International Taxation

A Report to the Treasurer

Volume 2

The Board of Taxation Consultation with the Community — Summary of Submissions

The Board of Taxation

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PREFACE

On 2 May 2002, the Treasurer announced details of a review of international taxation arrangements. The Treasurer announced that the Board would undertake public consultation on aspects of Australia's international tax arrangements following the public release of a consultation paper prepared by the Treasury.

On 22 August 2002, the Treasurer released the consultation paper *Review of International Taxation Arrangements*, prepared by the Commonwealth Department of the Treasury (Treasury Paper). The Treasurer announced that the Treasury Paper would set out options that would form the basis for public consultation to be undertaken by the Board.

This report (Volume 2) summarises the outcome of the consultation process undertaken by the Board and the views expressed by stakeholders in public submissions on the Treasury Paper. The report has been prepared for the purposes of the Board and gives an overview of the content of submissions but does not attempt to deal with all aspects of submissions made. For more comprehensive information about the public submissions made to the Board, readers should refer directly to those submissions. Public submissions made to the Board are available at the Board's website www.taxboard.gov.au.

To help ensure the accuracy of the summaries in this volume, the summaries were prepared by a team within the Board of Taxation Secretariat separate from that working on the Board's recommendations.

Table 1 sets out the names of parties who assisted the Board by making public submissions. Table 2 lists a number of key stakeholders who met with the Board after the close of submissions to discuss their submissions.

The chart below at Figure 1 sets out a break up of the background of organisations and individuals making submissions to the Board.

Figure 1: RITA Submissions by organisation

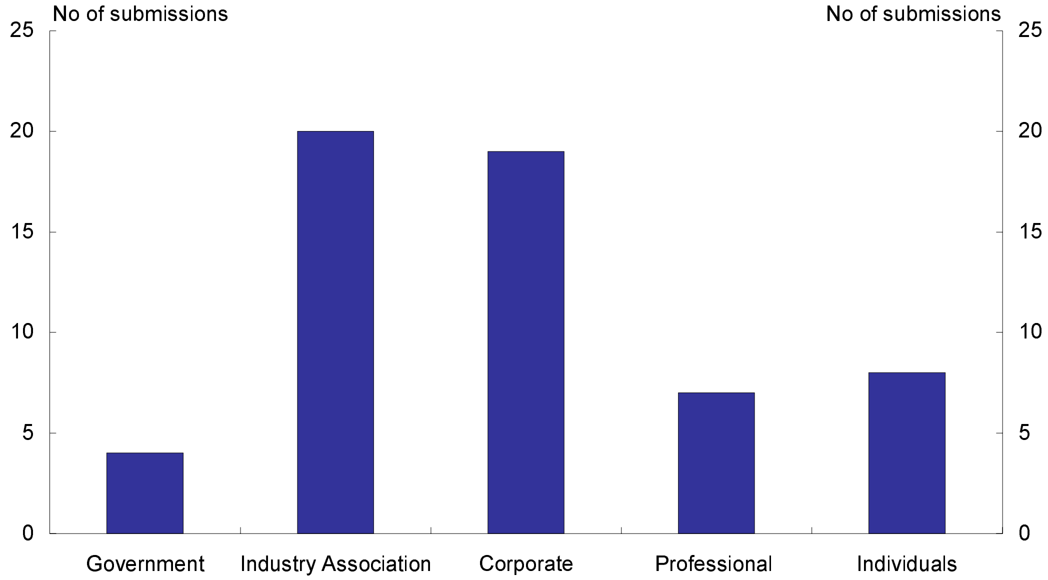

Table 1: List of individuals and organisations providing submissions to the Board on the Review of International Taxation Arrangements

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

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

Submission Number	Organisation/Individual
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
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)

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

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

Table 2: List of organisations with which the Board's working group met with following the close of submissions

Organisation/Individual
Australian Bankers' Association
Australian Chamber of Commerce and Industry
BHP Billiton Ltd
Brambles Industries Ltd
Business Coalition for Tax Reform
Business Council of Australia
Corporate Tax Association
CPA Australia
International Banks & Securities Association of Australia
Investment and Financial Services Association
Institute of Chartered Accountants in Australia
Group of 100
Rio Tinto Ltd
Taxation Institute of Australia
Westfield Holdings Ltd

EXECUTIVE SUMMARY

Chapter 1: Maintaining Australia's competitiveness in a global economy

A number of submissions referred to the importance of the Review of International Taxation Arrangements as an avenue to address problems that exist in Australia's international tax system.

Submissions referred to reforms that have taken place to the international tax regimes of other countries to encourage new investment and highlighted the risks faced by Australia if its existing international tax arrangements remained unchanged.

A number of submissions stressed the need to have an ongoing process of review and reform of the tax system rather than uncoordinated, intermittent and piecemeal reforms when significant problems presented themselves.

Chapter 2: Attracting equity capital for offshore expansion

Many submissions noted that the current dividend imputation system works effectively and should be retained.

Most submissions supported adopting a combination of Options 2.1A (non-refundable tax credits for unfranked dividends paid out of foreign source income) and 2.1B (dividend streaming).

Most submissions indicated that a one-ninth credit would be insufficient to remove the shareholder level bias; many submissions seeking that a three-sevenths credit should apply.

Some submissions noted that Option 2.1B, while worthwhile, may be effective initially for only a limited number of companies that have a reasonable symmetry between foreign income derived and the level of non-resident shareholders. A number of submissions considered, however, that in the longer term more companies could potentially have matching levels of foreign income and foreign shareholders, enabling streaming to be effective for them.

Most submissions did not support Option 2.1C (providing franking credits for foreign dividend withholding tax paid by Australian companies). Submissions noted that the availability of franking credits for any withholding tax on repatriated dividends to Australia would have limited importance. This reflects the trend to reduce withholding tax rates in new treaty negotiations (for example, the US Protocol and treaties containing most favoured nation provisions).

A number of submissions noted that dual listed company structures overcome the domestic bias of the imputation system in certain circumstances but are not practical, relevant or viable in every situation.

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

Most submissions point out that the controlled foreign company (CFC) rules are very complex and impose very high compliance costs on companies with international operations. Many submissions called for fundamental reform of the CFC provisions. Some submissions, however, sought that in the more immediate term that specific problem areas of the CFC provisions should be addressed.

A common theme was that there should be an exemption from the CFC rules for CFCs based in broad-exemption listed countries (BELCs).

The problems caused by the tainted service rules was raised as a major issue. Submissions noted that these rules were developed when services income was not a significant feature of the economy. Many submissions suggested that the rules should be more targeted or should not apply to active businesses. Unlike when the CFC rules were being developed, there are now well enforced transfer pricing rules and an effective general anti avoidance rule, and these rules should primarily be relied on to target any abuses in this area.

There was a general view that the list of BELCs should be expanded to include more countries based on clearly articulated criteria. With the reduction in Australia's company tax rate in recent years, a number of submissions considered more countries are likely to have comparable taxation regimes/tax rates to Australia.

Submissions noted that there is often a need to undertake corporate reorganisations due to acquisitions, business combinations, amalgamations, corporate streamlining and/or in advance of divestments. However, companies cannot reorganise without incurring a significant tax liability, except in some cases where the CFCs are resident in the same foreign country. There was a broad view that roll-over relief should be expanded, with some submissions noting that all forms of corporate reorganisation allowed under the capital gains tax (CGT) provisions should also apply under the CFC rules.

Many submissions stressed that Australian companies are not being used as regional holding companies. Submissions suggested one contributing factor is Australia's taxation treatment of capital gains earned by foreign subsidiaries of foreign-owned Australian companies. Australia taxes profits that are not taxable in similar circumstances if foreign owners establish their holding company outside Australia in some other regional locations.

Many submissions pointed to the problems with the current company residence test and recommended that the current test be reviewed. Most submissions suggested introducing a test based solely on place of incorporation. Such a test would, according to the submissions, result in very significant compliance cost savings.

Chapter 4: Promoting Australia as a global financial services centre

There was a general view that the foreign investment fund (FIF) rules are too complex and impose very high compliance costs and should be totally rewritten in the long term. Many submissions noted that the attribution rules impose significant costs as an attribution account must be kept for each investment at the shareholder level.

In the shorter term, submissions proposed that the FIF rules be amended to address a number of specific issues. A number of submissions favoured a complete carve out from the FIF rules for genuine public offer vehicles such as registered managed investment schemes and life companies.

Submissions suggested that reform in the FIF area could result in significant economic benefits for Australia. The potential benefits included the prospect for significant additional offshore investment in Australian managed funds from offshore investors.

More onerous tax consequences arise for investments in managed funds compared to direct investments and this tax impediment restricts the amount of investments made by non-residents in Australian managed funds. Submissions generally supported measures aimed at exempting capital gains of non-residents in the circumstances proposed in Options 4.6 and 4.7.

