds of problem occur with the taxation of unrealised foreign gains and the treaty result in relation to trusts — that is, taxation where an Australian trust is involved, but not where a foreign trust is involved.

4.42 The withholding regime creates compliance problems for unit trusts. They must check how much has been distributed to particular unitholders during the year to calculate how much to withhold. Further, the lack of an exemption from interest withholding tax for trusts comparable to companies makes offshore borrowing by trusts more difficult and expensive.

4.43 The tax regimes for foreign trusts are not properly coordinated. One regime can effectively remove an exemption given by another regime, producing results not intended by the underlying policy. The Review of Business Taxation (RBT) noted this problem and proposed a resolution that would have eliminated one of the regimes (the special rules in Division 6 of the 1936 Act for foreign trusts) and ensured that the other regimes operated as intended.

4.44 The exceptions in the transferor trust regime for pre-1989 and migration trusts have been relied on by high-wealth individuals for avoiding tax on offshore trusts that they control.

Evidence of the problems

4.45 The different treatment of resident funds compared to foreign funds has long been a source of concern for the Australian managed funds industry and the subject of submissions to government, mainly in relation to the impact on investments in Australian assets such as shares in Australian companies. Recently, for other good reasons, mutual funds and REITs in the US have been largely removed from attribution under the FIF regime. This can mean that Australian investors favour foreign funds for investment in foreign assets, compared to Australian funds investing in the same assets.

4.46 The ATO has informally dealt with the tax treaty problem for managed investment funds as a holding matter, although the RBT proposed a legislative response. As a result of a recent court decision[1], it will be difficult for the ATO to continue the current informal solution.

4.47 The cost base write down problem, which has been dealt with in other areas, has not been covered in the foreign income area even though the problem has been known for some time.

4.48 Also, the ATO and the funds industry have been negotiating for many years to try to deal with the issues raised in withholding on Australian fund distributions. There is inconsistency in practice across the funds management industry in dealing with withholding issues.

4.49 The Arnold Report[2] recognised the problems of interaction between different regimes for taxing offshore trusts in relation to implementing the FIF regime in 1993. Further study of the problem was then recommended. The RBT revisited the problem and recommended reform. Nothing has yet occurred. The problem can only be dealt with in practice by ignoring the clear operation of the law — which is hardly a satisfactory situation.

1 *Unisys Corporation v Federal Commissioner of Taxation* [2002] NSWSC 1115.

2 *Report on the Implementation Issues Arising from the Foreign Investment Fund Legislation*, 14 August 1992.

Policy issues

4.50 As funds in Australia are generally treated as conduits, many of the outcomes described above do not make any sense. They also favour foreign funds over Australian managed funds. The result is a clear disincentive to use Australia as a funds management base for foreign unitholders and foreign income. Lack of access to a standard international exemption from interest withholding tax for Australian-based trusts also produces a similar result. The result undermines the objective of promoting Australia as a global financial services centre.

4.51 In relation to transferor trusts, the pre-1989 exception could once have been justified as a transitional rule. But it is now twelve years since the provisions came into effect, and any transitional concerns are long past. The immigrant exception continues to apply to trusts settled by current immigrants before coming to Australia. It is not clear why immigrants should be treated on an on-going basis more generously than other settlers.

Potential solutions

Option 4.6: To consider exempting from CGT gains to which non-resident beneficiaries are presently entitled that relate to assets without the necessary connection with Australia. Whether an asset has the necessary connection with Australia could be determined as if the trustee of the resident trust was a non-resident

4.52 Many of the problems identified so far arise from fundamental problems in the way in which the CGT deals with trusts. In the mid 1990s, the ATO formed a group to try to solve these broader problems, but nothing has eventuated. Accordingly, within the context of the current review, it seems appropriate to formulate more specific solutions. The suggestion in the Treasury Paper that, with respect to non-resident investors, Australian funds calculate capital gains as if they were non-residents, will solve the problem dealt with in Option 4.6. It was widely supported in submissions.

4.53 The tax treaty problem arises from special provisions in domestic law and tax treaties that are intended to deal with tax avoidance using trusts to carry on businesses under treaties. They were never intended to apply to managed funds of the normal kind. As the RBT demonstrated, a short provision in domestic law will deal with the issue.

4.54 In combination with other measures canvassed under following options, the Board's proposed measures will overcome the disadvantages which resident funds currently experience. Many of the problems are technical issues in the current law, but they remain important nevertheless. The measures received strong support in submissions.

Option 4.6: Exemption of CGT gains for non-resident investors in Australian managed funds

Recommendation 4.6(1):

The Board recommends that non-resident investors who benefit under Australian trusts should be taken to be presently entitled only to so much of a capital gain as would be taxable if the trustee were non-resident.

Recommendation 4.6(2):

The Board recommends that the law be amended so that a non-resident investor in an Australian managed fund is not taken to be carrying on a business in Australia.

Option 4.7: To consider the feasibility of exempting from CGT gains on the disposal of a non-portfolio interest in a unit trust that relates to unrealised gains on assets that do not have the necessary connection with Australia

4.55 This option deals with a conduit income problem arising from unrealised gains in trusts that are reflected when units in the trust are sold. As only non-portfolio investments in unit trusts are affected, a specific solution would require a special conduit regime for a very narrow problem. As discussed in the previous chapter, special conduit regimes are very complex to design and legislate.

4.56 As investments by managed funds (apart from property trusts) are themselves generally portfolio in nature, one approach to the problem would be to remove from the Australian tax regime non-portfolio investments in Australian managed funds. This could be done in domestic law or selectively by tax treaty (perhaps in combination with domestic law). An integrity concern could arise if the response to this measure was to use these funds for non-portfolio investment purposes where the underlying non-portfolio investment would be subject to CGT if held directly. An investment spread requirement similar to that in Recommendation 4.1(1) could be imposed to overcome this concern. Any such investment spread requirement would need industry consultation to ensure that it was practical and achieved its desired objective. A number of Australia's treaty partners already unilaterally exempt Australian non-portfolio investors in mutual or managed funds. Whilst the ideal long-term solution is to incorporate an exemption of this nature in our treaties, immediate action should be taken where treaty partners already unilaterally provide that relief to Australian residents. In the case of property trusts, the issue could be handled by whatever rules are adopted generally to deal with holding land in Australia through an entity (whether company, partnership or trust).

4.57 As with CFCs, a systemic solution to this issue is preferable to a special regime. If the Board's Recommendation 4.7 is adopted, then Recommendation 4.8 would be relevant only to cases where non-portfolio interests in Australian managed funds that held assets not necessarily connected with Australia were still subject to taxation.

4.58 In the absence of such measures, Australian managed funds will suffer disadvantages compared to foreign funds where non-resident investors are involved.

Option 4.7: CGT exemption for gains on disposal of a non-portfolio interest in a unit trust

Recommendation 4.7:

The Board recommends an exemption of capital gains by non-residents on the disposal of non-portfolio interests in Australian managed funds in the form of unit trusts be provided by treaty, on a treaty by treaty basis. In the short term, an exemption should be provided to treaty partners who currently unilaterally exempt Australian residents in broadly similar circumstances. To the extent that managed funds hold land in Australia, the same look-through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.

Option 4.8: To consider amending the CGT rules so that a distribution of income to which a non-resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain from Option 4.6), does not reduce the non-resident investor's cost base in a unit trust

4.59 The current position is an oversight. It should be dealt with in the same way as a number of other cases where cost base write down rules are not appropriate. Although a technical measure, it removes a discrimination against Australian managed funds that has no policy basis. The measure was supported in submissions.

4.60 Adopting the previous recommendation would considerably reduce the cases where this problem arises.

Option 4.8: Amending the CGT rules to ensure that the cost base of non-residents' interests in unit trusts are not reduced by non-assessable distributions with a foreign source

Recommendation 4.8:

The Board recommends that capital gains tax rules be amended so that a distribution of foreign income to non-resident investors does not reduce the cost base of the investor in the Australian trusts that are subject to Division 6 of the 1936 Act.

Other changes to the tax regime for managed funds

4.61 The RBT recommended a general 30 per cent flat rate of withholding tax for non-residents. The Government indicated in the last Budget that it is not proceeding with this reform but will look at changing the current rules in particular situations.

4.62 Withholding on property unit trusts could be set at a flat 30 per cent for distributions to non-resident companies, individuals and others. This would simplify compliance in the industry. The tax rate could be subject to possible treaty reduction to 15 per cent where reciprocal treatment is afforded to Australian-resident investors in foreign property trusts. In the US protocol, this has happened for Australian residents investing in US REITs, but not in reverse. Further, treaty rules should also be considered on a treaty-by-treaty basis to ensure that Australian property trusts are not disadvantaged in their investments overseas.

4.63 Currently, foreign unitholders can file a return and claim deductions against the income (commonly, interest would be the only deduction). The Board does not recommend changing this rule. Rental income derived directly by non-residents is subject to deductions, and the same should apply to rental income derived through unit trusts to preserve conduit treatment.

4.64 Withholding on other types of Australian managed funds should also be removed, except for dividends, interest and royalties. This will reduce compliance complexities and give Australian managed funds equivalent treatment to many of their foreign counterparts. The widely-held debenture exemption should be extended to Australian managed funds, to remove the current discrimination between managed funds and companies and to give equivalent treatment to many overseas funds. Property trusts in particular are expected by the markets to borrow to partly fund their investments; but they are effectively limited to borrowing in Australia, because of the lack of the withholding tax exemption for widely issued debentures of companies.

4.65 These changes were strongly supported in a number of submissions. They were seen as necessary to align the treatment of Australian managed funds and foreign-managed funds.

Additional Recommendations: Other changes to the tax regime for managed funds

Recommendation 4.8A:

The Board recommends that withholding tax on net rental income of property trusts be set at a flat rate of 30 per cent, subject to treaty reduction to 15 per cent on a reciprocal basis.

Recommendation 4.8B:

The Board recommends that withholding for other income of widely held Australian unit trusts that are subject to Division 6 of the 1936 Act be removed, except in relation to interest, dividends and royalties.

Recommendation 4.8C:

The Board recommends that exemption from interest withholding tax be available to widely held Australian unit trusts that are subject to Division 6 of the 1936 Act for widely distributed debentures issued to non-residents.

Option 4.9: To consider proceeding with the recommendation of the Review of Business Taxation rationalising the application of the current rules to foreign trusts

4.66 This issue interacts with the discussion of the FIF regime in earlier parts of this chapter. The RBT solution ensures that the FIF exemptions operate as intended. Even if the FIF regime is significantly overhauled, its relationship with other regimes will still need to be dealt with. The relationships among themselves of the other regimes is also a matter that needs to be resolved. This change was supported by submissions.

Option 4.9: Foreign trusts

Recommendation 4.9:

The Board recommends the implementation of the Review of Business Taxation recommendations for simplifying the taxation of foreign trusts.

Option 4.10: To consider proceeding with the recommendation of the Review of Business Taxation in relation to transferor trusts

4.67 The policy concern here is similar to the FIF regime. Wealthy residents should not be able to avoid Australian tax by accumulating foreign source passive income in foreign private trusts which they have been instrumental in creating. Proving that a resident continues to control a foreign trust that the resident has created directly or indirectly is very difficult, as the trusts are usually located in tax havens which do not permit access to information about them.

4.68 The solution to this particular problem is to remove the control test from those trusts to which it applies, and to adopt the transitional provisions recommended by the RBT to allow such trusts to be unwound for relatively little tax cost.

Option 4.10: Transferor trusts

Recommendation 4.10:

The Board recommends that the taxation of transferor trusts should be amended as recommended by the Review of Business Taxation.

Permanent establishments

Policy objective

4.69 The objective of Australia's transfer pricing rules is to allocate income to Australia on the basis of prices and dealings that would be derived between unrelated parties.

Current position

4.70 Under current law and its interpretation of tax treaties, Australia uses the single entity approach for calculating the income of permanent establishments (PEs). However, developments in the Organisation for Economic Cooperation and

Development (OECD) and elsewhere, favour the separate entity approach. The differences between the two approaches are technical but important. Essentially, the single entity approach allocates income and deductions, while the separate entity approach constructs transactions between head office and branch as if they were parent and subsidiary. No country currently adopts a pure version of either approach.

4.71 Australian law currently taxes dividends received by PEs in Australia from Australian resident companies under dividend withholding tax, with the result that no deductions can be claimed against the income. Foreign bank branches have argued that they should be entitled to imputation credits on their investments in the same way as Australian banks.

4.72 Foreign bank branches in Australia receive different treatment to Australian banks when raising funds in the Australian market with hybrid instruments (such as income securities). Under the debt equity rules introduced in 2001, for Australian banks the return on the securities is non-deductible but is a frankable dividend. For foreign bank branches (being non-resident companies), the return on the securities is non-deductible and non-frankable. The converse problem for Australian banks when issuing income securities offshore in competition with foreign banks was solved by the debt equity rules, by giving a deduction for the return. However, Australian banks consider themselves to be at a competitive disadvantage to foreign banks, which use tax deductible capital raised under hybrid securities issued overseas to fund their Australian operations. Australian banks are unable to use tax deductible capital to fund the operations of their Australian branch.

Problems

4.73 Problems in the taxation of bank branches involve a mixture of issues under domestic law and the proper approach under tax treaties to the separate versus single entity approach. The international norm has long since settled on separate entity treatment for banks and similar financiers.

4.74 The current treatment of dividends under domestic law is clearly contrary to Australia's tax treaties. Foreign bank branches have a particular problem in this area, and their treatment contributes to the impression of Australia as a less than friendly base for financial services. It is also unclear what withholding tax rate applies in this case where a tax treaty is involved (15 per cent or 30 per cent). Although it has been held that imputation credits must be given to branches of non-residents in the context of the European Union, there is no international norm in this area.