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

There was a general view that Australia's current tax laws dealing with foreign expatriates present an unfriendly and unwelcoming tax environment compared with some other developed countries. The problems raised in submissions concerning attracting skilled expatriates apply not only to senior foreign executives but also to nurses, scientists, teachers and similar personnel. However, achieving reform in this area was being hampered by perceptions that high paid executives would be the main beneficiaries in this area.

Many submissions referred to the need to ensure that the measures in Taxation Laws Amendment Bill (No. 7) 2002 are passed through Parliament.

The general view expressed in submissions was that departing residents who defer their capital gains tax liability should not be required to provide security against future payment of the liability. Similarly, submission did not support the Review of Business Taxation, *A Tax System Redesigned*, report, July 1999 recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A.

Submissions supported efforts to address the double taxation of employee share options and the establishment of a specialist Australian Taxation Office (ATO) cell focusing on the tax issues facing foreign expatriates.

Chapter 6: Other issues raised in submissions

A number of submissions raised issues that were not directly connected to the options canvassed in the Treasury Paper. Some of these issues directly related to the chapters in the Treasury Paper, while others concerned other international tax issues.

A number of the additional issues related to a range of CFC issues in Chapter 3 of the report, whilst others related to Chapter 5 and sought changes to Australia's taxation law to reduce the extent to which the tax laws affect foreign expatriates. Finally, a range of general issues were raised with a number that related to Australia's managed funds industry.

CHAPTER 1: MAINTAINING AUSTRALIA'S COMPETITIVENESS IN A GLOBAL ECONOMY

Summary of Submissions

A number of submissions referred to the importance of the Review of International Taxation as an avenue to address problems that exist in Australia's international tax system.

Several submissions mentioned the impact of the globalisation of the international economy and noted escalating international investment and business activity and the trend for more internationally mobile segments of labour markets.

The submissions highlighted trends in the taxation regimes of other countries and referred to reforms that have taken place to the international tax regimes of other countries to encourage new investment and improve efficiency. The risks faced by Australia if its existing international tax arrangements remained unchanged in the face of ongoing changes overseas were highlighted in several submissions.

A number of submissions stressed that there was a need to have an ongoing process of review and reform of the tax system rather than uncoordinated, intermittent and piecemeal reforms when significant problems presented themselves.

Finally, several submissions suggested potential guiding principles that could be applied in the development of tax policy and legislation in the international tax area.

Trends in international taxation

1.1 The Ernst & Young submission took the view that perhaps the most significant international tax development over the last two decades was the trend to reducing rates of tax on income from capital. Over that period, the Ernst & Young submission noted that most countries, including Australia, have sought to improve the efficiency of their tax regimes. The submission referred to a trend toward collecting a greater proportion of revenue from indirect consumption taxes such as a goods and services taxes and reducing the rates of tax imposed on income from capital.

1.2 Ernst & Young noted that in view of the increasing mobility of income from capital, many countries have reduced the rates of company and withholding tax imposed on the income of foreign investors to reduce the domestic cost of capital, increase investment and improve their international competitiveness.

1.3 Reducing the rate of tax on foreign investors also increases the effective marginal tax rates imposed on savings the Ernst & Young submission noted. Consequently, many countries have been seeking to reduce the rates of personal tax imposed on income from capital, particularly dividend income. The submission referred to the 'dual' income tax regimes that many Nordic countries have implemented that impose a low flat rate of tax on income from capital, whilst continuing to tax income from labour under progressive tax rates.

1.4 The Business Council of Australia/Corporate Tax Association (BCA/CTA) submission referred to recent changes to the international tax systems of other countries to attract new investment, including the United Kingdom (UK), Germany, Sweden, Ireland, Singapore and Israel.

1.5 Recognising that taxation may be a significant factor in international investment decisions, many countries have specifically tailored their tax systems to attract new investment stated the BCA/CTA. The submission noted that countries such as the UK, Germany and Sweden (as well as emerging countries like Singapore, Ireland and Israel) are fine-tuning their tax systems to retain and attract business.

1.6 The BCA/CTA submission highlighted that:

- the UK Government recently stated publicly that it wishes to make Britain 'the best place in the world for multinationals to locate'[1];
- Sweden, often proposed as a successful peer of Australia, introduced in its annual Budget for 2001 a series of measures designed to make it a more attractive headquarters location; and
- Germany recently announced tax reform measures for similar purposes.

The impact on Australia of international tax trends

1.7 The BCA/CTA submission noted that the rapid and ongoing globalisation of the international economy presents Australia with both threats and opportunities and that Australia's international tax arrangements are a key element in meeting that challenge.

1 UK Pre-Budget Report dated 8 November 2000.

1.8 Australia's present international tax arrangements, however, are inadequate according to the BCA/CTA because:

- they prevent Australia fully grasping the opportunities of greater participation in the international economy. They distort commercial decision-making and are arbitrary and unnecessarily complex. Moreover, the submission noted that in the face of rapidly changing international tax regimes around the world, Australia's international tax arrangements are becoming even less competitive.

- while the Australian economy is growing, Australia accounts only for around one and a half percent of global market capitalisation and Australia is very remote from major markets and financial centres.

1.9 Sustaining Australia's current rates of growth over the next ten years, according to the BCA/CTA, will deliver a level of national income in 2012 that is around 50 per cent higher in real terms than its 2002 level.[2]

1.10 The BCA/CTA noted that the world and Australia's place in it are changing rapidly. Across the world, international investment and business activity are escalating and distinct segments of labour markets are becoming more internationally mobile. The submission gave information on the large increase in world direct foreign investment outflows in the period 1994 to 1999.

1.11 Particularly over the past twenty years, the BCA/CTA noted that foreign investment from Australia has grown faster than inward investment and, in 2000-01, the value of outwards foreign direct investment (FDI) exceeded the value of inwards direct foreign investment.

1.12 While these movements have added to Australia's growth potential, there are strong signs according to the BCA/CTA that Australia's competitiveness as both a destination and source of international investment is falling behind the rest of the world. The BCA/CTA referred to data showing that Australia's share of worldwide FDI declined significantly based on a comparison of data comparing annual averages for 1988-93 and 1994-99.

1.13 A central factor in these negative trends according to the BCA/CTA is the lagging state of Australia's international taxation arrangements. Other countries have made, or are actively considering, major improvements to the competitiveness of their international taxation arrangements stated the BCA/CTA. However, the BCA/CTA stated that no one familiar with Australia's international tax regime could deny that it presents a barrier to inbound and outbound investment and that it inhibits Australia's ability to attract and retain skilled personnel.

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2 Allowing for population growth of around 1 per cent per year, real growth of around 4 per cent per year would deliver average real income per person 33 per cent above 2002 levels by 2012.

1.14 Australia's size and its geographical remoteness place it at risk of becoming marginalised in the global economy, according to the BCA/CTA. The submission noted that Australia needs to ensure it can compensate for the 'tyranny of distance' and its associated diseconomies, by developing its commercial links with other countries in our region and further afield.

1.15 The BCA/CTA stated that from a business perspective the importance of reform is compounded by a number of features of the contemporary business environment:

- as the internationalisation of business proceeds rapidly, more foreign companies are considering Australia as a base from which to direct their growth in the region. Many of these decisions are once-in-a-lifetime opportunities;
- a rising proportion of new Australian businesses are currently seeking early growth opportunities in other countries;
- a large number of well-established, Australian-based companies have become world leaders in their industry sectors with successful operations abroad; and
- the combination of increased global opportunities and the relatively uncompetitive status of our taxation of personal income is making it more difficult for Australia to attract and retain highly-skilled personnel.

1.16 Many younger, emerging companies have a greater international focus than some of our larger, domestically focused companies, and emerging companies are often more mobile than larger companies stated the BCA/CTA submission. Tax issues are just as important, noted the submission, for dynamic young companies as they are for large successful companies in Australia. The BCA/CTA considered that international tax is no longer a big business issue.

1.17 The BCA/CTA pointed out that a number of factors influence the decision of an Australian parent company to move offshore or the decision of a foreign multinational company to locate its regional headquarters in Australia. The submission noted that the geographic location of suppliers and customers, capital markets, competition policy, the taxation of both parent company group and executives, as well as the profile of shareholders are all important factors.

1.18 The Australian Stock Exchange Ltd (ASX) noted that the growth in outbound investment by Australian firms also poses challenges for the Australian tax system, which was largely developed prior to that trend emerging.

1.19 As the Productivity Commission noted earlier this year according to the ASX, in its report *Offshore Investment by Australian Firms: Survey Evidence*, outbound investment by Australian firms has grown significantly in the past decade. However, the level and growth has not been high in comparison to other developed countries.

While many factors impact on decisions to invest abroad, the same report noted that companies ranked foreign and domestic tax considerations as relatively important factors influencing investment decisions.

1.20 The ASX noted that it was important to ensure that the system is not overly complex or biases investment decisions. Investment decisions made on purely commercial grounds are those most likely to enhance national welfare stated the ASX. It noted, however, that when those decisions are distorted by tax arrangements the result can detract from national welfare.

1.21 For example, the ASX cited that a handful of Australian companies have relocated offshore. Usually this reflects the changing nature of the firm's business interests (as foreign operations become a more important element of the total group) and a desire to be closer to their main markets, stated the ASX.

1.22 The Axiss Australia submission referred to Australia's attractiveness as a location for financial services based on its strongly performing economy overlaid with a highly skilled workforce and low-cost business infrastructure. These attributes, the submission stated, complemented by the aforementioned strategic advantages, are enticing global financial services firms to establish operations in Australia and from Australia to service the region.

1.23 The Axiss Australia submission noted that the financial services sector itself is a major contributor to Australia's strong economy. Finance and insurance is now the third largest sector generating in excess of 7 per cent of gross domestic product (GDP). This is more than twice that of agriculture and around 40 per cent greater than mining, two traditional contributors to Australia's economic wellbeing. The expansion of finance and insurance has also aided growth in related sectors such as communications, and property and business services.

1.24 The Western Australian Government submission stated that Western Australia increasingly relies on the competitiveness of the Federal tax system as local companies grow and participate in global markets. It stated that Western Australia also relies on offshore investors to bring in much needed capital, market networks and expertise for continued growth. The submission noted that, although the state is endowed with many natural resources, the continued strong growth of its economy is at risk unless the Commonwealth takes a more sophisticated approach to the increasingly seamless global market.

Continuous process of review

1.25 A number of submissions proposed that reform of international tax arrangements should be part of an ongoing process of review.

1.26 Ernst & Young took the view that the problems being experienced with the international tax regime are the result of numerous uncoordinated, intermittent and piecemeal reforms over the last decade.

1.27 Ernst & Young noted that to ensure that Australia maintains an internationally competitive tax system, the Government must commit to an ongoing process of review and reform of the Australian tax system rather than the current piecemeal and intermittent process of reform. Ernst & Young also considered that it was necessary to learn from the experiences of other countries in implementing international tax reforms.

1.28 Telstra stressed the need for Australia's international tax legislation to remain dynamic and for the Government to adopt a pro-active and continuous improvement process to ensure that the tax law remains relevant to changing economic circumstances.

1.29 The International Banks & Securities Association of Australia (IBSA) submission stated that international tax is a problem area for companies as it does not keep abreast of economic, financial and legal developments. In its submission, the IBSA stated that international tax rules should be developed on an ongoing basis through a domestic forum, benchmarking Australia's tax system against our leading competitors and international 'best practice' on an ongoing basis.

Tax principles for the Review of International Taxation

1.30 A number of submissions proposed principles that should guide the development of tax policy and legislative design arising from the Review of International Taxation.

1.31 The BHP Billiton submission proposed a set of objectives against which it suggested the Board should test its final recommendations. These were:

- to encourage Australian companies to invest offshore;
- to encourage foreign investor to invest in Australian companies;
- to provide neutrality for domestic investors between investing in domestic companies with only Australian based activities versus domestic companies with foreign based activities;
- to encourage foreign companies to locate parent or regional parent companies in Australia and encourage foreign ownership of assets by Australian companies; and
- for Australia to levy tax only on passive foreign income earned in unlisted countries.

1.32 The Mineral Council of Australia submission proposed that any reforms should be assessed against the established tax policy principles of efficiency, equity simplicity and revenue integrity. It proposed the following design rule for international tax that had been derived from principles developed by the Business Coalition for Tax Reform (BCTR):

- foreign income and the sale of foreign assets by foreign shareholders should not be taxed in Australia;
- Australia should levy tax only on passive (for example, interest and royalties) foreign income earned in unlisted countries;
- active income taxed in a foreign jurisdiction should not be subject to further tax in Australia (through to the 'ultimate' shareholder);
- the tax system should not discourage foreign companies from locating parent or regional parent companies in Australia and discourage foreign ownership of assets under Australian companies;
- foreign expatriate employees should face the same tax treatment as Australian employees; and
- determination of residency for Australian taxation purposes should be simple and certain.

1.33 The submission by KPMG proposed that the recommendations for reform of Australia's international taxation regime should be based on the following principles:

- the tax system should ensure that horizontal equity or neutrality exists in the system;
- the tax system should ameliorate the double taxation of foreign source income and at least not accentuate it;
- there should be similar effective taxation for shareholders that invest directly in foreign entities to those that invest indirectly through a domestic entity;
- non-residents should not be subject to Australian taxation consequences (directly or indirectly) on foreign source income (including capital gains) that merely passes through Australia, that is, conduit income flows;
- Australia's tax regime should provide simplicity and certainty for all investors with clear principles reflected in legislation and cost of compliance and administration minimised where possible; and
- Australia's tax system should be internationally competitive in its rates, structure and administration.

1.34 Ernst & Young considered that reform options should not be evaluated solely on the basis of their ability to reduce the domestic cost of capital, but also to minimise other adverse effects of taxation on multinationals, including the extent to which the tax system:

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

Chapter 2: Attracting equity capital for offshore expansion

Summary of Submissions

Problem with current law

Submissions generally noted that when a company franks dividends, franking credits on dividends to non-resident shareholders are wasted as the credits cannot be streamed to Australian shareholders alone. Accordingly, as Australian companies increasingly receive income from offshore, this increases the overall level of taxation on resident shareholders.

A number of submissions noted that the current dividend imputation rules create a disincentive for Australian multinational companies to expand their foreign operations and generate foreign profits. This is because when foreign profits that have been subject to foreign tax are distributed to Australian resident shareholders they are subject to effective double taxation, when compared with the distribution of Australian-sourced profits.

Evidence of problem

Most submissions considered that the bias at the shareholder level did affect the cost of capital of companies. Several submissions referred to recent studies that showed that imputation credits increase the value of equities which is consistent with the view that Australian investors in general determine the cost of capital rather than global capital markets.

This was also supported by the observation generally in submissions that few Australian companies could readily access overseas equity markets for capital raising and that the proportion of foreign shareholders in companies generally was significantly less than the level of foreign earnings of companies.

One submission contained modelling results that generally showed that the Options 2.1A to C would reduce the cost of capital of an Australian company deriving foreign source income (FSI).

Several submission argued that even if it were the case that foreign investors represent a company's marginal source of equity funding, investment decisions made by companies still consider the impact on the after-tax rate of return to existing domestic shareholders of a decision to invest offshore. The submissions noted that where those rates of return are likely to be adversely affected, companies may avoid offshore expansion.

Solution

There was strong support in submissions for retaining the current dividend imputation system with submissions noting the influence it had had in increasing Australian investor's level of ownership of shares of Australian companies.

Almost all submissions proposed adopting a combination of Options 2.1A and 2.1B. Most submissions supported Option 2.1B, although Option 2.1A received a higher level of support than Option 2.1B. Option 2.1A was seen as benefiting all resident shareholders of Australian companies deriving FSI.

In contrast, submissions recognised that the maximum benefits of Option 2.1B would flow to the more limited number of Australian companies with a reasonable correspondence between the proportion of foreign income derived and foreign shareholders. A number of submissions noted that in the longer term many emerging companies would aim to more closely match the proportion of their foreign shareholders with their foreign earnings. Consequently, over time Option 2.1B would have much wider application.

Most submissions noted a one-ninth credit under Option 2.1A would only partially remove the bias at the shareholder level against direct investment offshore. Submissions strongly supported the rate of credit being set at higher than one-ninth with a number of submissions stating that a three-seventh credit would be necessary to completely remove the bias.

Several submissions proposed a dividend or partial dividend exemption model as an alternative to a tax credit model proposed under Option 2.1A. However, some submissions viewed this alternative approach as favouring higher marginal rate taxpayers.

Submissions generally supported streaming of FSI to foreign shareholders with some submissions stressing the importance of allowing streaming to occur via stapled stock arrangements.

Several submissions noted that even if Options 2.1A and 2.1B were implemented there is potential for Australian companies to continue to consider dual listed structures for non-tax reasons. However, it is likely to remove taxation as an important factor in the assessment of these structures they noted.

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.

Problems with current law

2.1 Submissions generally noted that when a company franks dividends, franking credits on dividends to non-resident shareholders are wasted, as franking credits cannot be streamed to Australian shareholders alone. Accordingly, as Australian companies increasingly receive income from offshore, this increases the overall level of taxation on resident shareholders.