4.75 The debt equity rules create competitive advantages and disadvantages for foreign bank branches in Australia and the Australian banks which compete with them, depending on the precise way in which the operations in Australia are being funded.

Evidence of the problems

4.76 The problem involving the treaty treatment of bank branches is the subject of several current audits.

4.77 The problem involving withholding tax has been known since imputation was introduced. It was not a significant problem until foreign bank branches entered Australia on a large scale in the mid-1990s. Currently, different banks adopt different practices to deal with it.

4.78 The differing problems involving the debt equity rules has been raised in submissions for foreign banks and separately for Australian banks. The government consulted widely with Australian banks in 2001 in relation to debt equity issues offshore, but the onshore issues remain.

Policy issues raised by the problems

4.79 The RBT recognised the issue of single entity versus separate entity approaches to dealing with PEs. It recommended that Australia move gradually towards the separate entity approach (given that the international consensus is in the process of some change). However, it has long been recognised that the separate entity approach is the most suitable for bank branches. Australian law has some specific measures that adopt this approach partly, but not fully.

Potential solutions

Option 4.11: To consider specific tax issues outside the Government's current tax reform programme where the lack of separate entity treatment inappropriately impedes the use of branch structures

4.80 The international standard of the separate entity approach for bank branches could appropriately be adopted into Australian law. The half-measures to date have produced considerable doubt and friction between the ATO and banks, particularly foreign bank branches. The result again is to portray Australia as an unfavourable location for operations of financial institutions.

4.81 In the case of dividends, domestic law should be restored to its 1987 position, so that dividends received by branches should be subject to tax by assessment. The issue of imputation credits in this context, like the debt equity issues, raise broader questions about the operation of the imputation system and the debt equity rules.

Option 4.11: Permanent establishments

Recommendation 4.11(1):

The Board recommends that the separate entity approach be applied to branches of foreign banks and to other financial institutions, which are subject to similar treatment to banks under the thin capitalisation rules.

Recommendation 4.11(2):

The Board recommends that dividends received by branches of non-residents be subject to tax by assessment and not to withholding tax.

Administration and integrity issues

4.82 The FIF recommendations have the potential to significantly reduce the compliance costs for businesses and the tax administration costs.

4.83 Increasing the balanced portfolio exemption threshold to 10 per cent could reduce monitoring costs and will reduce transactional costs associated with selling down holdings at the end of each financial year. It will also lower ongoing administrative costs.

4.84 Exempting MISs, life companies, index funds and complying superannuation funds, and widening the base for the balanced portfolio exemption may have integrity issues that may (in the legislative design phase) need to be considered with specialist industry input.

4.85 The other recommendations for the tax regime applicable to managed funds are likely to significantly reduce compliance costs. They may have administrative systems implications in the short-term. The recommendation to restrict the types of non-resident distributions from which fund trustees are obliged to withhold tax also has attendant integrity issues.

4.86 The recommendations on taxation of foreign trusts and transferor trusts will significantly simplify the trust assessing rules and reduce compliance costs.

4.87 The recommendations on the taxation treatment for branches of non-residents would serve to further align them with the treatment accorded subsidiary companies. Any remaining integrity issues could be dealt with by transfer pricing principles and by continuing Australia's efforts in international fora to help achieve an accepted interpretation of the separate entity approach.

Chapter 5: Improving Australia's tax treatment of foreign expatriates

Policy objectives

5.1 The Board was asked to consult with a view to improving Australia's taxation treatment of foreign expatriates to enhance Australia's attractiveness to overseas talent.

5.2 Attracting and retaining top-level talent is one of the greatest challenges facing Australian businesses, large and small alike. Competition for the best people is fierce. Today's employees have become increasingly mobile and have more options than ever before. The challenge applies in all industries, and in both domestic and global environments. To compete globally and to access new skills and ideas, Australia must be able to attract skilled workers.

5.3 Countries around the world are boosting efforts to attract highly educated and skilled workers to compete internationally. Those countries include some of Australia's major trading partners, such as the United Kingdom (UK), Singapore, Thailand and Hong Kong. Tax relief for foreign expatriates is a key incentive issue. The submissions received as part of the consultative process make the point that each of the four countries listed above operates a 'remittance' based system for taxing personal income of foreign expatriates working within their borders. Generally speaking, the foreign passive income of a foreign expatriate working in the relevant country is exempt from tax in that country unless the expatriate chooses to remit the income to that country.

5.4 The submissions also argued that (apart from a limited exemption from the foreign investment fund (FIF) regime and the Medicare Levy for temporary residents) the Australian taxation system offers no personal income incentive for individuals to relocate to Australia. They also argue that Australia has always been considered a high tax country for individuals, with high marginal tax rates that apply at low thresholds. These factors make it difficult to convince overseas expatriates to accept employment here. Indeed, the submissions maintain that the current Australian taxation treatment of foreign expatriates who become temporary residents, and the high costs this imposes on business, discourage many businesses from locating in Australia or bringing skilled people here.

Option 5.1: To consider whether to proceed with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred capital gains tax liability

Current law

5.5 Under current law, Australia allows departing individuals to elect to defer the capital gains tax (CGT) liability that arises on change of residence. However, the election relates only to assets not having the necessary connection with Australia. Assets having the necessary connection with Australia are taxed in the hands of non-residents, and so there is no need to levy (or defer) tax on change of residence. The cost to the individual of making the election is that the full capital gain made on disposal then becomes taxable — not merely the gain arising while the taxpayer was resident in Australia. The individual can also be subject to double taxation in either case, depending on the law of the other country.

Problem

5.6 There is no administrative mechanism to collect the tax after the change of residence. Hence, Australia's tax claim in these cases is often ineffective. Most countries, including Australia, generally do not assist in enforcing foreign tax claims. Australia has modified this position in relation to New Zealand (NZ) tax claims under Closer Economic Relations, and in a very limited way with the United States of America (US) in the US treaty (to the same extent NZ and the US can enforce Australian tax claims).

Policy issues arising from the problem

5.7 Making an unenforceable tax claim brings into question the underlying tax policy. It can also bring the tax law into disrespect. On the other hand, the law should not encourage tax-motivated changes of residence, which would occur if the present rule were dropped. The law should also avoid international double taxation.

Potential solutions

5.8 Two basic solutions are possible: enforce the tax claim, or give it up.

5.9 The Review of Business Taxation (RBT) recommended using a security mechanism to enforce the tax claim. This recommendation was made in the context of a general overhaul of tax collection from non-residents. The Government announced in the last Budget that it was not going to proceed with the general overhaul, but rather deal with specific problems. This decision considerably weakens any case for toughened enforcement.

5.10 Further, the submissions made as part of the consultative process unanimously recommended against implementing the RBT recommendation. The submissions maintained that the RBT recommendation would create cash flow problems, amount to a tax on gains that may never be realised, possibly lead to double taxation on the same gain, potentially give rise to inflated potential gains as a result of exchange rate fluctuations, exacerbate existing CGT problems for expatriates, and increase compliance, complexity and enforcement burdens.

5.11 Moreover, this particular situation arises most commonly for expatriate taxpayers when departing Australia. Since the Government has indicated in the ways outlined in the Treasury Paper that it wishes to soften the current impact of the tax system on expatriates, to pursue the RBT recommendation would be counter-productive.

5.12 The Organisation for Economic Cooperation and Development (OECD) has introduced into the OECD Model Double Tax Convention, from 2002, a general treaty provision for assistance in collecting tax claims. This is a much better way for Australia to deal with the problems of enforcing tax claims. This is raised briefly in Chapter 3.

5.13 Whether Australia should retain the tax claim in domestic law is a separate issue. The US Protocol comprehensively deals with the tax claim in a way that ensures that tax is collected on the capital gains while avoiding double taxation. If the individual does not make the election, Australia collects the tax up to the point of change of residence and the US thereafter; if the individual makes the election, the US collects the tax in full.

5.14 If Australia were to give up the tax claim unilaterally, in many cases the capital gains would not be taxed anywhere. This would create an incentive for resident individuals to give up residence when they propose to realise a large capital gain. For that reason, the Board does not support calls to amend the domestic law to provide unilateral exemption from CGT in these circumstances.

5.15 Hence, the Board considers that the best solution is not to proceed with the RBT recommendation. The problem should be addressed on a treaty-by-treaty basis to ensure (on the one hand) that gains do not escape tax merely because of a change of residence, and (on the other hand) that there is no double taxation of the gain.

5.16 This issue relates to the discussion of tax treaties in Chapter 3 (Option 3.5). It also relates to the taxation of share options, discussed below (Options 5.2 and 5.3).

Option 5.1: Residents departing Australia providing security for deferred CGT liability

Recommendation 5.1:

The Board recommends against proceeding with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred capital gains tax liability.

Option 5.2: To consider addressing the double taxation of employee share options through bilateral tax treaty negotiations and possible consequential changes to Australia's domestic tax law treatment

Option 5.3: To consider whether to proceed with the RBT recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A

Current law

5.17 Australia taxes employee share scheme benefits under the income tax (rather than the fringe benefits tax) provisions. The point of taxation, in general terms, can be the time of grant or exercise of the option, with the employee being taxable on the value of what is received less what is paid. An annual exemption of $1,000 is available if taxation occurs up-front. Most executives defer the taxing point (the value of deferral exceeding the $1,000 exemption). Once taxed under the income tax, they fall under the CGT provisions, so that subsequent increases in value will generally be taxed with the 50 per cent CGT discount. The availability of the CGT discount has led some executives in recent times to elect up-front taxation.

Problem

5.18 The international treatment of such plans is currently uncoordinated. As a result, the plans may become virtually unworkable internationally because of double taxation and compliance problems; or they may become the vehicles of tax planning to reduce tax beyond what is possible purely in the domestic environment.

Policy issues arising from the problem

5.19 Other countries combine elements of concession, taxing point, and income character (employment or CGT) differently to Australia. This means that different amounts are taxed at different times in different countries. Option schemes also may have earning periods that span residence in more than one country for the expatriate, so that the tax treatment is further complicated by residence changes. Different countries may also take different views on whether the income involved in options accrues over time or is all attributed to a particular taxing point. Working out the tax treatment of option schemes internationally thus becomes complex and uncertain.

Evidence

5.20 The international problems relating to share plans have been the subject of considerable discussion both in international tax journals and in the OECD.

Potential Solutions

5.21 The RBT recognised the problems. It recommended short-term changes to deal with cases where Australian tax does not apply because of gaps in the law and, in the longer term, a more thorough review of the issue. The OECD currently has a project under way to seek some common international ground and has released a Discussion Document for comment. The OECD should finalise its position in 2003.

5.22 The submissions made as part of the consultative process generally support the OECD approach of allocating full residence taxation to the treaty partner in which the share options are exercised. The other treaty partner's taxing right is limited to that proportion of the gain on the option which relates to the period(s) between the grant and the exercise of the option during which the individual has worked in the partner country. However, the submissions also expressed concerns that, given the extended time that bilateral negotiations can take, the domestic law will need amending to provide more immediate relief along the OECD lines.

5.23 Option 5.2 is addressed to avoiding double taxation and, in the Board's view, deserves support. The Board believes that no country can comprehensively deal with double taxation problems in this area on its own. However, to resolve this issue treaty by treaty will take a prolonged period of time and the Board is conscious of the need for immediate relief in this area. Accordingly, the Board believes that in the short-term Australia should change its domestic law to ensure that double taxation does not occur. In the longer-term, the matter can be dealt with comprehensively and formally through treaty negotiation.

5.24 Numerous submissions suggested ways to change the domestic law to overcome the double taxation problem. Some submissions supported the UK approach, under which an individual is liable for tax at the time of exercise in the country in which he or she was a resident when the option was granted, regardless of residency at the time of exercise. Others called for the tax treatment of discounts on employee share options (ESOs) and employee shares to be brought into line with the tax treatment of salary and wages relating to overseas employment. Still others supported removal of the taxing point on termination of a temporary resident's

Australian resident status and complete exemption from Australian tax on gains from pre-arrival stock options.

5.25 The Board believes that it should be possible in the short-term to change Australia's domestic law to adopt a balanced approach to the problem (pending subsequent formal treaty negotiation) to achieve the following:

- giving Australia the right to tax the appropriate amount commensurate with the employee's temporal connection with Australia;
- closer alignment with the tax treatment of employee income both in Australia and overseas; and
- simplified tax provisions in line with those of our major trading/investing partners.

5.26 Option 5.3 received no support in the consultative process. Indeed, it was unanimously condemned on the basis that it would create another taxation event in Australia and add to the many existing unresolved double taxation issues. The submissions also argued that it would create cash flow and currency valuation problems and discourage expatriates from coming to Australia.

5.27 The RBT recommendation referred to in Option 5.3 was intended to deal with avoidance of taxation by exercising the election discussed in relation to Option 5.1 and then escaping all Australian taxation on the options because of defective application of the CGT to share options or enforcement concerns generally. There is an inherent conflict between Options 5.1 and 5.3. The former does not seek to levy taxation until eventual disposal of an individual assets (but to now seek security for the ultimate payment), whilst the latter seeks to actually impose tax at the time of cessation of residency. The problem can be mitigated by amending any defective domestic laws to ensure that the double non-taxation situation does not arise. Tax treaties can then allocate taxing rights over share options between treaty partners to coordinate the operation of the respective domestic laws.

5.28 Given all of the circumstances and the Board's recommendations in relation to Options 5.1 and 5.2, the Board sees no compelling reason to adopt the RBT recommendation in Option 5.3.