2.2 The submission made by Prafula Fernandez stated that when a company franks dividends, non-resident shareholders cannot benefit from the franking credits.

2.3 The BHP Billiton submission noted that the current rules contain a bias because underlying foreign tax is not recognised when profits of Australian companies are distributed to shareholders.

2.4 The Australian Bankers' Association (ABA) submission noted that the current dividend imputation rules create a disincentive for Australian multinational companies to expand their foreign operations and generate foreign profits. This is because the ABA stated that such profits, when distributed to Australian resident shareholders, are subject to effective double taxation, when compared with the distribution of Australian-sourced profits.

2.5 Ernst & Young noted that the inability of Australian shareholders to claim a credit for foreign taxes creates a bias at the shareholder level against investment in Australian companies expanding offshore. The submission noted that the current franking credit and foreign dividend account rules (FDA) reduce:

- the value of imputation credits the company can attach to the Australian source dividend income it distributes to Australian shareholders as flows of conduit income effectively consume some of the imputation credits that should have been paid to Australian shareholders;

- the value of exempt dividends that can be paid out of the FDA to foreign shareholders as the flow of conduit income effectively consumes some of the exempt dividends that should have been payable to foreign shareholders.

2.6 Wayne Mayo in his submission noted that more than one layer of tax often applies to foreign-source income (FSI) flowing through Australian companies to individual domestic shareholders. This is because, he stated, foreign taxes on FSI are not included as imputation credits under Australia's imputation system.

2.7 Similarly, the Australian Institute of Company Directors (AICD) submission pointed out that the current dividend imputation system increases the overall level of taxation on resident shareholders given the increasing levels of FSI of Australian companies.

2.8 The AICD considered that if Australian investors are dissuaded for tax reasons from investing in Australian companies expanding offshore, these companies will eventually have a preponderance of offshore investors and it will be inevitable that they will cease to be resident in Australia. The submission stated that this must eventually be contrary to Australia's longer term best interests, politically, culturally and economically.

2.9 The Taxation Institute of Australia (TIA) submission referred to the inability of Australian resident shareholders to receive credits for foreign company tax paid by a branch or offshore subsidiary of an Australian company.

2.10 The CPA Australia submission firstly noted that Australian businesses that reach maximum size in Australia are forced to seek offshore opportunities with a resulting build up of unfranked dividends for distribution. However, CPA Australia stated that the current dividend imputation system produces a tax bias in favour of Australian Parent Holding Companies investing in Australia rather than in offshore businesses.

2.11 The Deloitte Touche Tohmatsu submission noted that the inherent bias in the current imputation system for investment in Australian companies mostly operating in Australia.

2.12 The Business Coalition for Tax Reform (BCTR) submission stated that a bias occurs at the shareholder level favouring domestic investment by companies over direct investment offshore. BCTR supported a principle that requires equivalent treatment of distributed profits, regardless of source. It noted that the dividend imputation system favours domestic investment at the shareholder level because

Australian resident shareholders cannot receive credits for foreign company tax paid by a branch or offshore subsidiary of an Australian company.

2.13 The Business Council of Australia and the Corporate Tax Association (BCA/CTA) submission pointed out that imputation works well in a closed economy, where all firms competing for equity capital have their returns to shareholders taxed, by imputing tax paid at the corporate level to individual shareholders on a gross-up and credit basis. However, where firms operate globally, and pay foreign tax on their foreign earnings, this alters the investment dynamics. Accordingly to BCA/CTA imputation indirectly creates a bias against investing in Australian based companies that derive most of their profits offshore.

2.14 In its submission the Australian Stock Exchange Ltd (ASX) pointed out that the overall tax burden on business and shareholders is important but so are factors that distort business decision making. It noted that FDI is increasingly sensitive to host country tax arrangements and stressed that Australia needs to minimise tax on the most mobile factors of production, such as capital given the international trend to reduce taxation of capital.

2.15 The Government of Western Australia's submission stated that the notion that offshore investment should be treated any differently to domestic investment is anachronistic. It noted that clear economic benefits arise to Australia from having internationally focused companies operating in Australia.

2.16 The Minerals Council of Australia's submission noted that Australia's current international taxation arrangements are biased against Australian companies with global shareholdings and global investments. It notes that this bias was not a concern when imputation was first brought in but has evolved in recent years as a consequence of the evolution of the Australian economy.

2.17 KPMG considered that there was a bias against FSI at the domestic shareholder level which needs addressing. According to the submission, that bias may impair the international competitiveness of Australian businesses and their capacity to expand offshore.

Evidence of existing problem

2.18 The AICD submission suggested that evidence of the problems of Australia's international tax system includes that:

- Australian investors are discouraged from investing in Australian companies expanding offshore;
- there is a tendency for Australian companies to move offshore; and
- residents and non-residents value Australian companies differently.

2.19 The ASX submission cited as evidence of the problem of attracting equity capital for offshore expansion that several Australian companies have relocated offshore whilst others have established dual listed structures.

2.20 Ernst & Young noted that Australian shareholders investing in companies earning foreign income pay tax at a much higher rate than if they invested in companies earning purely Australian sourced income. The submission also pointed out that generally, Australian shareholders investing directly in a foreign company receive a credit for foreign tax paid directly on any dividends received, but those investing overseas indirectly through an Australian multinational company do not.

2.21 The submission made by Rio Tinto suggested that due to the shareholder bias and the more attractive United Kingdom (UK) treatment of non-UK source income and capital, investment from the UK provides a better return for all Rio Tinto Group shareholders through the company's dual listed company structure.

2.22 KPMG referred to numerical estimates in the Treasury Consultation Paper that illustrate the bias on direct investment offshore. The submission also referred to KPMG's International Comparative Study for the Business Council of Australia of July 2002 on the existence of a bias.

2.23 A supplementary submission for the BCA/CTA/ABA stated that the recent proposals by the United States (US) Administration to permit a corporation to distribute tax-free dividends to its shareholders, to the extent that those dividends are paid out of previously taxed income, will have significant implications for Australia and Australian corporates if implemented. The submission noted that the measures recognised that the double taxation of corporate profits creates severe economic distortions including:

- creating a bias in favour of debt compared to equity; and
- encouraging companies to retain earnings.

2.24 The BCA/CTA/ABA supplementary submission considered that it was highly relevant that the US proposal would avoid creating the sort of bias against foreign earnings that Australia's tax system currently suffers from. The submission considered that the US proposal places a higher imperative on effecting changes to Australia's current international tax regime in relation to the double taxation of foreign profits.

2.25 The BCA/CTA/ABA supplementary submission contained a case study evidencing that franking credits are clearly valued by shareholders and noting that the current tax treatment of foreign source profits results at least in part in the offshore reinvestment of foreign profits in lieu of repatriating the profits to Australia. The case study indicated that a company with a high level of foreign income but with a large

Australian shareholder base had to earn a higher pre-tax rate of return than its domestic competitors.

Evidence of the bias on the cost of capital of companies

2.26 A number of submissions noted that the bias between the tax treatment of foreign and domestic source income of resident investors adversely affects both the cost of equity capital for Australian companies and adversely impacts the overall competitiveness of Australian based multinational companies.

2.27 The ABA submission noted that the structural inefficiencies in the current dividend imputation system in turn increase the cost of capital and adversely impact the overall competitiveness of Australian-based multinational companies. This has led some Australian companies according to the ABA submission to consider options for relocating their head offices and to assess complex global merger structures, such as dual listed company arrangements.

2.28 The IFSA submission referred to the Consultation Paper*: Review of International Taxation Arrangements*, August 2002 (Treasury Paper) and suggests that before any reform option is examined, it is necessary to clearly demonstrate that a structural disincentive against offshore investment exists. The IFSA submission noted that the Treasury Paper considers that such a disincentive will be demonstrated if it can be shown that a company's cost of capital is increased as a result of the existence of the imputation system, and it must be proved that the marginal price-setter of stock prices for a company is not a non-resident.

2.29 According to the IFSA this proposition results from the Treasury view that as a non-resident price setter's investment decisions are unaffected by biases created by the imputation system, then changes to the treatment of FSI within the Australian tax system cannot affect the cost of capital.

2.30 The IFSA submission, however, took the view that the cost of capital is not, in isolation, the only aspect of an investment decision where tax system attributes such as imputation have an effect on a company's decision to invest offshore. In making an investment decision, the submission states, a company will look beyond the pure investment decision itself (such as hurdle rates, risk premiums, synergy benefits as well as non-financial aspects such as comparable legal systems) and will also look at the impact the investment decision will have on shareholder value.

2.31 It is quite clear from Chapter 2 of the Treasury Paper (refer Table 2.1), the IFSA submission suggested that a higher pre-tax hurdle rate is required for investments in comparable or higher taxed countries for an individual or superannuation fund, to achieve the same after tax return as a benchmark domestic investment. According to the IFSA submission, this fact is not ignored by firms in making an investment decision. Even if the marginal price setter for a stock is a non-resident, or the cost of capital is found to be lower offshore, the IFSA submission suggests that companies will necessarily consider the impact of the investment decision on their existing shareholders.

2.32 The IFSA submission stated that the above effect of the imputation system on investment decisions can be demonstrated by analysing the investment model used by all IFSA member companies which includes shareholder value calculations in analysing whether an investment should be made. The submission states that shareholder value component of the calculation takes into account after tax returns to shareholders, which includes a value for imputation credits to shareholders.

2.33 The IFSA submission considered that, even setting aside the above considerations, most capital raising situations involving Australian companies, the marginal price-setter of stock prices in Australia is a domestic investor, who is most likely an institution, but often an individual. Numerous investment situations demonstrate, according to the IFSA submission, that the active involvement of domestic investors in capital raisings as the marginal investor, generally in preference to non-residents. The IFSA submission cited the following example of this:

- dividend reinvestment plans (DRPs) are commonly used to tap existing shareholders for equity capital. This method is more likely to attract an investment by an existing resident shareholder rather than from some theoretical price-setting non-resident investor, particularly as DRPs are often not offered to non-resident shareholders;
- rights issues can be used to fund a company's larger investment needs. They access existing shareholders proportionately, which obviously includes substantial numbers of resident shareholders. Clearly rights are often in a tradeable form, which means the existing shareholder may not in fact end up as the new shareholder, however, there is nevertheless again likely to be a skew towards investment by existing shareholders (including domestic residents) rather than a price-setting non-resident;
- domestic index investors will need to participate proportionally in capital raisings by domestic companies (or participate in the secondary market) in order to maintain their relevant index weightings. They are, therefore, likely to be the marginal investor;
- Government privatisations (such as the Commonwealth Bank, Telstra) have lead to high levels of domestic shareholders with high levels of domestic share ownership in general throughout the economy. This active participation by 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 implies a regular flow of investment capital. The net inflow amount for managed monies for the year ended March 2002 was $15 billion and for the year ended March 2001 was

> $20 billion (refer Assirt Market Share reports). It is estimated that approximately 20 per cent of these monies are directed into equities markets. The availability of this money means that domestic investors are extremely likely to be competing with non-resident investors when companies are raising capital from the market.

2.34 Whilst difficult to conclusively prove that a marginal investor is not a non-resident, the IFSA submission considered that to succeed in this analysis it is only necessary to demonstrate that in many/most situations a resident investor will in fact be the marginal investor. The submission considered that anecdotal evidence also supports this view.

2.35 The IFSA submission gave as an example the three recent capital raisings of AMP Limited which have all occurred in Australia despite it being likely to be categorised as a large multinational company that can readily access (cheaper) offshore capital markets. The IFSA noted that despite the fact that AMP can access foreign capital markets, it currently considers the marginal price setter of its stock to be a resident.

2.36 The IFSA also gave an example of reset preference shares. It noted that such shares are a new capital instrument that pays a return analogous to a fixed interest return, but with the addition of franking credits. The calculation of the yield on such shares, according to IFSA, takes into account and is reduced by 100 per cent of the value of any franking credits attached to the dividend. The IFSA considered that the pricing of the equity return on such shares indicates that they are targeted at domestic shareholders that are able to utilise franking credits. Non-residents would not be expected to invest in such instruments. Accordingly, the marginal investor can be expected to be a resident.

2.37 The AICD submission considered that the higher rate of tax paid by Australian shareholders on foreign sourced dividends would be likely to result in an increase in the cost of capital at least for the newly emerging Australian multinationals. The submission referred to a paper by Hathaway and Officer that pointed to a tendency for Australian investors to lean towards holding equities in Australian domestic companies.

2.38 The AICD submission noted that results published by a number of researchers have pointed to the fact that imputation credits increase the value of equities, a result that is inconsistent with a view that the cost of capital in a small open economy is determined by global capital markets rather than by Australian investors. The reason for this outcome the AICD stated is that there are information asymmetries in financial markets which means that residents and non-residents will value Australian companies differently. As a result, Australian companies according to the AICD will find their cost of equity rising as the extent of their investment offshore increases.

2.39 The AICD stated that the view of analysts is that imputation does influence portfolio decisions of investors and the value that they place on equities, and this, combined with the body of research literature on the issue, seems to provide enough evidence for the matter to be a concern for policy makers. Policy makers in many other countries have been convinced according to the AICD submission that high and uneven taxation of income from capital causes economic problems, despite the conclusions that may be drawn from purely theoretical models.

2.40 The Deloitte Touche Tohmatsu submission questioned whether many larger Australian companies have access to global capital markets as well as the Australian market. The submission considered that only a few Australian-based multinationals can currently access global equity markets in any meaningful way. This means that, the submission stated, for the time being at least, most Australian multinationals must continue to consider the needs of the Australian capital market and the continued appetite of that market for franking credits.

2.41 The CPA Australia submission made the following points in relation to the cost of capital issue:

- Australian investors in receipt of unfranked distributions by a parent holding company from FSI take account of the lower relative return in a manner that impacts the cost of capital;

- foreign investors are influenced by the effective after tax return on dividends from investments made directly in businesses in their country of origin compared to an indirect return via non conduit locations such as Australia; and

- foreign investors appear more prepared to invest in debt/note issues. Generally such arrangements are more flexible in terms of matching the profiles of foreign investors with the business activities of companies when compared to their current impact of investing in equity issues. There is an obvious difference in the relative cost of capital between debt compared to equity that is in part influenced by the factors mentioned.

2.42 The joint 10 companies submission noted that the existence of the bias against earning foreign income can have a negative impact upon the value of a company and hence increase its cost of capital, making it more difficult to be competitive in domestic and foreign capital markets.

2.43 The joint 10 companies indicated that investors calculate the after-tax return from shares in the company and discount it to take account of the time value of money (including a premium for equity risk).

2.44 If the discounted after-tax return is greater than the trading price then the joint 10 companies stated the investor will be inclined to buy. If the discounted after-tax return is less than the trading price then investors holding those shares will be inclined to sell. The trading price therefore trends towards the market's expectation of the discounted after-tax return (from both profits and growth) on the shares according to the joint 10 companies.

2.45 The 'marginal investor', stated the joint 10 companies, is the investor who is prepared to pay the highest price for a share in a company and therefore sets its market price. The Australian Competition and Consumer Commission (ACCC) believes according to the joint 10 companies that the marginal investor is an Australian resident.

2.46 Given the above, the joint 10 companies noted that it would therefore expect the value of a share in a company that pays franked dividends to be higher than the value of a share in a company that pays unfranked dividends (all other things being equal).

2.47 The joint 10 companies stated that Australian companies will find it increasingly difficult to pay franked dividends as the level of foreign income as a proportion of total income increases. The cost of equity capital for such a company will therefore increase as they expand offshore.

2.48 The joint 10 companies stated that academics, market commentators and regulators take imputation credits into account (50 per cent to 60 per cent of the amount of the credit) for the purposes of calculating the value of a share. If imputation credits are only generated by Australian tax payments then the joint 10 companies stated that the effect will be to increase the cost of capital for companies that earn a significant proportion of their profits from foreign countries.

2.49 The joint 10 companies indicated that many public companies manage their distribution policies within the constraints of available imputation credits to partially compensate for the imputation bias by advance tax payments, deferring dividend payments and repatriating profits back to Australia from overseas operations.

2.50 The BCTR submission noted that a bias clearly exists at the shareholder level due to the higher effective tax rates on distributed foreign earnings. However, the BCTR agreed the key issue should not be the bias itself, but rather its impact on the cost of capital of Australian based corporate groups. Its submission stated that addressing the bias at the shareholder level may well be worthwhile on equity grounds but it would not at the same time make a broader impact on economic activity, wealth creation and jobs. The BCTR considered, however, that the bias is likely to have an adverse impact on the cost of funds of Australian companies.

2.51 The Institute of Chartered Accountants in Australia (ICAA) submission referred to the recent Reserve Bank article 'Dual Listed Companies' (DLCs) in the Reserve Bank of Australia Bulletin of October 2002 which while looking to the difficulties in establishing the precise cost of capital outcomes for DLCs suggested that DLCs trade at premiums in the Australian market. The ICAA suggests that at least one reason for this would be the availability of the franking credits in relation to the

Australian company in the DLC structure, which enhances the attractiveness of such a company to Australian investors.

2.52 The Australian Chamber of Commerce and Industry (ACCI) submission noted that the extent to which the bias that exists at the shareholder level towards domestic firms affects the cost of capital is the important question that requires detailed examination. It noted that obtaining answers to these questions is made all the more precarious because of the difficulty of accurately measuring the benefits to the economy overall from removing such a bias.