5.29 The share option issue is related to Option 5.1 and the discussion of tax treaties in Chapter 3 (Option 3.5).

Option 5.2: Employee share options

Recommendation 5.2:

The Board recommends that the double taxation of employee share options should be addressed through immediate changes to Australia's domestic taxation laws to overcome double taxation, with subsequent bilateral tax treaty negotiations to ensure that the issue is dealt with comprehensively.

Option 5.3: Cessation event for Division 13A purposes

Recommendation 5.3:

The Board recommends against proceeding with the Review of Business Taxation recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A of the 1936 Act.

Option 5.4: To consider the Australian Taxation Office establishing a specialist cell to work with employers to deal with the tax administration of foreign expatriates

Current law

5.30 Although professional firms in the private sector have specialists in expatriate tax issues, there is no similar concentration of expertise in the Australian Taxation Office (ATO).

Problem

5.31 As a result of the lack of concentrated expertise in the ATO, it is difficult to get prompt and consistent ATO responses to tax problems concerning expatriate issues.

Evidence

5.32 Many submissions referred to the difficulties in locating ATO officers experienced in this area, and to the variability of treatment of expatriate tax issues.

Potential Solution

5.33 The ATO generally has sought to establish Centres of Expertise when dealing with international tax issues. Expatriate taxation is an area where this approach is also appropriate. Accordingly, the Board recommends that the ATO establish a Centre of

Expertise to deal with tax administration concerns of expatriate employees and to provide clear, consistent and sound advice in relation to all expatriate taxation issues.

Option 5.4: ATO specialist cell for foreign expatriates

Recommendation 5.4:

The Board recommends that the Australian Taxation Office establish a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.

Administration and integrity issues

5.34 The recommendations in this chapter are expected to raise only minimal administration and integrity issues (which will be looked at as part of the legislative design phase).

CHAPTER 6: ADDITIONAL ISSUES RAISED IN THE SUBMISSIONS

Introduction

6.1 The submissions to the Board raised numerous issues in addition to the specific options canvassed in the Treasury Paper.

6.2 While many of those issues raised valid concerns that are not encompassed in the specific options under consideration, others had been referred to in the Treasury Paper as either being under consideration or having already been addressed. Given that the Board's terms of reference specified the Treasury Paper as the basis of the Board's consultations, and given the limited time available to complete this review, the Board has focused on the specific options canvassed in the Treasury Paper. Of course, the Board has addressed additional issues that it regarded as integral to the options under consideration. But there was insufficient time to do justice to many other worthwhile suggestions that came forward as part of the consultation process.

6.3 Accordingly, the Board considered it useful to separately record a number of the additional issues that are not otherwise incorporated in the main body of this report or canvassed in the Treasury Paper. It is noted also that some of the additional issues raised in the submissions that have already been dealt with by the Government (for example, foreign exchange losses, triangulation case with New Zealand) are not covered in this chapter.

Allowing foreign-owned entities to frank distributions to residents who hold equity interests in entities that are issued in Australia

Problem with current law

6.4 Franking credits are available to domestic entities but not to foreign entities that are wholly-owned by non-residents. This means that domestic companies can raise equity capital finance in the local capital market at more competitive rates (and hence can pay a lower cost of capital) than comparable foreign-owned companies that cannot frank dividends paid to residents, forcing them out of this capital market.

Proposed solution from public submissions

6.5 Foreign-owned entities (that is, those with greater than 95 per cent foreign ownership) should be permitted to frank distributions to residents who hold equity interests in entities that are issued in Australia. This should apply both to foreign-owned subsidiaries and to permanent establishments that issue equity interests to Australian shareholders.

Issues relating to promoting Australia as a location for internationally-focused companies (Chapter 3)

Extend foreign investment fund (FIF) treatment of bare trusts and nominee arrangements to controlled foreign company (CFC) rules

Problem with current law

6.6 For FIF purposes, section 484 of the *Income Tax Assessment Act 1936* (1936 Act) disregards the existence of nominee or bare trust arrangements. There is no such comparable provision in the CFC regime.

Proposed solution from public submissions

6.7 A provision similar to section 484 should be inserted into the CFC regime.

Heavy compliance costs for publicly traded trusts

Problem with current law

6.8 The current public trading trust rules impose significant compliance costs on an Australian unit trust. Division 6C of the 1936 Act raises an anti-competitive tax barrier to Australian listed property trusts investing offshore. This makes no sense where the public unit trust owns property in a broad-exemption listed country (BELC), as there is no risk to the revenue.

Evidence

6.9 Where the trust controls a real estate investment trust (REIT) in the United States (US), the REIT must observe its own REIT requirements and also those of Division 6C. This results in unnecessary overlapping. Further, if an investor chooses to invest in the REIT directly rather than through Australian listed property trusts, Division 6C is not relevant (that is, creates a bias).

Proposed solution from public submissions

6.10 Exclude from the operation of Division 6C controlling interests in foreign property owning vehicles in BELCs.

Issues relating to promoting Australia as a global financial services centre (Chapter 4)

Capital gains tax (CGT) discount may not be available for Australian investors

Problem with current law

6.11 The benefit of the CGT discount concession on gains from assets held more than 12 months is not available in some cases under Division 115 of the *Income Tax Assessment Act 1997* (1997 Act). Under the current paragraph 115-215(3)(b) of the 1997 Act, the calculation of discount capital gains of an Australian investor in US trusts is unduly convoluted.

Current law

6.12 Paragraph 513(1)(b) of the 1936 Act was inserted in 1999 to allow exemption (from FIF measures) for a company or trust that is treated as a regulated investment company or a real estate investment trust, for the purposes of the US Internal Revenue Code of 1986.

6.13 Long term capital gains (more than 12 months) in the US are taxed at concessional rates, and Australian investors are informed of the amount of gains, which are prima facie eligible for CGT discount in Australia.

6.14 US mutual funds (trusts) do not lodge tax returns in Australia, but Australian investors (beneficiaries) should include income from the US funds under section 97[1], or under section 99B[2] of the 1936 Act.

6.15 However, under subsection 96A(1), an amount is not to be included in the assessable income of a beneficiary on a presently entitled basis under section 97, if the beneficiary is a resident, and the trust is a non-resident, and FIF income is included in assessable income (that is, section 529 applies), but for section 513 exemptions apply. It is taxed under section 99B.

6.16 On the other hand, if an Australian beneficiary is not caught under section 529, not due to section 513 exemptions but due to section 525[3] or section 515[4] exemptions, then the beneficiary is taxed under section 97. Subsection 96A(1) does not apply to exclude from taxing under section 97.

1 Section 97 applies to the assessable income of an Australian beneficiary of a non-resident trust (on a presently entitled basis) where the FIF measures apply to the beneficiary's interest in the trust.

2 If the trust income has been previously assessed to the trustee or the beneficiary when the income was derived, the same income is not assessed again when it is actually received. However, if the amount has not been taxed previously, and the beneficiary is a resident at any time during the income year, it is subject to Australian tax under section 99B.

3 Balanced portfolio exemption — value not exceeding 5 per cent of sum of values of all interest.

4 Exemption for value of interests not exceeding $50,000.

6.17 The CGT discount for trusts provided under section 115-215 of the 1997 Act operates only where the beneficiary is assessed under sections 97, 98A or 100, but not where section 99B applies.

6.18 Further, under paragraph 115-215(3)(b), an Australian investor would calculate CGT by doubling the amount of the taxable discount gain distributed from the US trust, and then discounting it back by 50 per cent — a convoluted way of calculation.

Evidence of existing problem

6.19 The result of this technical anomaly is that an Australian investor in a US mutual fund who does not rely on the US FIF exemptions is eligible for CGT discount in Australia. Yet the same investor who relies on the US FIF exemption is not eligible for Australian CGT discount available under Division 115.

Proposed solution from public submissions

6.20 Subsection 99B(1) of the 1936 Act should be incorporated into paragraph 115-215(2)(b) of the 1997 Act. No suggestion for improving paragraph 115-215(3)(b) was provided. Also, section 513 should be expanded to cover other investments such as Dublin-based investment funds.

Hybrid Tier 1 capital not deductible

Problem with current law

6.21 Under the debt/equity rules, treatment of hybrid Tier 1 capital is not deductible. This affects international competitiveness. The issue relates to the interplay between tax and regulatory rules.

Evidence of existing problem

6.22 Following the US Protocol (effective from 1 July 2003), US banks will be able to lend to Australian companies free of any Australian tax liability or substantive regulation, while enjoying the benefits of low cost hybrid funding in the US. It is understood that similar terms are to be included in new United Kingdom and German treaties.

Proposed solution from public submissions

6.23 A panel should be formed by the Board to consider the treatment of Tier 1 capital for tax purposes, taking into account the interests of the relevant parties. The panel should include representatives of the Australian Bankers' Association, Treasury and Australian Prudential Regulation Authority.

Issues relating to improving Australia's tax treatment of foreign expatriates (Chapter 5)

Tax Laws Amendment Bill (No. 7) 2002

Problem

6.24 Several submissions expressed concern that TLAB (No. 7) has not been passed.

Proposed solution from public submissions:

6.25 Schedule passage of the Bill as a matter of priority.

Tax administration

6.26 Some issues arose that could be examined as part of an ongoing review of responsible tax administration. For example, many submissions argued that the current means of determining residency is out of date and step with Australia's need to create a more definitive tax environment. Basing a person's residency status on where their mail is delivered, or where they keep their goods, is not appropriate in determining the residency status of people coming to and leaving Australia on a temporary basis.

High top marginal tax rate is a disincentive for foreign expatriates

Problem with current law

6.27 Australia's high top marginal tax rate is a disincentive in bringing skilled workers into Australia, as are other aspects of taxation of expatriates.

6.28 When foreign expatriates are brought into Australia, their employers bear the harsh costs arising from Australia's tax setting. These costs ultimately make Australia less competitive. The problem is not limited to wealthy foreign expatriates but includes middle income expertise coming to Australia.

Evidence of existing problem

6.29 For global banks, the seamless interchange of talent and specialist skills among worldwide staff is an important element of global business strategies and career development programs. Many expatriates are on high salaries. Reform would make Australia a more attractive career location.

6.30 Bringing a foreign expatriate to Australia results in considerable costs, including the payment by employers of additional income tax that is payable in Australia (and also fringe benefits tax in respect of this payment).

Proposed solution from public submissions

6.31 Expatriate taxation measures in the TLAB (No. 7) should be enacted.

6.32 The preparation of tax returns for foreign expatriates should be simplified.

International tax issues not specifically related to the Review of International Taxation Arrangement chapters

Compliance costs of determining eligible returns for certain securities

Problem with current law

6.33 Significant compliance costs are incurred in working out whether securities have an eligible return for the purposes of Division 16E of the 1936 Act.

Proposed solution from public submissions

6.34 The Australian Taxation Office should maintain a database of securities to which Division 16E applies.

Consolidations — interaction of Australian and foreign tax rules

Problem with current law

6.35 The interaction between Australian tax rules and those of the home jurisdiction may create instances where a foreign owned entity does not want to consolidate fully for tax purposes.

Evidence of existing problem

6.36 The US double dip rules may inhibit an entity from grouping its losses with other members of its tax consolidation group.

Proposed solution from public submissions

6.37 A foreign-owned entity within a tax consolidation group should be given the option to not group its losses with other entities in the tax-consolidated group.

Blackhole expenditures

Problem with current law

6.38 There is a range of expenditure not recognised by the tax system, such as the need to make payments for exclusive rights to a sales territory or product that should be given tax relief.

Proposed solution from public submissions

6.39 Systematic treatment of rights and blackhole expenditures should be implemented.

Treatment of intangibles

Problem with current law

6.40 The treatment of intangibles is not internationally competitive.

6.41 The current law allows the amortisation of the development costs on limited types of intellectual property interests. The Government recently announced the capital allowance provisions with effect from 1 July 2001, but it stated that there remains a considerable amount of non-deductible expenditure on the creation of intangible property that falls outside of capital allowance provisions.

Proposed solution from public submissions

6.42 Expand existing limited categories of intangible property eligible for write-off under the uniform capital allowances rules.

6.43 In the medium term, Australia should consider an enhanced process for the amortisation of business intangibles particularly in the context of acquisitions.

6.44 A tax amortisation allowance for the development of all forms of intangible property should be introduced to remove a major obstacle to Australia becoming a centre for research and development and innovation.

Venture capital (VC)

Problem with current law

6.45 One of the unattractive features of the Australian tax environment is the lack of truly viable VC concessions, despite the measures were proposed in the Review of Business Taxation and introduced in 1999.

Proposed solution from public submissions

6.46 Support the need for a strong and active VC industry to raise the equity required to fund innovation, economic growth and employment creation. VC investment provides significant sources of funding for early stage investments (for example, in biotechnology, computer technology, engineering and other innovative production processes).

6.47 Effective VC concessions should be developed and introduced.

6.48 The recent VC reforms proposed is welcomed, but the criteria to qualify for these VC concessions may be limited.

Depreciation regime

Problem with current law

6.49 Problems arise from the arbitrary (and non-transparent) nature of concessions given to the treatment of depreciation of some assets but not others. This may have a negative impact on investment in general.

6.50 Some companies in Western Australia cannot utilise accelerated depreciation provisions as they did in the past. The recent reforms may be good for the established 'service sector', but are detrimental to businesses requiring new capital intensive investment. The new measures also favour large businesses rather than medium size emerging businesses.

Restructuring for Non-Operating Holding Companies (NOHCs)

Problem with current law

6.51 The Wallis Report recommended that banks should be able to establish NOHCs. However, Australian tax laws (scrip for scrip, and consolidation rules) do not go far enough to ensure that there are no associated tax consequences.