2.53 The ACCI stated that if the cost of capital were not influenced by the current imputation system, then the associated costs to government revenue and the benefits to shareholders would not necessarily dictate change and that the Government's primary focus must be to maintain economic conditions conducive to growth and this should be its overriding concern.

2.54 The ACCI noted that the objective for business is to reduce the cost of capital thereby making Australia more competitive internationally and if this outcome cannot be proven either through empirical analysis or illustration any changes to the current approach would need to be seriously considered as to whether they should proceed.

2.55 The ASX submission drew some conclusions about the impact of the options contained in the Treasury Paper on the cost of capital based on modelling work done for them by Ernst & Young. It noted that the estimated impact on the cost of capital is very sensitive to assumptions about who sets the cost of capital for Australian companies.

2.56 The ASX submission noted that there is an extensive economic literature[1] on rigidities in capital movements across borders. While some of this can be traced back to regulatory or tax differences amongst countries that have been reducing over time, the ASX stated that there remains a significant element which reflects the so-called 'home bias' of investors, which is harder to break down.

2.57 So, in practice, the ASX concluded that while there may be a small number of large Australian corporates with a significant international profile who can normally access global capital markets relatively freely, the vast majority of Australian companies will rely heavily on local markets (and hence a domestically determined cost of capital) for their financing.

2.58 The ASX submission stated that in their view the academic literature combined with anecdotal evidence from Australian corporates indicates that a simple

1 For example, Obstfeld M and Rogoff K (2000), *The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?* NBER Working Paper No 7777; Feldstein M (1994), *Tax Policy and International Capital Flows*, NBER Working Paper No 4851; and Gordon R and Bovenburg A (1994), *Why is Capital so Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation*, NBER Working Paper No 4796.

blanket assumption of perfect capital mobility is unrealistic. It noted that the modelling assumptions prepared for it were based on the assumption that the cost of capital of the various reform options is supplied by an Australian.

2.59 The ASX indicated that Options 2.1A, 2.1B, and 2.1C would lead to a slight fall in the cost of capital under the modelled scenarios. It noted that the precise impact on companies will depend heavily on their particular circumstances including the extent and location of the offshore investments and shareholders; and their dividend distribution policies. A notional credit for Option 2.1A above the one-ninth identified in the Treasury paper, would according to the ASX, be necessary to generate a reasonable reduction in the cost of capital.

2.60 The ASX noted that Options 2.1A and 2.1C would reduce the cost of capital for those Australian companies with restricted access to international capital markets while Option 2.1B would reduce the cost of capital for mature Australian multinational companies with significant offshore investments and numbers of foreign shareholders.

2.61 The BCA/CTA submission noted that its members with significant foreign earnings continue to have a disproportionate domestic shareholder base. This mismatch is the product of the relatively small size of Australian companies according to the submission, as well as the information costs associated with foreign investors assessing the prospects of such companies in what to them is a distant and unfamiliar market. The submission concluded that with very few exceptions, Australian companies simply do not register in foreign equity markets.

2.62 The BCA/CTA noted that other factors which tend to support the active involvement of domestic investors in equity raisings include the widespread use of dividend reinvestment schemes, rights issues, the needs of domestic index investors and imputation funds, as well as the continuing growth of domestic superannuation savings. The submission concluded that domestic investors would always represent a major source of funds in new equity raisings, and franking credits are clearly valued by this important segment of the Australian equities market.

2.63 The BCA/CTA submission stated that even if it were the case that foreign investors represent a company's marginal source of equity funding, investment decisions made at the entity level would nevertheless factor in the impact on the after-tax rate of return to existing domestic shareholders of a decision to invest offshore. The submission noted that where those rates of return are likely to be adversely affected, company managers may think twice about expanding offshore, or at least demand a higher pre-tax rate of return before doing so.

2.64 Recently published research suggests according to the BCA/CTA submission that imputation credits have significant value in the context of the capital asset pricing model, see for example, Officer (1994)[2] and JB Were (1996)[3]. More recent work by Lally (June 2002)[4] and the ACCC (September 2002)[5] suggests that, according to the submission, that national equity markets should be seen as segmented rather than integrated, so that foreign investors may be disregarded for the purposes of valuing franking credits. While these studies do not appear to have focused solely on Australian companies that are expanding offshore, the submission acknowledged neither were they confined to purely domestic companies. Their conclusions, it stated, are inconsistent with the marginal foreign equity investor approach suggested in the Treasury Paper.

2.65 Accordingly, the BCA/CTA submission viewed the cost of capital impact as significant and recommended that it should be addressed. It noted that further economic modelling work was being carried out that had been commissioned by the BCA and ABA.

2.66 The Ernst & Young submission noted that the impact of the shareholder bias on the cost of capital is difficult to determine as it depends on the identity of the marginal investor and the efficiency with which capital markets operate. It stated, however, that the bias does have the potential to increase the cost of capital due to capital market imperfections. Ernst & Young considered that even large Australian multinationals have difficulty raising foreign equity.

2.67 Ernst & Young indicated that it was difficult to determine the extent to which the bias actually increases the cost of capital of Australian multinational companies. However, it noted that discussions with clients suggested that the bias is likely to have a more noticeable impact on the cost of capital for the smaller, less well known, emerging Australian multinationals who rely heavily on Australian shareholders for equity finance. It noted, however, that it appears to be a concern for a much wider group of companies.

Solution

2.68 Many submissions noted that the current dividend imputation system works effectively and should be retained.

2.69 In this regard the ICAA submission stated that the core features of the dividend imputation system have factors encouraging Australian investors to participate in share markets. The focus should be on removing inefficiencies, rather than removing imputation, it stated.

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2 'The Cost of Capital of a Company under an Imputation Tax System', *Accounting and Finance*, vol. 34. pp. 1-17.
3 Australian Equity Market Profile, JB Were & Son, March 1996.
4 'The Cost of Capital under Dividend Imputation', Martin Lally, Victoria University of Wellington, June 2002.
5 'Victorian Transmission Network Revenue Caps 2003-2008: Draft Decision, 24 September 2002.

2.70 The Council of Small Business Organisations of Australia Ltd (COSBOA) submission sought that any changes to the company imputation system should not disadvantage small to medium sized businesses, noting that may small businesses use the imputation system to capitalise their businesses and upon retirement they liquidate their retained earnings through dividend distributions.

2.71 The BCA/CTA submission acknowledged that Australia's dividend imputation system has been an important factor in lifting the level of share ownership by Australian investors to one of the highest in the world. Accordingly, the submission proposed that the dividend imputation system be left undisturbed, and any measures that might be adopted to address the imputation bias should operate in conjunction with the imputation system. In particular, the BCA/CTA considered that the recent European reforms in this area may point in the direction that Australia should head in the future.

2.72 The Ernst & Young submission was of the view that Options 2.1A and 2.1B should be implemented in the short term. However, in the medium term the submission proposed that the options should be evaluated alongside the approaches that other countries have been pursuing in order to reduce personal tax rates, the disincentive to save and invest, and the bias in favour of domestic investment. In particular, Ernst & Young sought that the following alternative options should be considered in the medium term:

- the reduction in the top rate of personal income tax while maintaining dividend imputation; and
- applying a lower rate of tax to income from capital, particularly dividend income, such as via a dual income tax system, a split rate tax system or a UK style notional tax credit regime. In particular, it considered that consideration should be given to abolishing the current imputation system and replacing it with a UK style notional credit approach.

Combining Option 2.1A & 2.1B

2.73 Most submissions suggested that the Board should pursue a combination of Options 2.1A and 2.1B. Option 2.1A was seen as benefiting all resident shareholders of Australian companies deriving FSI.

2.74 The Association of Superannuation Funds of Australia (ASFA) submission expressed no real preference for Option 2.1A, 2.1B or 2.1C as a means of reducing the bias at the shareholder level. The submission noted that Option 2.1B might have some marginal advantages in terms of lower compliance cost burden at both the company and shareholder levels.

2.75 The ASFA considered that any proposal for providing further tax relief at the shareholder level should be given careful consideration in regard to the prospective costs and benefits, and should be considered relative to other possible tax options, including reducing the tax on superannuation contributions.

Option 2.1A

2.76 Many submissions suggested that a one-ninth shareholder credit would be insufficient to remove the bias.

2.77 The CPA Australia submission stated that the credit should be higher than one-ninth. It suggested that it be a non-refundable credit and that it could be limited to income from active businesses. The credit, the submission proposed, should put Australian shareholders in a position equivalent to receiving franked dividends.

2.78 The BCTR submission similarly sought that the credit be set at a level greater than one-ninth.

2.79 The Barkoczy/De Zilva submission noted that Option 2.1A adopts an arbitrary credit not tied to any actual foreign tax paid and that it may not provide full relief against foreign taxes.

2.80 The Westfield Holdings Ltd submission indicated that its most preferred option was Option 2.1A. Westfield stated that Australian shareholders should be in a neutral position in terms of domestic or international investment and noted that a one-ninth credit or 10 per cent of the grossed up dividend still leaves a significant bias.

2.81 The AICD submission indicated that a credit of more than one-ninth was needed. It suggested that a credit in the range of one-quarter to three-sevenths would achieve the desired result.

2.82 The submission made by Prafula Fernandez noted that Option 2.1A (and the other options in the Treasury Paper) only marginally reduce the bias.

2.83 The ICAA submission recommended that a three-sevenths shareholder credit should be introduced. Issues to be resolved, it noted were which investors would be eligible, and whether the credit should be offset against other income. The ICAA considered that the net effect of the tax incentive would be to retain an attractive environment for emerging Australian companies, growing on the global markets, to raise their capital in Australia. The submission stated that Option 2.1A would assist Australian global companies to retain Australian bases, and raise capital in Australian markets and is an important element in protecting the relationship of those companies with their Australian investors, and their ongoing activity in Australia.

2.84 Ernst & Young proposed that Option 2.1A be implemented. It considered that the level of notional credit needed to be significantly larger than the proposed one-ninth credit. It suggested that, although more work was needed, it was likely that the credit would need to be set at least one-quarter but probably closer to three-sevenths.

2.85 Ernst & Young stated that the implementation of Option 2.1A has the potential to:

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

2.86 In its submission the IFSA proposed that the receipt of a non-portfolio dividend by an Australian company from a foreign company should generate a credit to its FDA. The IFSA suggests that the credit be based on the foreign tax payable on the profits from which the dividend was paid, subject to a limit based on the maximum Australian tax payable on that income in a domestic context, being three-sevenths of the dividend. For dividends from a BELC, or from a limited exemption listed country (LELC) where the dividend is from income sourced in the LELC, the IFSA suggests that a credit of three-sevenths be automatically available. The IFSA proposed that Australian companies be able to frank a dividend from its franking account and/or FDA (at its option). The submission considered that non-resident shareholders receiving dividends that are franked from either the franking account or the FDA should be exempt from withholding tax to that extent. Finally, the submission provided that resident shareholders receiving a dividend that is franked from the FDA would gross up their income, and offset the credit against their tax liability based on their marginal tax rate, however, the offset would be limited to the actual Australian tax on the dividend income with no refundability of excess credits.

2.87 The IFSA submission stated that benefits that would arise from implementing Option 2.1A (and Option 2.1B) included:

- where foreign income is repatriated as a result of any change in the tax system, this will both accelerate and increase tax at the shareholder level;
- stock price rises can also be expected due to increased demand from residents and non-residents, which will increase CGT revenue once stocks are sold by residents;
- residence migration of companies beyond the Australian tax system is also likely to end, with consequent favourable revenue implications; and

- eliminating the bias from the foreign investment decision making process will allow more foreign investments to be made on their merits. This, the submission stated was likely to increase investment returns, in turn, enhancing retirement savings and reducing the drain on government funds for pensions.

2.88 The BHP Billiton submission recommended that Option 2.1A be implemented but proposed that the credit be set at three-sevenths for profits sourced in BELCs and up to three-sevenths but limited to underlying tax paid for income earned in non-BELCs. The submission noted that the detail of its proposal for Option 2.1A is in accordance with the submission of the joint 10 companies.

2.89 The BCA/CTA submission stated that the level of the credit proposed in Option 2.1A is not high enough to offset the high effective tax rates faced by shareholders receiving unfranked distributions out of taxed foreign earnings. It noted that a one-ninth credit would reduce a top marginal taxpayer's effective tax rate from 64 per cent to 61.6 per cent (assuming 30 per cent underlying tax; zero withholding tax). This it stated is not enough to impact significantly on shareholder behaviour, pricing and the cost of capital.

2.90 The BCA/CTA noted that a credit of three-sevenths of the unfranked dividend paid out of a designated foreign income account (FIA) would provide relief for foreign sourced dividends on the same basis as dividend imputation does now for domestic earnings. This would ensure according to the submission, that as for domestic shareholders 'top up' tax is paid by high marginal rate resident shareholders. Its submission acknowledged that, although, providing a shareholder credit at a rate of three-sevenths would increase the direct cost to the revenue, second round revenue effects, in the form of increased profit repatriation, combined with top-up tax for some resident individuals, would go some way towards offsetting the revenue impact.

2.91 The BCA/CTA outlined a number of mechanisms for containing the revenue cost of the Option 2.1A, including:

- making the shareholder credits non-refundable;
- making the credit non-offsettable against other income;
- limiting the credit to dividends paid by companies resident in, for example, broad-exemption listed countries; and
- considering some alternative level of credit.

2.92 The BCA/CTA considered that further work be undertaken to analyse the advantages and disadvantages of a three-sevenths credit compared to a partial exemption.

2.93 The Minerals Council supported Option 2.1A. It suggested a variant of Option 2.1A under which the credit provided is enough to compensate for both the withholding tax and any underlying tax whilst accommodating situations where the credit rate is higher than the foreign tax paid. It submission proposed that this could be implemented by:

- the FDA system being converted into a tax paid system;
- an Australian company being entitled to a credit in its FDA when it receives a non-portfolio dividend from a foreign company. The credit will correspond to the amount of foreign tax on the dividend and the profits from which it was paid, however, the credit will be limited to the Australian tax that would have been imposed on those profits in a domestic context (that is, three-sevenths of the dividend);
- the credit for BELCs to be limited to three-sevenths of the dividend and in the case of LELCs and unlisted countries to be based on the actual foreign tax paid but not exceeding three-sevenths of the dividend;
- an Australian company will be entitled to frank a dividend from its franking account and/or FDA (at its option); and
- non-resident shareholders that receive a dividend that is franked from the franking account or FDA will be exempt from withholding tax.

2.94 In its submission Deloitte Touche Tohmatsu considered that Option 2.1A would encourage investment by Australian companies seeking to invest offshore, but suggested that a credit of one-ninth is too low and should be increased to three-sevenths. It noted that if a three-sevenths credit is considered too high, this credit could be limited to dividends paid by companies resident in, for example, broad-exemption listed countries. This, however, the submission acknowledged, would add complexity to the legislation and increase compliance costs.

2.95 The Clough Ltd submission noted that the Option 2.1A proposal to provide imputation credits for foreign tax paid or a direct credit for foreign tax paid against Australian tax payable would have a cost to the revenue. However, it indicated that it would support the proposal particularly if Australia adopted the US system.

2.96 Rio Tinto Ltd in its submission supported Option 2.1A and noted it did not require legislative complexity. It noted, however, that a non-contingent credit of one-ninth would not sufficiently compensate its shareholders for foreign tax paid by the group.

2.97 KPMG supported a partial credit under Option 2.1A of between one-third and three-sevenths if a (partial) exemption model was not adopted.

2.98 The joint 10 companies submission recommended that Option 2.1A be implemented and proposed that the credit be set at three-sevenths for profits sourced in BELCs and up to three-sevenths but limited to underlying tax paid for income earned in non-BELCs. The submission considered that the result of this change will therefore be to encourage companies to repatriate foreign profits to Australia (to claim the FDA credit) and then use the dividend income to pay a higher franked dividend to their shareholders. In many cases, according to the submission, shareholders will have a marginal tax rate that is higher than the corporate tax rate at which imputation and FDA credits are granted and therefore, the repatriation and on-payment of the foreign profits will therefore actually increase the collections of Australian tax.

2.99 The TIA submission supported Option 2.1A. It considered that its main drawback was that the benefit would be relatively small in that it would mitigate against, but not remove, the bias against offshore investment.

2.100 In its submission, the ACCI was of the view that is was essential that a proper cost-benefit analysis be conducted before any decision on implementing Option 2.1A is taken, and then, given that there are large potential costs to revenue, there must be an assessment of the relative importance of correcting this bias in the tax system against all of the other economic measures under consideration at the same time.

2.101 The ABA submission supported Option 2.1A. It considered that Option 2.1B and Option 2.1A (if the credit under Option 2.1A was set at a rate which is sufficient to substantially eliminate the double taxation of foreign earnings) would overcome many of the difficulties facing Australian based multinationals.

2.102 The likely benefits identified by the ABA from such a proposal included:

- increased foreign investor demand for shares of Australian multinationals due to the ability of foreign shareholders to benefit under their local tax regime;
- increased Australian investor demand for shares of Australian multinationals because of the increased franking capacity;
- 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;
- increased capacity for Australian multinationals to use their shares as acquisition currency in order to expand their foreign operations; and
- a reduction in the incentive for Australian multinationals to consider options to relocate their head office and to assess complex global merger structures, such as dual listed company arrangements.