Evidence of existing problem

6.52 Various detailed industry submissions over a number of years have addressed this issue.

Proposed solution from public submissions

6.53 Legislation should be enacted to provide appropriate tax relief to allow NOHCs to be established in a tax-neutral manner.

Ability to transfer losses incurred in countries outside Australia

Problem with current law

6.54 The construction services industry overseas is competitive, and can incur losses in some countries and make profits in others. The losses are currently quarantined and resulting in higher rates of tax.

Proposed solution from public submissions

6.55 Allow offsets of both exempt countries and non-exempt countries. Alternatively, at least allow grouping of non-exempt income from all sources.

ATTACHMENT 1: URGENT ISSUES IN THE CFC ISSUES REGISTER

Matters of urgent priority on the CFC issues register

Issue 1.1.14: 'Commencing Day'

When an Australian taxpayer acquires an interest in a foreign company which has never before been controlled from Australia, it should be reasonable to assume that Australian tax will not subsequently be payable on gains which have accrued prior to the time of acquisition by the Australian taxpayer. Unfortunately, the 'associate inclusive' nature of the control tests frequently make this assumption invalid. This anomalous situation has been identified for many years and is unacceptable. The matter is urgent because it affects very many acquisitions of overseas groups, especially where parts of these groups will be immediately on-sold with little or no economic gain to the Australian taxpayer.

Issue 1.1.17: Roll-over liberalisation

The liberalisation of the roll-over provisions is urgent because all of the hard work on this issue was completed in 1996. The fact that changes have not been prosecuted is difficult to understand, especially as it has been a high-priority matter for many years. The most urgent roll-over relates to shares in foreign subsidiaries which may need, for entirely non-tax reasons, to be transferred from the Australian resident member of a wholly owned group to a non-resident CFC member of the same group.

Issue 1.1.31: Mergers and amalgamations overseas

Corporations laws overseas increasingly allow forms of corporate reorganisation which are not possible in Australia. These present challenging technical issues under the CFC provisions, although the transactions typically involve little or no substantive change in the ownership of underlying assets. This is another situation where it is known that the Australian Taxation Office (ATO) has already invested substantial time and resources, but the taxpayer community is largely uninformed of the ATO's analysis. Most of the work was completed in 1997 and 1998, but appears not to have been developed into firm administrative guidelines.

Issue 1.1.38: Anstalts

The *Income Tax Assessment Act 1936* (1936 Act) should be amended to deem an anstalt to be a 'trust estate' for the purposes of the 1936 Act. This is urgent because it is an integrity measure; although I am not aware of the extent, if any, to which the use of anstalts is actually adopted by Australian resident taxpayers. Whilst it may be unnecessary (as the courts might be expected to reach the same conclusion under existing law), the current uncertainty could be swiftly resolved by legislative amendment.

Issue 1.1.39: Currency exchange fluctuation

The decline in the value of the Australian dollar during the course of the 2000 and 2001 calendar years (from US$65.64 cents to US$51.41) has resulted in many CFCs' capital losses (expressed in foreign currencies) being translated into capital gains (in Australian dollars) by virtue of section 103-20 of the *Income Tax Assessment Act 1997*. This issue has been a perpetual frustration for attributable taxpayers, but the magnitude of its inequitable consequences have more recently emerged. Also, the current position is notoriously asymmetrical between different types of gains and losses.

Issue 1.1.47: Limited liability companies (LLCs) in USA

Opportunities for overseas business expansion frequently first arise in USA, where it is possible for entities, such as LLCs, to elect to be taxed as partnerships (that is, transparently). Because these entities are treated as CFCs for Australian tax purposes, technical inconsistencies arise. These inconsistencies have been very well addressed in an ATO discussion paper of December 1998. It is now urgently required for that discussion paper to be issued as a Public Ruling.[1]

1 The Board understands that the Treasury is considering (in consultation with industry) these issues with a view to resolving the problem.

Issue 1.1.56: Loss grouping

The quarantining of CFC losses is excessive and should be reviewed. Losses are quarantined within classes within each CFC. If the current treatment is to continue, it is considered that the reasons for this excessive quarantining should be specifically published.

Issues 1.1.74 and 1.1.75: Tainted services

The increased development of the service sector and the improved policing of the transfer pricing provisions by the ATO since 1990, suggest that service income could now cease to be tainted. This presents an opportunity to both simplify and improve the CFC legislation. The issue should be considered as a matter or urgency. I note that such consideration will indeed be feasible in the context of Option 3.2 of the Review of International Tax Arrangements.

ATTACHMENT 2: OTHER ISSUES IN THE CFC ISSUES REGISTER

Australian Controlled Foreign Company Issues Register

(As developed over the years by the Foreign Source Income Subcommittee of the National Tax Liaison Group)

Assessment Report for the Board of Taxation

28 November 2002

Chapter 1: Controlled Foreign Companies

Section 1: Policy Issues

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	Substantiation Requirement				
1.1.1	The detailed *substantiation requirements* for the *active income test* are unnecessary. The onus is on the taxpayer to show they have passed the test. If they cannot show this, they automatically fail the test.	Unaltered	This is not a significant issue. To obtain relief under the *active income test*, a CFC (controlled foreign company) must comply with the substantiation requirements set out in section 451 of the 1936 Act (the Income Tax Assessment Act 1936); (unless otherwise stated, all section references in this document are to the 1936 Act). The problem (if any) is probably found in subsection 451(2) by which the requirements are not met if a CFC fails to provide certain documents, if requested by an *attributable taxpayer*. In some cases, by virtue of the *associate-inclusive* definition of *attributable taxpayer* (see section 361), the CFC may have no direct relationship with the relevant attributable taxpayer, and may therefore not provide the documents. This will cause the CFC to fail the *active income test* for all of its attributable taxpayers.	Further policy consideration	Low
	AFI Subsidiaries				
1.1.2	Review ss449 and 450 and modify as these sections may encourage *an Australian Financial Institution (AFI)* subsidiary to conduct its regional operations from a low tax jurisdiction in which it has a low physical and/or business presence.	Unaltered	If a CFC is an AFI subsidiary (defined in section 326) some types of income which, in the hands of an ordinary CFC would be *tainted*, are excluded from being tainted through the mechanisms of sections 449 and 450. [Importantly, these exclusions do not extend to services or loans provided either to Australian residents or to associates of the CFC.] However, to the extent that the exclusions are available, they merely require (in effect) that the relevant business not be conducted in Australia; accordingly, the relief is available whether the CFC conducts its business in a high-tax	Further policy consideration	Low

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			country or in a tax-free jurisdiction. The presumed argument of the proponents of this issue is that the relief should be dependent upon an additional *permanent establishment* test. The better view is that the income excluded under these sections is income that would be passive to an ordinary CFC, but it is active income for an AFI subsidiary because of the nature of its business. Where that AFI subsidiary is properly resident outside Australia, it should be permitted to compete with other financial institutions on the basis of overseas tax conditions, not Australian tax conditions. [See also 1.2.1 below.]		
1.1.3	There appears to be scope to tighten the exemption for AFI's to ensure the exemption is not available for regional banking activities conducted from a tax haven	Unaltered	See comments on para 1.1.2 (above).	Further policy consideration	Low
	Associate Section 318				
1.1.4	The *definition of associate* is too broad.	Unaltered	The definition of *associate* in section 318 has become used for various purposes in the Tax Acts [sometimes with modifications, such as with the concept of *associate entity* in the Thin Capitalisation provisions]. Section 318 is not only very broad, but also very difficult to comprehend (see, for example, paragraphs 318(2)(d)(i)(B) and 318(2)(f)). The most classic example of its breadth is that a wholly owned US subsidiary of an entirely foreign company (eg Exxon Inc) becomes a CFC merely because Exxon Inc is an *associate* of its own *Australian* subsidiaries (see paragraph 318(2)(d)(ii)(A)). Doubtless, the original intention was that the rule should be broad, but there should be some means by which its capacity to produce absurd outcomes is contained.	Further policy consideration	High

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
1.1.5	Does a CFC exist? Has a debt been waived – does 47A deem a dividend.	Don't Know	This issue has not been adequately identified. It should be noted however, that the case referred to (*Brewing Investments* [2000] FCA 34) was subsequently overturned on appeal by the Commissioner of Taxation (see [2000] FCA 920). This may resolve the matter, although the case was more concerned with section 47 (liquidations) than with section 47A.	Possibly already rectified	Low
	Attributable Income				
1.1.6	Section 387, reduces the amount included in attributable income by an amount included in assessable income from an interim dividend of a CFC paid to an attributable taxpayer from current year profits.	Unaltered	The reduction of attributable income that is provided by section 387 is a mechanism to prevent double taxation. The normal manner in which double taxation is prevented is *via* section 23AI, where previously attributed income is not again taxed when actually received by the attributable taxpayer. However, dividends paid to the attributable taxpayer *during* the eligible period fail to qualify for section 23AI relief because, if the attributable income was not reduced under section 387, no *attribution credit* would arise until the *end* of the *eligible period* (see para 371(5)(a)), and that would be too late to qualify the interim dividend for 23AI relief. It is difficult to discern that there is a problem.	None	Low
1.1.7	A submission for *a clawback* mechanism to govern the case where *previously attributed income is never actually received*. Such a scenario could arise if a CFC is forced into liquidation subsequent to attribution.	Unaltered	There already is, and always has been, a *clawback* mechanism; and it can be found in section 461. There is also a variation of section 461 for liquidations "down the chain" of CFCs, and this can be found in section 401. The shortcoming with section 461 is that it reduces the *capital proceeds* from the disposal of the shares in the liquidated CFC if the shares in the CFC were a capital asset. In other words, although the previously attributed income has been taxed as *income*, the relief for never having received the attributed income takes the form of a reduction in a *capital gain*, or in the creation or enlargement of a *capital loss*. This is not as generous as providing	Further policy consideration	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			an outright deduction, which would be fairer and more symmetrical. [See also issue para 1.1.5]		
1.1.8	Calculation of attributable income through the *modification to domestic provisions.*	Unaltered	The issue has not been adequately identified. It may be a manifestation of a recurring tension under the CFC rules between accounting income on the one hand, and taxable income under Australian principles on the other. For example, attributable income in principle assimilates a dividend paid by the CFC; but such a dividend would be limited to the (accounting) profits available to the CFC. In many cases however, recalculating attributable income of the CFC under the (Australian) Tax Acts has the outcome that the amount that is attributable exceeds the dividend that could have been declared from the equivalent accounting profit arising from the relevant (tainted) transaction. This is especially true of capital gains that are recalculated on the basis of Australian dollar exchange rates.	None	Low
1.1.9	Consideration for *an exemption* in calculating the attributable income of a CFC *for dividends paid from an FDA account.*	Unaltered	This is an interesting suggestion although it would be relevant only on very rare occasions, and it is probably not a relief that can be justified. It envisages a situation in which a CFC receives a dividend from an Australian resident company out of income derived from outside Australia by the Australian resident company. By virtue of the FDA account, the dividend is relieved from Australian withholding tax. The suggestion is that because it is treated like a franked dividend for withholding tax purposes, it should also be treated like a franked dividend for attribution purposes (see paragraph 402(2)(b)). The better view is that it should not; because, without the intervening CFC, the dividend would be assessable in the hands of an Australian resident company. [See also para 1.2.4 below.]	See also RITA para 3.11	Low

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
1.1.10	Definition of *"adjusted distributable profits"* In section 457 which assess attributable income of a CFC when it *changes residence from an unlisted country to a listed country or Australia.*	Unaltered	The issue has not been adequately identified. There is a distinction between the amount of the *adjusted distributable profits* to be assessed, depending whether the CFC is transferring its place of residence to Australia or to a listed country. In the case of the change to Australia, the *adjusted distributable profits* appropriately exclude unrealised profits because they will subsequently be taxed under normal Australian principles (including unrealised capital gains, by virtue of section 136-50 of the Income Tax Assessment Act 1997 (the "1997 Act")). However, in the case of a change to a listed country, the adjusted distributable profits *include* unrealised profits. The provisions appear to *assume* that the listed country will not seek to subsequently tax profits which are accrued but unrealised at the time of residence change. That is, a cost base "entry step-up" is assumed to be provided by the listed country. In cases where that assumption is not correct, and in cases (eg New Zealand) where the subsequent gain may be exempt from tax in the listed country, double taxation can arise. [See also para 1.2.5 below.]	See also RITA Para 3.9. [If all dividends from CFCs were potentially exempt under section 23AJ, section 457 could possibly be repealed]	Medium
1.1.11	Calculation of Attributable Income and self-amendment for FIFs held by CFC UK.	Don't Know	The issue has not been adequately identified. [See also para 1.2.6 below.]	None	Low

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
1.1.12	Policy advice on the FTC system in FSI context in relation to income "baskets" for FTC and FSI measures to be provided for TLIP rewrite	Unaltered	The basket differentiation is actually between the foreign loss offset measures (subsection 160AFD(8)) and the foreign tax credit rules (section 160AF(7)), the principal difference being that the loss offset rules distinguish between interest income and other passive income (called "modified passive income"); the credit rules make no such distinction. The CFC loss rules effectively "borrow" the foreign loss rules from section 160AFD, but then carve-out capital losses as a further separate basket (see subsection 424(1)). [In passing it can also be noted that "passive income" for all of these purposes is defined in section 160AEA and is to be distinguished from "passive income" under section 446 which is used simply to determine whether or not the type of income is *tainted*.] In the interests of simplifying these provisions, it would seem feasible for these differences to be removed.	Further policy consideration	Medium
	Attributable Income - Notional				
1.1.13	Consideration should be given to allowing CFCs a deduction for a FIF loss under the market value method for determining FIF income on a similar basis to the deduction available for Aust residents under sec 532.	Unaltered	This would appear to be more of a technical problem than a policy issue. The policy is clear that previously recognised FIF income (under the market value method, at least) can be reversed in a future year when the market value falls. From a policy perspective, it should make no difference whether the FIF interest is held directly by an Australian resident or by a CFC.	Amendment required	High
1.1.14	In calculating the attributable income of a CFC, gains that accrue prior to the company becoming a CFC are exempted. Consideration should be given to extending this exemption to *gains which accrue prior to an*	Unaltered	This is an extremely common problem, because there are so many companies outside Australia which are technically CFCs although they have never been controlled by Australian residents (see comments under para 1.1.4 above using Exxon as a hypothetical example). One live example was where an Australian company was acquiring a New Zealand company from an unrelated Singaporean	Urgent amendment required	Urgent

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	attribution percentage of an attributable taxpayer arising in relation to a CFC.		owner. The New Zealand company had never been controlled by or from Australia, but the Singaporean resident owner had associates who were resident in Australia. Consequently, the *commencing day* for the purposes of section 412 had occurred long before the Australian company acquired the shares in the New Zealand company. The subsequent sell-off of unwanted *tainted assets* by the New Zealand company would give rise to attributable income based on an historic, low cost base which had no connection with either the current Australian shareholder, or with any other Australian resident having an attribution percentage in the New Zealand company.		
	Attribution Accounts				
1.1.15	Submissions to TLGSC that a CFC which disposes of a CFC or FIF *receive an attribution debit through the disposal consideration is not included in attributable income*. S 401 & 461 - reduction of disposal consideration where attributed income not distributed.	Unaltered	If a CFC ('A') disposes of an interest in another CFC ('B') after the Australian attributable taxpayer has recognised attributable income in respect of B, but before B has distributed that income (or its equivalent) to A, the attributable taxpayer requires not only interim relief as per paragraph 401(1)(c) (from the amount of gain attributable upon the disposal of B) but also longer term relief in respect of the value of the former attributable income which continues to abide within A (in the form of the proceeds of B). This longer term relief should not be dependent upon the availability of the short term relief, especially if the short term relief is not needed. The attributable taxpayer needs to be allowed to debit the attribution account it runs in respect of B, and to credit the attribution account it runs in respect of A. [See also para 1.2.7 below.]	ATO Ruling could adopt a purposive interpretation of paragraph 401(1)(a)	High
	Definition of Australian Entity				
1.1.16	S336 definition of *Australian entity* should exclude qualifying *regional*	Unaltered	This is an ambit claim for extended tax relief for Regional Headquarters Companies. If this amendment was made, it would be	See also RITA	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	headquarters located in Australia.		*one way* of excluding such companies from having to recognise attributable income from CFCs. It is not really a CFC issue. At present, reliefs for Regional Headquarters Companies are restricted to set-up cost deductibility (section 82CA), and (like other Australian companies) flow-through of foreign dividends free of Australian withholding tax *via* the FDA (foreign dividend account) mechanism.	Para 3.10	
	CGT Issues				
1.1.17	The CGT roll-over relief provisions in the CFC measures should be *liberalised*.	Unaltered	The Australian Taxation Office ('ATO') obtained detailed independent advice on this discrete matter from Professor Brian Arnold (then of the University of Western Ontario), dated 2 August 1996. Shaddick & Spence has a copy of his report, received when Richard Shaddick was a member of the Foreign Income Subcommittee of the National Tax Liaison Group. Essentially, Professor Arnold agreed that the rollover provisions in the CFC measures should be liberalised. It is not clear why the issue has not been advanced since 1996. [See also para 1.2.8 below.]	Urgent amendment required. Cross-refers to RITA option 3.1.	Urgent
1.1.18	Extend *rollover relief to all group disposals* involving CFCs.	Unaltered	See para 1.1.17 above.	Urgent amendment required	Urgent
para 1.1.19	Section 419 and the section *160ZZO rollover relief* should be extended to cover *all transfers by Aust* resident companies to *group company CFCs*.	Unaltered	See para 1.1.17 above.	Urgent amendment required	Urgent
1.1.20	Issue if a *capital loss can give rise to EDCI* in Reg 152B.	Resolved	Given the ATO's final position in *Dismin Investments Pty Ltd v F C of T* (2001 ATC 4377) and notwithstanding the original judgement of Heerey J, it now seems clear that *Designated Concession Income* is restricted (in the context of capital gains and losses) to amounts "which are gains of a capital nature according to ordinary concepts"	Already Resolved	N/A

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			(see para 22 of the judgement of the Full Federal Court). This accords with the dividend-like assimilation of attributable income, as mentioned under para 1.1.8 (above). [See also para1.2.9 below.]		
1.1.21	The *definition of capital gains* for the purposes of designated concession income in Reg 152B does *not include gains arising on created assets*.	Unaltered	There is a policy question as to whether the Income Tax Regulations should reflect all of the CGT Events which can arise under the 1997 Act. In part, this question raises (again) the fundamental tension between accounting and taxable profits and the dividend assimilation issue. Another issue this raises is the scope of paragraph 385(2)(a)(ii) which can make a gain attributable even if it is not *designated concession income*. [See also para 1.2.10 below.]	Further policy consideration	High
1.1.22	Tax *paid by a shareholder and refunded to a company* is not a reduction in tax for the purposes of Reg 152C.	Unaltered	The New Zealand Tax system now imposes a withholding tax on dividends paid to shareholders, funded by a corresponding refund of tax otherwise payable on the company's profits. It is agreed that this should be clarified as not a *reduction of tax* for the purposes of Income Tax Regulation 152C. [See also para 1.2.11 below.]	ATO Ruling could resolve this.	High
1.1.23	Indonesia government paying a tax on behalf of company.	Don't Know	There is a variety of circumstances in developing countries where contracts are negotiated with the country's government or with a state-owned enterprise, on an after- tax basis. These raise difficult issues in terms of whether the profits have, or have not been 'subject to tax'; and will sometimes turn upon whether any tax *reimbursement* is made by the government itself or by an independent instrumentality. The circumstances are quite common, but it is relatively uncommon for the relevant income to be *tainted*.	Some cases could be handled by ATO ruling. Others may require further policy consideration.	Medium
1.1.24	*All capital gains* accruing for the purposes of Part IIIA on *the deemed disposal* of an asset should be taken into account in the *active income test*	Unaltered (except for CGT Event J1)	This is another manifestation of the tension between accounting income and taxable income. However, the case for accounting income to prevail is stronger in the context of the *active income test* than it is for *designated concession income*. This is because the	Further policy consideration	High

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	and passive.		*active income test* has always been intended to act as a pragmatic compliance mechanism under which it should not be necessary to undertake excessively detailed computations. The existing rules do incorporate some variations to accounting income, including J1 event amounts (see subsection 434(1A)), arm's length consideration concepts (see subsection 434(3)), and recognition of rollovers (see section 438). A counter-argument to adopting Tax Act principles to the *active income test* would be to adopt accounting income concepts to the calculation of *attributable income*; that would be more consistent with the dividend assimulation concept and would certainly simplify the CFC provisions. [See also paras 1.2.14 and 1.2.15 below.]		
1.1.25	*All capital gains* accruing for the purposes of Part IIIA, are taken into account in determining whether a CFC has *designated concession income* and active income test.	Unaltered (except for CGT Event J1)	See comments under para 1.1.24 above	Further policy consideration	High
1.1.26	Ensure taxation of capital gains is not avoided or minimised on the disposal of tainted assets, by arrangements designed to dilute the Oz taxpayer's attribution interest in the CFC that holds tainted assets that have received rollover relief.	Resolved.	This point should have been adequately resolved by the *degrouping* provisions (CGT Event J1) as introduced in the May 1997 Budget. If not, this type of activity could presumably be challenged under Part IVA. [See also para 1.2.16 below.]	Already resolved (unless evidence exists to the contrary)	N/A
1.1.27	Modify section 438 so that when a CFC ceases to be a subsidiary of the *ultimate holding company, a gain arises on an asset rolled over to the*	Unaltered	At present CGT Event J1 does not apply, either domestically or in the CFC provisions, if the rollover took place within an unbroken *sub-group*. It is not clear why the proponents of this issue appear to believe that this *sub-group* relief should be abolished for CFCs	Further policy consideration	Low (absent further evidence

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	CFC. Gain is tainted income. 1997-98 Budget announcement.		when it remains available domestically. [See also para 1.2.17 below.]		of mischief)
1.1.28	Creation of capital losses in NZ by manipulation of cost bases of 30 June 1990 non taxable Aust assets. 160ZK(5) overcomes this arrangement domestically, but does not cover CFCs.	Unaltered	If a dividend is paid out of pre-acquisition profits by a CFC, this likely suppresses the value of the shares in the CFC, but the cost base of those shares is unaltered. Australian domestic law prevents a capital loss arising in these circumstances, but only where the dividend has been *rebatable* (see subsection 110-55(7) of the 1997 Act, formerly subsection 160ZK(5) of the 1936 Act). Provided the dividend is neither taxed in a listed country, nor *attributable income* for Australian purposes, a similar adjustment to the *reduced cost base* of the shares would be appropriate. [See also paras 1.2.12 and 1.2.18 below.]	Amendment required	High
1.1.29	Policy review of interaction of CFC measures and CGT provisions	Unaltered	This is an umbrella statement embracing the more detailed issues discussed elsewhere. It is too broad to be useful on its own. However, it is agreed that the other, detailed issues should be addressed on the basis of sound general principles, not piecemeal.	Further policy consideration	High
1.1.30	FSI team to consider the underlying policy rationale on the characterisation of attributable income referable to capital gains in Part X.	Unaltered	Attributed capital gains constitute *assessable income* for the attributable taxpayer in Australia, and cannot therefore be offset against capital losses of the attributable taxpayer. This has been the source of frequent taxpayer criticism of the CFC provisions. The response, thus far, has been to refer to the dividend assimilation concept within the CFC measures. However, it can be observed that this concept is sometimes abandoned (see for example para 1.1.24 above) and a policy decision could be taken to abandon it here. [Alternatively, the dividend assimilation concept could be made more dominant as also discussed under para 1.1.24].	Further policy consideration	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
1.1.31	Review of offshore amalgamations in the FSI context	Unaltered	This has been the topic of some understandable vacillation on the part of the ATO. It is not an easy area to analyse because overseas corporate laws provide different forms of *mergers* and *amalgamations* with different legal consequences. Shaddick & Spence has had to advise on merger situations in Canada, Indonesia, New Zealand and USA; and there are probably many more countries where similar transactions can occur. Initially, the ATO provided a number of favourable Private Rulings, in about 1994, in respect of mergers in New Zealand. In about 1995/96 such Rulings ceased to be issued. Papers obtained by Shaddick & Spence under the *Freedom of Information Act* confirm that the ATO decided to take a more analytical approach. Minutes of a "Peak Technical Forum" in December 1997 and April 1998 confirm an intention to issue a Public Ruling on this point. It is likely that a draft of a Public Ruling was well advanced in 1998, but no draft has yet been issued for public comment.	ATO Public Ruling required	Urgent
	Control Rules				
1.1.32	The *definition of a CFC* should be *simplified*.	Unaltered	It is not clear whether the proponents of this issue consider that the provisions of section 340 should be simplified, or whether the supporting concepts (such as *associates* and *associate-inclusive control interests*) should be simplified. Assuming only the former, there is very little that can be simplified in section 340 itself. Paragraphs (a) and (c) are both straightforward. Consideration could be given to the repeal of paragraph (b) as it does not add much to (a) and (c); and it is also cryptic in subparagraph (b)(ii) because of the definition of the term "group" in Section 317. Consideration could possibly be given to the need for the existing separation between *control interests* and *attribution interests*. At	Further policy consideration	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			present, the existence of a CFC depends upon *control interests,* which include the interests of all associates. But, when deciding how much attributable income needs to be assessable to an Australian attributable taxpayer, only *attribution interests* are taken into account, and these exclude the interests of associates. Making the definition of a CFC dependent only upon *attribution interests* would likely impair the integrity of the CFC provisions, but it would also significantly reduce their unintended consequences and it would materially reduce the complexity of the law.		
1.1.33	The *associate and the control rules* in effect, achieve the same thing. A submission suggests the associate rules at least as far as they relate to companies, should be restricted to *onshore entities* and the tracing done offshore(?). As the definition for a controlled foreign entity that is a CFC is wider than the definition of associate (ie, the definition of associate requires more than 50%), there would not be many cases where an *offshore* corporate associate was not a CFC. If such a rule were to be adopted, it would overcome many of the problems that are currently.	Unaltered	It is not agreed that the *associate* and *control* rules achieve the same thing. The *associate* rules support the *control* rule. The problem is that the *associate* rules are so broad that they have the capacity to impute the existence of *control* where it does not actually exist. Many Australian residents have relatives overseas. These relatives are their *associates* (see paragraph 318(1)(a)), with the result that the Australian resident is considered to have an *associate-inclusive control interest* in any company controlled by his or her overseas relatives (see paragraph 349(1)(c)). The submission suggests that this sort of problem could be resolved if overseas associates were to be excluded from the calculation of the control interests. The submission is correct but, as in the comment in para 1.1.32 (above), the change would likely also impair the integrity of the CFC provisions. The better approach would be to limit the application of the *associate* rules to those circumstances where the Australian resident has substantial influence in respect of the interest of the *associate* in the overseas company.	Further policy consideration	Medium
1.1.34	The *tracing rules* in the *CFC* legislation are similar to those in the	Unaltered	As a matter of good legislative policy, it may not be a bad idea to harmonise a number of similar rules used for different purposes in	Further policy consideration	Low

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	foreign tax credit provisions and, to a certain extent, those in the *loss provisions*. Thought should be given to having a *unified* tracing rule across the Act or at least across the international provisions.		the Tax Acts. However, the *control tracing rules* in the CFC provisions are presently quite different to the *related foreign company* rules for foreign tax credit purposes (see section 160AFB).		
1.1.35	*Control rules may not be applicable to a guarantee company* as it has no shareholders and no share capital.	Unaltered	A company limited by guarantee can still be a CFC if its *de facto* control rests with Australian residents or their associates (see paragraph 340(c)). Furthermore, the definition of *shareholder* in section 6 includes *member*. Accordingly, it would be possible for a member of a company limited by guarantee to have an *attribution interest* in the company. It has been suggested that companies limited by guarantee can circumvent the CFC provisions, but that is far from clear. [See also para 1.2.20 below.]	ATO Public Ruling required	High
1.1.36	Reduces the 50% or greater associate inclusive control interest test to greater than 50% for incorporated joint ventures where actual control of income or type of transactions resides with the foreign partner because of foreign jurisdictional regulation.	Unaltered	This proposal has merit, although it is difficult to imagine why the relevant CFC would not pass the *active income test* and/or not have very little *adjusted tainted income*.	Further policy consideration	High
1.1.37	Disallowed insurance premiums. Control and attribution rules are important because of relationship with insurance company and taxpayer.	Unaltered	The issue has not been adequately identified. Assuming that the “captive foreign insurance company” is a CFC, the attribution rules in paragraphs 448(1)(d) and (e) appear to be adequate. Also, if the premiums are excessive, they can probably be disallowed to the Australian insured party under Division 13. The only issue must be that some “captives” are not CFCs. Without more factual details, this	None	N/A

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			would seem to be unlikely.		
1.1.38	Review of Liechtenstein Anstalts and the operation of the FSI measures	Unaltered	It is true that the CFC measures do not apply to Anstalts as such, because they are not normally considered to be *companies* under the Australian Tax Acts. Strictly speaking, they are possibly also not *trusts*, although there is a strong expectation that, if and when addressed by an Australian court, they will be regarded as sufficiently similar to a trust for the *FIF, present entitlement, and/or transferor trust* rules to apply. A useful paper on the status of Anstalts for Australian tax purposes was presented by Mr Matt Selig (an ATO officer, but presenting in a private capacity) in July 1998 at a Colloquium held in Queensland by the Taxation Law and Policy Research Institute of Deakin University (Victoria). If there is evidence of these entities being established overseas by Australian residents, it is recommended that the Tax Acts should be urgently amended to include such entities as *trust estates*, notwithstanding that they tend to have both company and trust-like characteristics.	Urgent amendment required	High (Urgent if evidence of abuse)
	Currency Exchange Gains				
1.1.39	It is possible for a *capital gain* to give rise to attribution where in fact *no gain actually* accrued merely through the *conversion of foreign dollars to Aus dollars.*	Unaltered	Not only is this a further manifestation of the fundamental conflict between accounting income and taxable income (thereby transgressing the dividend assimilation concept), but it also raises substantial practical difficulties for taxpayers and their agents in attempting to comply with the CFC provisions. Currency exchange fluctuations which affect *assets* (including foreign bank accounts and intercompany accounts, and movements between such accounts) are subject to the capital gains tax computation rules in section 103-20 of the 1997 Act; these can produce ridiculous outcomes such as those described in Tax Determination TD 1999/37. On the other hand, currency exchange fluctuations which affect *liabilities* are (quite appropriately) only recognised if they	Urgent amendment required	Urgent

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			occur in the denomination of the functional currency of the CFC (see for example TD 92/108). For liquid assets at least, currency exchange differences should not be recognised unless they are realised in the functional currency of the CFC. Arguably, the same should apply to other tainted assets (such as shares). [Ironically, with the Australian dollar now ascending in value, this amendment may not be as useful as it would have been during the declining period of 2000/2001.] [See also paras 1.2.19, 1.2.21, 1.2.25, 1.3.1, 1.3.2 and 1.3.5 below.]		
	Deminimus Test				
1.1.40	The de-minimus test for *broad-exemption listed country* CFCs should be expanded by *expanding the $50 000 threshold.*	Unaltered	We agree. The A$50,000 which was introduced in 1990 represents almost A$70,000 in 2002 Dollars. Furthermore, the Australian dollar has diminished further in value against other currencies. A revised *minimum* figure of A$100,000 is recommended. [See also para 1.2.26 below.]	Amendment required	Medium
1.1.41	**The de minimus exclusion only applies to BELC . It should be extended to all listed countries and be increased.**	Unaltered	When *limited-exemption listed countries* were covered by section 385 (prior to 1997) CFCs resident in those countries qualified for this relief. The change in status in 1997 has meant that they are now denied the relief. We agree that the relief should be extended. [See also para 1.2.27 below.]	Further policy consideration	Medium
	Calculation and Treatment of …				
1.1.42	Section 458 assess non-portfolio dividends from an unlisted country CFC to another CFC with a common attributable taxpayer. The component 'T' in the *formula in sec 458 does not include Australian tax paid including*	Unaltered	The issue, as described, does not seem to be valid. However, there is a remote situation which could occur where a dividend paid by one CFC to another CFC is assessable in Australia to the recipient CFC, by virtue of section 44(1)(b). In these circumstances, if the dividend was paid out of profits that were neither attributable nor "exempting", it is possible that the dividend could also be	Amendment required	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	withholding tax.		assessable to the attributable taxpayer under section 458. Although the situation is admittedly obscure, the remedy is simple and therefore recommended: In paragraph 458(2)(a) the words "or in Australia" can be added after the words "listed country".		
	Double Taxation				
1.1.43	Possible double taxation where *one beneficiary of trust is assessed* under accruals measures and *another receives the income or corpus* of the trust.	Unaltered	The general CFC principle is that the only Australian taxpayer who can be exempt from tax upon the actual receipt of previously attributed income is the taxpayer to whom the income was previously attributed. The principle is not beyond reconsideration; for example, the same principle does not apply in the Transferor Trust provisions (see paragraph 99B(2)(d)).	Further policy consideration	Medium
1.1.44	Double taxation may occur where an Australian company purchases an offshore group, where a company in that group is a resident of an unlisted country. Similar situation has been raised by a private taxpayer, where there is a Netherlands holding company between the UK company and unlisted country Co, due to the participation exemption in the Netherlands. FTC issues upon repatriation of income.	**Unaltered**	Where a CFC in an unlisted country is held *via* a CFC in a listed country, there is always the prospect that income, which has borne little tax in the unlisted country will be taxed more heavily when it is paid as a dividend to the CFC in the listed country. If an Australian attributable taxpayer has paid tax on the low-taxed income at the time when it was originally derived in the unlisted country, the subsequent imposition of listed country taxation represents "double taxation". However, the Australian *foreign tax credit* rules provide a remedy for this when a dividend is subsequently paid from the CFC in the listed country to an Australian company, notwithstanding that the subsequent dividend is exempt (see section 160AFCD). At the time that the original income is derived, it is not possible to predict with certainty that the listed country tax will be paid. For this reason, the existing Australian remedy in section 160AFCD is considered appropriate.	Remedy exists	N/A
1.1.45	Submission has been received pointing out that a reduction of	Unaltered	See also para 1.1.44 (above). The existing rules are quite pragmatic, taking into account Australia's self-assessment system.	Further policy	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	attributable income under section 456A does not apply where the CFC is not subjected to the foreign accruals regime until after the income year commencing during the CFC's SAP.		The design is intended to prevent constant amendment of assessments to take into account events that occur after the end of the attributable taxpayer's income year. Shaddick & Spence is not familiar with the specific problem described in relation to the UK's accruals tax law: if the additional time required occurs before the relevant Australian tax return has to be lodged, consideration could be given to allowing that additional time. [See also para 1.2.29 below.]	consideration	
1.1.46	A submission for a general relief provision to be introduced. The provision could operate by the application of general principals or at the CoT discretion where unintended consequences operate to disadvantage a taxpayer.	Unaltered	The CFC provisions can produce absurd results. The current manner in which the provisions are administered by the ATO suggests that there is absolutely no leeway for the provisions to be administered more sensibly, notwithstanding that such sensible administration was anticipated when the provisions were first introduced. Regrettably, the actual language of the law which produces the absurd outcomes is often not ambiguous (just too broad), so that the *Acts Interpretation Act* cannot be invoked to provide a remedy. This submission point does justify further consideration, but would presumably have to operate in a balanced fashion for both taxpayers and the ATO.	Further policy consideration	High
1.1.47	Problems have arisen with the creation of limited liability companies ("LLC") in the US. Where the LLC is a CFC, it is possible for double taxation to occur. This is because the foreign tax may be paid by the Aust entity as a partner rather than by the limited liability company. Accordingly, when attribution occurs, a foreign tax credit may not be available to the	Unaltered	A discussion paper was prepared by the ATO in December 1998 which addressed a number of issues pertaining to US Limited Partnerships and LLC's. The discussion paper appeared to consider that a foreign tax credit *would be available*. That would be an appropriate outcome, but no Public Ruling to that effect has yet been issued. [TD 2001/ D14 does not address this issue]. [See also paras 1.1.77, 1.2.30 and 1.2.39 below.]	ATO Public Ruling required	Urgent

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	attributable taxpayer under sec 160AFCA. This is because no deduction is allowable to the CFC under sec 393 as the foreign tax has not been paid by the CFC.				
	Entitled to Acquire				
1.1.48	The concept of *entitled to acquire is too broad* and may cover many arrangements where a taxpayer has little control over the potential acquisition. Consideration should be given to limiting the concept to exclude such things as pre emptive rights.	Resolved	See Ruling TR 2002/3.	Rectified	N/A
	Insurance Issues		**[This is not an industry in which Shaddick & Spence carries specialist expertise]**		
1.1.49	The law may need *amendment* so that *sec 112C* applies to *exempt* CFC income derived as a result of *activities in connection with a life insurance business carried on by a PE of an Aust life company using funds obtained from the issue of life policies to non-residents.*	Possibly resolved	The issue is not adequately identified. It is not clear whether the issue is concerned with CFCs or with non-Australian branches (PE's) of Australian life companies. To the extent that the issue relates to non-Australian branches of Australian life companies, it appears that the required exemption can now be found in paragraph 320-35(1)(d) of the 1997 Act.	Possibly rectified	N/A
1.1.50	A request to extend the exemption for notionally exempt income of a CFC's lower tier FIF to a wider variety of	Don't know	The issue is not adequately identified.	Don't know	??

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	managed funds other than those similar to statutory funds. IFSA claim no equivalent concept of statutory funds in foreign jurisdictions.				
1.1.51	The *control tracing interest* and *attribution percentage* of a fund maintained by a foreign life insurance company should be *reduced* to the extent interests held in foreign companies and trusts are *referable to funds from non-resident policy holders.*	Unaltered	Whilst it would seem relatively unusual for an insurance company to have such a large holding in a foreign company as part of its policy funds portfolio, this appears to be a valid submission point. The funds portfolio is held for the benefit of policyholders and not for the benefit of shareholders.	Further policy consideration	Medium
	Interest in a Trust				
1.1.52	There are problems in the *differences in the definition* of interest in a trust *between the CFC, FIF and the trust rules in secs 96B & 96C.*	Unaltered	The differences exist in the language of the legislation, but it is unlikely that any substantive difference exists from a policy perspective. It was apparently intended that section 96B should provide the most comprehensive view of an interest in a trust ("including an interest that is to arise in the future or is contingent on the happening of an event"); however the prevailing view is that it does not really achieve any more than the other provisions. A harmonised dictionary definition of an "interest in a trust estate" is desirable, and would tend to simplify the law.	Amendment required	High
	Loss Issues				
1.1.53	Losses incurred by a CFC should *not be quarantined on a class of income basis.*	Unaltered	Under the dividend assimilation concept, there is an argument that the CFC rules are *not* intended to mimic direct derivation of the attributed foreign income, in which case a valid argument can also be made that attributable income all belongs to the *modified passive*	Further policy consideration	High

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			class, likewise losses. At present, policy becomes confused between the dividend assimilation concept and the mimicry of direct derivation.		
1.1.54	*Group loss transfers* should be available between *subsidiaries to the extent of their offshore PE operations are in unlisted countries.*	Unaltered	This issue was raised before 1997. Since 1997, the submission would be that wholly-owned CFCs in non-broad-exemption listed countries should be allowed to transfer losses to other wholly-owned CFCs in non-broad-exemption listed countries. This becomes particularly noticeable in relation to intercompany accounts owing between commonly owned CFCs. Typically, they are advised (by virtue of Division 13) to charge arm's length interest on these accounts:- consequently, the interest income is commonly attributable in respect of the receiving CFC, but the attributable taxpayer often obtains no relief in respect of the interest paid by the paying CFC. In paragraph 6.12 of the April 1989 Information Paper, it is argued that the existence of the *active income test* renders group relief unnecessary, but this should be reconsidered.	Further policy consideration	Urgent
1.1.55	Net capital losses should be a*vailable for transfer between group CFCs in listed countries*.	Unaltered	This issue would also have been raised before 1997. It could apply to all group CFCs but there is now an effective self-help remedy for non-broad-exemption listed countries in that they are permitted to roll-over tainted assets to one another as per Item 3 of the table in subsection 419(1). Rather than encourage that type of self-help, it would be appropriate for a group attributable taxpayer to be allowed to apply unused capital losses of any group CFC against capital gains of any other CFC in the same, wholly owned group.	Further policy consideration	Urgent
1.1.56	Representation for allowing *losses to be transferred between CFCs.*	Unaltered	See para 1.1.54 and para 1.1.55 (above)	Further policy consideration	Urgent
1.1.57	Quarantining of losses. *Income*	Unaltered	In terms of attributed *capital gains* see discussion under para 1.1.30	Further policy	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	attributed back to Aust should retain its character. For eg, a capital *gain made offshore should be able to be offset against the attributable taxpayer's domestic capital losses*.		(above). In all other respects, note that attributable income of *all* classes is considered to be *passive income* for foreign tax credit purposes, and to be *modified passive income* for loss quarantining purposes. Whilst this might be considered to be a somewhat broad-brushed approach, it reduces the complexity of the legislation and it also adheres to the dividend assimilation principle.	consideration	
	Operative or Assessing Provision [s. 456]				
1.1.58	Should *expenses for deriving attributable income* be *allowable deductions* under section 51?	Largely resolved	The introduction of section 25-90 of the 1997 Act via New Business Tax System (Thin Capitalisation) Act 2001 has effectively resolved this problem (if any), at least in respect of *debt deductions*. The existing provisions probably permit proportionate deductions to be claimed in respect of other expenses; and there should be no objection to that.	Rectified	N/A
1.1.59	*Avoidance* of assessing provision section 458 *by* holding *non-voting shares in the unlisted country CFC* to which a dividend is paid by a listed country CFC.	Unaltered	The function of section 458 can be frustrated if the dividend paid from an unlisted country CFC to a listed country CFC is not a portfolio dividend. There appears to be no good policy reason for restricting the operation of section 458 to non-portfolio dividends. It is recommended that the words "non-portfolio" should be deleted from paragraph 458(1)(a). [See also para 1.2.31 below.]	Amendment required	High
1.1.60	Problem with *formulae* in s458 which does *not recognise* the taxable portion of a dividend if the section 458 *amount* has been *reduced for foreign withholding tax*.	Resolved	The gross-up suggested by the proponents of this issue appears to be already contained in subsection 6AC(5). [See also para 1.2.32 below.]	Rectified	N/A
1.1.61	Attribution percentage should be *measured* by the taxpayer's	Unaltered	With section 47A it is important to bear in mind that the entity receiving the benefit is deemed to have received a dividend whether	Arguably	N/A

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	attribution % in the CFC paying the s47A dividend and not the CFC receiving the S47A dividend.		or not that entity is a shareholder in, or has an attribution interest in the CFC providing the benefit. It is also important to bear in mind that an Australian resident can be an attributable taxpayer in respect of a CFC without having any attribution percentage whatsoever in that CFC. If a CFC in which an Australian resident has an attribution percentage pays a benefit to a CFC in which that Australian resident is an attributable taxpayer but without an attribution percentage, it follows that the Australian taxpayer is not in a position to enjoy the fruit of the benefit, even though an associate may be in such a position. The onus of taxation should, as far as possible, fall on the enriched party, not otherwise. Accordingly, it is submitted that the existing rules apply properly.	None	
	Passive Income Section 446				
1.1.62	Amend definition of passive income to *exclude certain amounts* of passive income *which form part of the core business* of the taxpayer.	Unaltered	At present, this sort of relief is restricted to *AFI subsidiaries* as set out in sections 449 and 450, and to insurance companies in subsections 446(2) and (4). A more general form of relief could be considered, and would be consistent with the need to encourage commercial CFCs to compete with rivals outside Australia, unhindered by Australian tax constraints.	Further policy consideration	High
1.1.63	Amend s446 to allow for an *exemption for interest income derived by start-up companies*, which is incidental to an active business.	Unaltered	For *foreign tax credit* purposes, there is a special definition of interest income (see subsection 160AE(3)), which excludes a number of items such as "interest derived by a person from a transaction directly related to the active conduct of a trade or business". It would be a good idea if the same exclusions applied to the definition of "tainted interest income" in section 317. It would also be a good idea if the exclusions extended to start-up situations where there is an abnormal cash deposit awaiting investment in an untainted asset within a reasonable period. The extension could	Further policy consideration	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			apply both for subsection 160AE(3) purposes and for section 446 purposes.		
	Redeemable Preference				
1.1.64	Treatment of RPS for FSI Purposes.	Unaltered	The issue is not adequately identified. It may be noted that, in 2001, section 389A was inserted in the 1936 Act. For the purposes of calculating attributable income, the 2001 "debt/equity" provisions are disregarded. Also, it may be noted that some Redeemable Preference Shares may constitute *eligible finance shares* under section 327 or *widely distributed finance shares* under section 327A. It is also important to remember that Redeemable Preference Shares can take many forms and serve many purposes. The nature of the issue addressed by the proponent of this item is entirely unclear.	Arguably none	N/A
	Resident				
1.1.65	The *effect of the rewritten definition of a resident* on the international rules needs to be studied.	Not yet a problem	Under RITA option 3.12, a company whose central management and control is in Australia would not be resident in Australia unless it also *carries on business* in Australia. If this change was made, some companies which have previously been resident in Australia may cease to be, and may therefore become CFCs. It would need to be considered whether or not the "change of residence" should trigger the normal deemed disposal for CGT purposes (CGT Event I1); arguably there need be no such trigger for tainted assets of such a company becoming resident in a non-broad-exemption listed country; [at present, section 418A applies]. Under RITA option 3.13 a company that is not resident in Australia for tax treaty purposes may also be treated as not resident in Australia for domestic Australian tax purposes. In Australia's CFC	Cross-refers to RITA options 3.12 and 3.13; Some consequential amendments would likely be required.	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			provisions, this concept is already in place through the mechanism of a *Part X Australian resident,* as defined in section 317.		
	Comparably Taxed				
1.1.66	Review the *broad exemption listed countries* to *determine if the income or gains are comparably taxed* in them or are they "subject to a reduction in tax" .	Unaltered	When the CFC rules were first introduced, there was a list of specific tax incentives provided in respect of listed countries, and tainted income that enjoyed these concessions was attributable (Regulation 152D(1)(c)); there were also separate generic tax advantages which were treated similarly, but not listed by country (Regulation 152D(1)(a) and (b)). The radical reduction, in 1997, of the relevant countries to the current list of just 7 *broad-exemption listed countries* presented an opportunity (so far not seized) to do away with the generic items and draw up a more extensive, specific list of concessions in each of those 7 countries, thereby ensuring that only concessions which are particularly objectionable to the Australian government would give rise to attributable income from CFCs resident in those countries.	Further policy consideration	Medium
			[An alternative approach which has received some recent support, would be to exempt CFCs resident in those countries from the CFC measures altogether.]		[High]
	Substituted Accounting				
1.1.67	SS 319(6) allows for a *short SAP where a CFC ceases to exist during its normal SAP*. CFC rules being avoided.	Unaltered	The proponent's argument is that the abbreviated *Statutory Accounting Period* for CFCs which are liquidated, should also be adopted for CFCs which are sold during a *Statutory Accounting Period*. The argument has merit, but raises some structural issues concerning the CFC measures, because the role of the *Statutory Accounting Period* is specific to the CFC itself, rather than to its attributable taxpayers. There would also need to be a symmetrical	Further policy consideration	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			relief for the part of the *Statutory Accounting Period* that presently occurs *before* an attributable taxpayer acquires his or her interest in the CFC. The present rules are more inequitable for a buyer than for a seller, because the buyer is potentially "buying" accrued attributable income, whereas a seller will likely recognise the accrued attributable income in the form of assessable disposal proceeds. Although the suggestion has some merit, it would add complexity to the CFC provisions		
1.1.68	*Difference in time zones* which follow Australia's time zone may be *able to defer attribution for a 12 month period.* S319	No	This concern seems to be unfounded. The use of 30 June as the tax or reporting date in the overseas country (adopting the overseas time zone) would prevent the CFC electing an alternative *Statutory Accounting Period* under section 319 (see paragraphs 319(3)(a)(ii)(A) and (B)). [See also para 1.2.34 below.]	None	N/A
	Tainted Assets [s.317]				
1.1.69	Is *goodwill* a tainted asset?	Unaltered	Goodwill is not a tainted asset under the definition in section 317. There is no apparent reason why it should be regarded as a tainted asset, nor why this question erupts from time to time. The better question may be whether shares in subsidiary companies should continue to be treated as *tainted*?	ATO Public Ruling required	Medium
1.1.70	*Land held separately* from the entity that operates *an active business* on the land is a tainted asset for the entity that holds the land.	Resolved	In 1997, the concept of *special excluded rental income* was introduced to section 317, and this type of rental income is treated as *untainted*, thereby preventing the land from being a *tainted asset.* There could be further technical amendments to the definition of *special excluded rental income* but these would not affect the policy, which is clear. The technical concerns are not mainstream so that, in the main, the issue has been resolved.	Rectified	N/A

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	Tainted Royalty Income [s.317]				
1.1.71	The s 317 definition of tainted royalty income may *include amounts specifically excluded from the definition of tainted rental income* by paragraphs (e) and (f) of that definition. This result was not intended.	Unaltered	Where there are substantial operative or maintenance services provided with the lease of a ship or container, the entire rental income from the lease is not considered to be *tainted rental income*. But rents from the use, or the right to use, such commercial equipment are also *royalties* under the normal definition of royalties in section 6. Consistent with recent draft ruling TR 2002/D11, the position with royalties is that they include *ancillary* services. It is anomalous that services which operate to exclude rental income from attribution are *not* permitted to exclude the same income from attribution under the alternative heading of *tainted royalty income*. The definition of *tainted royalty income* needs to be aligned. [See also para 1.2.36 below.]	Amendment required	High
1.1.72	There is a problem with the definition of *tainted royalty income* as it applies to the *music industry*.	Unaltered	The problem is not immediately apparent; but presumably results from the characterisation of royalties as *passive income* rather than as active income. For royalties to be tainted (passive) the subject matter must not have originated with the CFC nor be substantially enhanced by the CFC. The argument must be that the music industry is in the active business of exploiting original work that it neither originates nor enhances, but considers it unreasonable that its *active* profits should fall within the *passive* income basket for attribution purposes. See also para 1.1.62 above	Further policy consideration	High
	Tainted Sales Income				
1.1.73	Representation that the "*substantial alteration & substantial manufacture" tests* in tainted sales should be *defined.*	Resolved	It is difficult to imagine what additional definitions could be required beyond subsections 447(4) (substantial alteration test), and 447(4A) (substantial manufacture test). These were added to the Act in 1992, although it would appear that the issue has been raised subsequently. [See also para 1.2.37 below.]	Rectified	N/A

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	Tainted Services Income [s.448]				
1.1.74	The change to the *3 lists* in 1997 has *increased* the focus on the *difference between the definitions of tainted sales income and tainted services income*. A service provided to an associate will always be tainted whereas a sale to an associate will only be tainted if the associate is either a Part X Aust resident or a non-resident operating in Aust through a PE.	Unaltered	There are good arguments to suggest that service income should never be tainted. If the services are being provided from outside Australia, the consequential income has a source outside Australia and it cannot be said to have been artificially mobilised out of Australia. Conversely, if the services are actually being provided by an Australian resident or by an Australian permanent establishment of a non-resident, Australia's transfer pricing rules (Division 13) already operate to ensure that Australia levies tax on the added value. Many CFCs do provide services to non-associated Australian residents from outside Australia. It remains unclear why this income should be *tainted*. Services income should either cease to be tainted altogether, or limited to services provided to Australian residents who are also associates of the CFC.	Cross-refers to RITA 3.3. Further policy consideration	Urgent
1.1.75	Exclude from tainted services income for repair and maintenance services provided to a group company as such services represent a major integral part of the groups wagon hiring operations.	Unaltered	The description of the particular taxpayer's concern (services provided by a CFC in Austria to (presumably) other European members of the group) provides an excellent example of the concerns discussed at para 1.1.74 (above)	Cross-Refers RITA 3.3. Further policy consideration	Urgent
	Tainted Rental Income				
1.1.76	Submission for an active rental income exclusion from tainted rental income where considerable maintenance and management services are provided with leased plant and equipment	Unaltered	The submission would appear to be more appropriately directed against *tainted royalty income* than *tainted rental income* (see para 1.1.71 above), because tainted rental income arises only in respect of items leased to associates, whereas tainted royalty income would include amounts leased to non-associates. The submission has merit and deserves favourable consideration. See also para 1.1.62	Further policy consideration	High

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
			(above).		
	US Entities				
1.1.77	Review of hybrid entities such as US LLC's, LLP's and LP's in the FSI context – to provide strategic and technical advice to assist segments to complete PBR requests.	Unaltered	See comments under para 1.1.47 (above)	ATO Public Ruling required. (follow with Further policy consideration if necessary)	Urgent

Chapter 1: Controlled Foreign Companies

Section 2: Technical Issues

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	AFI Subsidiaries				
1.2.1	There appears to be scope to tighten the exemption for AFI's to ensure the exemption is not available for regional banking activities conducted from a tax haven	Unaltered	See comments under para 1.1.2 (above)	Further policy consideration	Low
	Associate Section 318				
1.2.2	The words *"application of this"* should be *deleted from the definition* of associate in sub-subparagraph 318(2)(e)(I)(B).	Resolved	The relevant words were removed in 1998.	Rectified	N/A
	Attributable Income				
1.2.3	Clarification is required in subparagraph 385(2)(a)(i) which refers to an amount that is both adjusted tainted income and eligible designated concession income ("EDCI").	Unaltered	There is certainly a lack of discipline in the drafting. The language could be altered to say "*that includes or is included in eligible designated concession income…"* instead of merely "*that is included in eligible designated concession income…".*	Amendment required	High
1.2.4	Attributable income - exemption from withholding tax under FDA – s 402	Unaltered	See comments under para 1.1.9 (above)	See also RITA para 3.11	Low
1.2.5	*S 457 definition of adjusted distributable profits*	Unaltered	See comments under para 1.1.10 (above)	See also RITA para 3.9	Medium
1.2.6	Calculation of Attributable Income and	Don't Know	The issue has not been adequately identified (see also para 1.1.11	None	Low

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	self-amendment for FIFs held by CFC UK.		above)		
	Attribution Accounts				
1.2.7	Submissions to TLGSC that a CFC which disposes of a CFC or FIF *receive an attribution debit through the disposal consideration is not included in attributable income.* S401 & 461 - reduction of disposal consideration where attributed income not distributed.	Unaltered	See comments under para 1.1.15	ATO Ruling required	High
	CGT Issues				
1.2.8	Section 419 and the section 160ZZO rollover relief should be extended to cover all transfers by Aust resident companies to group company CFCs.	Unaltered	Agreed. See comments under para 1.1.17 (above) and Professor Arnold's report of 2 August 1996.	Urgent amendment required	Urgent
1.2.9	Issue if a capital loss can give rise to EDCI in Reg 152B.	Resolved	It cannot. See comments under para 1.1.20 (above)	Already resolved	N/A
1.2.10	The *definition of capital gains* for the purposes of designated concession income in Reg 152B does *not include gains arising on created assets.*	Unaltered	See comments under para 1.1.21 (above)	Further policy consideration	High
1.2.11	Tax *paid by a shareholder and refunded to a company* is not a reduction in tax for the purposes of Reg 152C.	Unaltered	See comments under para 1.1.22 (above)	ATO ruling required	High
1.2.12	Amendment to CGT modified provisions in Subdivision C Part X	Unaltered	See comments under para 1.1. 28 (above)	Amendment required	High

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	needed to reflect S160ZK(5) which prevents *manipulation of cost base of "30 June non-taxable asset".*				
1.2.13	A *capital loss crystallisation amendment* to CFC modified provisions in Part X re section 160ZZO	Resolved	It appears that subdivision 170-D will now ensure that no capital loss is crystallised if the CFC transferee is a member of the same *linked group.* Subdivision 170-D was introduced with effect from 21 October 1999.	Rectified	N/A
1.2.14	*All capital gains* accruing for the purposes of Part IIIA on *the deemed disposal* of an asset should be taken into account in the *active income test* and passive.	Unaltered (except for CGT Event J1)	See comments under para 1.1.24 (above)	Further policy consideration	High
1.2.15	*All capital gains* accruing for the purposes of Part IIIA, are taken into account in determining whether a CFC has *designated concession income* and active income test.	Unaltered (except for CGT event J1)	See comments under para 1.1.24 (above)	Further policy consideration	High
1.2.16	Ensure taxation of capital gains is not avoided or minimised on the disposal of tainted assets, by arrangements designed to dilute the Oz taxpayer's attribution interest in the CFC that holds tainted assets that have received rollover relief.	Resolved	**See comments under para 1.1.26 (above)**	Already resolved (unless evidence exists to the contrary)	N/A
1.2.17	Modify section 438 so that when a CFC ceases to be a subsidiary of the *ultimate holding company, a gain arises on an asset rolled over to the*	Unaltered	**See comments under para 1.1.27 (above)**	Further policy consideration	Low (absent further evidence

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	CFC. Gain is tainted income. 1997-98 Budget announcement.				of mischief)
1.2.18	Creation of capital losses in NZ by manipulation of cost bases of 30 June 1990 non taxable Aust assets. 160ZK(5) overcomes this arrangement domestically, but does not cover CFCs.	Unaltered	See comments under para 1.1.28 (above)	Amendment required	High
1.2.19	Application of s160K(5) to determine the attributable income of a CFC in relation to gains and losses of a capital nature where Part IIIA, as modified, applies.	Unaltered	This is the current position (read section 103-20 of the 1997 Act for the former section 160K(5)). There is a strong argument that the current position is flawed, as described in the comments under para 1.1.39 (above).	Urgent amendment required	Urgent
	Control Rules				
1.2.20	*Control rules may not be applicable to a guarantee company* as it has no shareholders and no share capital.	Unaltered	See comments under para 1.1.35 (above)	ATO Public Ruling required	High
	Currency Exchange Gains & Losses				
1.2.21	It is possible for a *capital gain* to give rise to attribution where in fact *no gain actually* accrued merely through the *conversion of foreign dollars to Aus dollars.*	Unaltered	See comments under para 1.1.39 (above)	Urgent amendment required	Urgent
1.2.22	Rules are required to ensure that currency exchange gains and losses arising from the conversion of	Unaltered	TD 1999/37 does not deal with this point. A fundamental problem is that *net tainted currency exchange gains* are treated as *passive income* for the purposes of attribution (sections 446(1)(n) and	Amendment required	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	amounts into a CFC's functional currency are characterised as belonging to the same class of income as the underlying transactions to which the amounts relate.		386(2)(a)) *but not* for the purposes of loss quarantine classification (sections 160AEA, 160AFD and 424). Suppose for example, that a CFC's bank deposit in foreign currency was switched in one year from US$ to Pds Sterling, and that a currency loss was realised. The loss would be deductible, presumably against the *interest class* of income; suppose in the following year the same CFC switched the same Pds Sterling deposit back to US$ and realised a gain. The gain would be attributable, but under the *other* class of income. Consequently the gain in year 2 cannot be offset against any unused part of the loss incurred in year 1. Other examples exist. [See also para 1.3.3 below.]		
1.2.23	A representation that the attributable income should be calculated in the functional currency of a CFC and then converted to Australian currency.	Unaltered	This would certainly make it more likely that the dividend assimilation concept would be retained and adhered to. It would likely also make the CFC provisions simpler. This would constitute a compromise between the existing rules and the accounting income approach discussed at para 1.1.24 (above). [See also para 1.3.4 below.]	Further policy consideration	High
1.2.24	An OZ company with a CFC. CFC disposes of 10% of its interest in a Canadian entity Is the foreign exchange gain attributable income of the CFC. Application of s160K to Part X	Unaltered	As Canada is a broad-exemption listed country, the proceeds of this tainted asset will be attributable if (i) there is a gain from the sale (ordinary meaning of gain as per *Dismin* see para 1.1.20 above); (ii) the gain is *exempt from tax* in Canada; and (iii) the CFC fails the *active income test.* If all three of these conditions are satisfied, the attributable capital gain is then calculated in Australian Dollar terms as required by section 103-20 of the 1997 Act (formerly subsection 160K(5) of the 1936 Act. The function of this section is to incorporate the foreign exchange gain (if any) into the calculation of the attributable capital gain on the sale of the tainted asset. It is not clear what issue is a concern here. If it is the application of section 103-20, see comments under para 1.1.39 (above).	Not identified	N/A

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
1.2.25	Application of s160K(5) to currency conversions of capital gains derived by CFCs into Australian dollars	Resolved by TD 1999/37	Subject to the possible policy alternative discussed at para 1.1.39 (above)	Previous uncertainty rectified.	N/A
	Deminimus Test				
1.2.26	The de-minimus test for *broad-exemption listed country* CFCs should be expanded by *expanding the $50 000 threshold*.	Unaltered	See comments under para 1.1.40 (above)	Amendment required	Medium
1.2.27	The de minimus exclusion only applies to BELC . It should be extended to all listed countries and be increased.	Unaltered	See comments under para 1.1.41 (above)	Further policy consideration	Medium
	Definition of Disposal				
1.2.28	**To clarify that *"disposal"* in part X has a *wider* meaning than *Part IIIA***	Don't know	It is difficult to assess this issue out of context. The CGT concept of *disposal* was formerly in section 160M(1) of the 1936 Act and is now in section 104-10 of the 1997 Act. The Part X definition of *disposal* indicates that (apart from its ordinary meaning) it includes the *redemption of an asset* and a *CGT Event J1*. It is not clear what further clarification is required.	None?	N/A
	Double Taxation				
1.2.29	Submission has been received pointing out that a reduction of attributable income under section 456A does not apply where the CFC is not subjected to the foreign accruals regime until after the income year commencing during the CFC's	Unaltered	See comments under para 1.1.45 (above)	Further policy consideration	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	SAP.				
1.2.30	Problems have arisen with the creation of limited liability companies ("LLC") in the US. Where the LLC is a CFC, it is possible for double taxation to occur. This is because the foreign tax may be paid by the Aust entity as a partner rather than by the limited liability company. Accordingly, when attribution occurs, a foreign tax credit may not be available to the attributable taxpayer under sec 160AFCA. This is because no deduction is allowable to the CFC under sec 393 as the foreign tax has not been paid by the CFC.	Unaltered	See comments under para 1.1.47 (above)	ATO Public Ruling required	Urgent
	Operative Or Assessing Provision Sections 456, 456A, 457, 458, 459, 459A				
1.2.31	*Avoidance* of assessing provision section 458 *by* holding *non-voting shares in the unlisted country CFC* to which a dividend is paid by a listed country CFC.	Unaltered	See comments under para 1.1.59 (above)	Amendment required	High
1.2.32	Problem with *formulae* in s458 which does *not recognise* the taxable portion of a dividend if the section 458 *amount* has been *reduced for foreign withholding tax*.	Resolved	See comments under para 1.1.60 (above)	Rectified	N/A

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
1.2.33	*Insert* before "listed country" the words *"broad-exemption"* in ss458(2A)	Unaltered	This is a minor technical amendment that should be made to align subsection 458(2A) with section 456A (accruals tax laws in *broad-exemption listed countries)*. [It is important to note that *no* equivalent amendment is required in paragraph 458(2)(a).]	Amendment required	Medium
	Substituted Accounting Periods				
1.2.34	*Difference in time zones* which follow Australia's time zone may be *able to defer attribution for a 12 month period.* S319	No	See comments under para 1.1.68 (above)	None	N/A
1.2.35	Exemption of an attributable taxpayer of a CFC with a lower tier FIF. *Refers to both SAP and NAP of a FIF.*	Unaltered	A CFC is also a FIF; so there have to be provisions to prevent both the FIF attribution rules and the CFC attribution rules applying in respect of the same company. The standard provision is Section 494, but section 431A performs the function of 494 where the interest in the CFC/FIF entity is itself held by another CFC. The normal rule is that the CFC provisions prevail over the FIF provisions. However this normal rule is subject to some alignment requirements between the *Statutory Accounting Period* of the company (in its CFC capacity) and the *Notional Accounting Period* of the company (in its FIF capacity). The alignment provisions occur in both sections 494 and 431A, but it is not entirely clear what mischief they are seeking to prevent.	Minor matter	Low
	Tainted Royalty Income [s. 317]				
1.2.36	The s 317 definition of tainted royalty income may *include amounts specifically excluded from the definition of tainted rental income* by paragraphs (e) and (f) of that definition. This result was not intended.	Unaltered	See comments under para 1.1.71 (above)	Amendment required	High

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
	Tainted Sales Income [s. 447]				
1.2.37	Representation that the "*substantial alteration & substantial manufacture" tests* in tainted sales should be *defined.*	Resolved	See comments under para 1.1.73 (above)	Rectified	N/A
1.2.38	S447 does not currently apply to 2^{nd} and beyond tiers of CFCs.	Unaltered	The tiers referred to appear to be contractual tiers rather than structural tiers. Tracing goods through chains of associated buyers and sellers would add considerable complexity to the CFC provisions. Since the provisions would only apply if the CFC failed the substantial alteration or substantial manufacture tests, it is unlikely that the arm's length transfer price of the goods would be significantly different at different points in the chain. Accordingly, any mischief here could probably be adequately challenged through Division 13, or failing that, through Part IVA	Amendment would be complex	Low
	US Entities				
1.2.39	Review of hybrid entities such as US LLC's, LLP's and LP's in the FSI context – to provide strategic and technical advice to assist segments to complete PBR requests.	Unaltered	See comments under para 1.1.47 (above). TD 2001/D14 deals with only a very small part of this issue.	ATO Public Ruling required	Urgent

Chapter 1: Controlled Foreign Companies

Section 3: Administrative Issues

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
.	**CGT Issues**				
1.3.1	Application of s160K(5) to determine the attributable income of a CFC in relation to gains and losses of a capital nature where Part IIIA, as modified, applies.	Resolved by TD 1999/37	Subject to the possible policy alternative discussed at para 1.1.39 (above)	Previous uncertainty rectified	N/A
	Currency Exchange				
1.3.2	It is possible for a *capital gain* to give rise to attribution where in fact *no gain actually* accrued merely through the *conversion of foreign dollars to Aus dollars*	Unaltered	See comments under para 1.1.39 (above)	Urgent amendment required	Urgent
1.3.3	Rules are required to ensure that currency exchange gains and losses *arising from the conversion* of amounts into a *CFC's functional currency* are *characterised* as belonging to the *same class* of income as the *underlying transactions* to which the amounts relate.	Unaltered	See comments under para 1.2.22 (above)	Amendment required	Medium

Issue No.	Issue	Still a Problem?	Explanatory Comments	Category	Priority
1.3.4	A representation that the *attributable income should be calculated in the functional currency* of a CFC and *then converted to Australian currency.*	Unaltered	See comments under para 1.2.23 (above)	Further policy consideration	High
1.3.5	Application of s160K(5) to currency conversions of capital gains derived by CFCs into Australian dollars	Resolved by TD 1999/37	Subject to the possible policy alternative discussed at para 1.1.39 (above)	Previous uncertainty rectified	N/A