2.103 The ABA stated that to the extent that Options 2.1A and 2.1B improve outcomes for shareholders, share prices should increase and this will have an offsetting impact on the cost to the revenue in a number of ways, namely:

- increased share prices should directly produce additional tax revenue through the imposition of CGT on the disposal of the relevant shares;
- improved earnings and share prices should reduce the cost of capital, creating a preference for equity over debt financing, with a resulting reduction in interest deductions claimed; and
- increased repatriation of foreign profits to Australia and ultimately increased distribution of those profits to Australian shareholders, will lead to increased Australian tax collections.

2.104 Cameron Rider supported Option 2.1A but proposed the following modifications to it to reduce the cost to the revenue and improve economic neutrality:

- the foreign dividend credit should be calculated so it does not exceed the average rate of foreign tax actually paid on FSI;
- introducing an ordering rule requiring companies to first pay franked dividends from taxed profit, then unfranked dividends from Australian source profits, and lastly unfranked dividends from FSI which will carry the dividend credit;
- introducing an additional foreign dividend credit so corporate non-portfolio investors can use Australian resident companies as holding companies for international joint ventures offshore and ensure eligibility for the credit based on the same anti-avoidance rules as franking credits.
- exempting unfranked dividends that qualify for the foreign dividend credit from dividend withholding tax.

2.105 The ASX submission stated that Option 2.1A provided the clearest assistance to the broadest range of Australian firms, by providing relief to all firms paying dividends out of FSI. It considered that it should be the centrepiece of any package.

2.106 The ASX noted that implementing Option 2.1A whilst retaining the current dividend imputation regime for those companies that have no foreign sourced income would:

- 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
- have a lower revenue cost than replacing the current dividend imputation regime with a UK style notional credit regime.

Dividend exemption model

2.107 PriceWaterhouseCoopers suggested that an alternative to Option 2.1A was to provide an extended dividend exemption for foreign sourced dividends. The BCTR suggested a partial exemption (80 per cent) for unfranked dividends paid out of foreign dividends. Similarly, Deloitte & Touche NZ proposed a dividend exemption model as an alternative model. CPA Australia suggested that Option 2.1A was more equitable than a dividend exemption model because exemptions favour high marginal tax rate investors.

2.108 The BCA/CTA considered that the use of a partial exemption model at the shareholder level could be considered as an alternative to the tax and credit approach. Such an approach, according to the submission, would involve a similar mechanism as the FDA system, which allows foreign source dividends to be paid to non-residents exempt from any further Australian tax (including withholding tax).

2.109 The BCA/CTA stated that a full exemption is not regarded as appropriate, since individuals on higher marginal rates would receive a much greater benefit under a full exemption than under a shareholder credit system (under a full exemption there would be no 'top-up' tax). This would raise cost to revenue and equity issues. It noted that a partial exemption model for foreign source dividends would allow foreign dividend income to flow through a chain of entities to the ultimate shareholders (either resident or non-resident) and resident shareholders would then be subject to tax under a partial exemption approach, while a flow-through exemption would apply to non-residents (as is presently the case under the FDA mechanism). The submission stated given the low tax rate facing complying superannuation funds, they and tax-exempt entities should be eligible for a full exemption.

2.110 The BCA/CTA stated that the partial exemption approach would maintain the progressiveness of the tax system, albeit in respect of the deemed taxable amount only. It noted that, while individuals on the top marginal rate would receive a larger absolute benefit, individuals across all tax brackets would experience relief of 80 per cent of the 'top-up' tax they currently face in respect of foreign sourced unfranked dividends.

2.111 KPMG supported extending the current exemption model for dividends to provide relief for domestic shareholders. However, if a (partial) exemption model was not adopted it supported the implementation of Option 2.1A. The submission considered that the adoption of partial exemption model has the greatest systemic capacity to facilitate improvements to international taxation arrangements.

Option 2.1B

2.112 Most submissions supported Option 2.1B, although Option 2.1A received a higher level of support than Option 2.1B. Many submissions noted that Option 2.1B, while worthwhile, may benefit only a limited number of companies at least initially. There was limited comment in submissions about unrestricted dividend steaming.

2.113 Streaming of foreign dividends directly to foreign shareholders via a stapled share arrangement where that is permitted under domestic law was favoured by the BCA/CTA. The submission noted that as stapled stock arrangements are not legally or commercially feasible in all countries where Australian companies might carry out operations, direct steaming of foreign dividends to foreign shareholders should be supplemented by a mechanism that permits the flow-through of FDA amounts to foreign shareholders through a chain of Australian companies.

2.114 The BCA/CTA submission noted that streaming would, in some jurisdictions, also provide non-resident shareholders with the benefits of their own domestic imputation system (for example, the UK), thereby further improving their after-tax return at no cost to the Australian revenue.

2.115 The BCA/CTA submission considered that the Review of International Taxation Arrangements is designed to bring benefits in the medium to long term, based on the structure of Australian companies in the future rather than as they are today. The submission suggested that in the longer term, many emerging companies would aim to get a closer matching of the proportion of their foreign shareholders with their foreign earnings resulting in the BCA/CTA expecting that over time this option would have much wider application.

2.116 The BCA/CTA considered that the cost to the revenue of dividend streaming would not be significant if it were to operate in conjunction with either a three-sevenths shareholder credit or an 80 per cent partial exemption. This is because it noted that the shareholder returns and cost of capital impact of adopting either of the first two options as the primary mechanism for addressing the imputation bias would mean that fewer Australian companies would need to consider streaming as a way of reducing the high effective tax rates resident shareholders face on foreign dividends.

2.117 The Minerals Council submission supported Option 2.1B and noted that it would remove an anti-globalisation bias facing Australian transnational companies which wish to use offshore equity in the parent Australian company to fund offshore investment as part of their key growth strategies. The submission noted that such a proposal only benefits companies with non-resident shareholders and that the extent of the benefit depends on the proportions of non-resident shareholders, FSI and level of profit distributions. For this reason, the Minerals Council considered Option 2.1B should not operate in isolation from Option 2.1A.

2.118 The Westfield Holdings Ltd submission noted that Option 2.1B is most beneficial where the percentage of foreign income equals that of non-resident shareholders. It noted that Westfield is not in that position. While the option would be of benefit as compared to the current position, Option 2.1A is preferred, the submission stated.

2.119 Ernst & Young considered that Option 2.1B was not an alternative to Option 2.1A or Option 2.1C, but should be considered in conjunction with other conduit reforms, including the implementation of a conduit holding company regime. It sought the implementation of either Option 2.1B or a conduit holding company regime (see Chapter 3) that would enable conduit income to flow through Australian multinational companies without adverse tax consequences for either Australian or foreign shareholders.

2.120 Ernst & Young stated that the implementation of Option 2.1B or a conduit holding company regime would:

- reduce the bias in favour of direct investment offshore;
- potentially reduce the cost of capital of affected companies;
- reduce the incentive for Australian companies to relocate operations offshore;
- reduce the need for the establishment of dual listed companies; and
- reduce disincentives for foreign multinational companies to set up regional headquarters in Australia.

2.121 The IFSA submission supported Option 2.1B and noted that Australian franking and FDA penalties should not apply to streaming arrangements. The IFSA stated that whilst it accepted that streaming of dividends primarily benefits companies with existing foreign shareholder bases, it nevertheless recommended that it needed to be considered as a way of encouraging other resident companies to attract foreign shareholders. It considered that it would also be likely to improve returns to non-resident shareholders and attract non-resident shareholders.

2.122 There was support in the Rio Tinto Ltd submission for Option 2.1B for economic reasons and because of the possible creation of an incentive in favour of foreign investment.

2.123 The Deloitte & Touche NZ submission took the view that because New Zealand is a capital importer it is in its interest to support Option 2.1B.

2.124 CPA Australia suggested that the current prohibition against streaming does not reflect the economic reality of the modern business environment, for example, shareholders with different profiles often take ownership positions in companies with different economic and ownership rights. In its submission it proposed that companies should have the ability to stream dividends either from the Australian holding company or from their foreign subsidiary.

2.125 CPA Australia indicated that the streaming mechanism should not result in the erosion of franking credits otherwise available to domestic shareholders. The submission indicated that this could be managed by having a mechanism based on a foreign income account. The submission proposed that the risk to the Australian revenue base from introducing dividend streaming needed to be managed by limiting streaming to FSI from either comparably taxed locations and/or from active businesses.

2.126 The ICAA submission proposed that companies should have the ability to stream dividends either from the Australian holding company or from the foreign subsidiary to foreign shareholders.

2.127 The BCTR submission pointed out that dividend streaming should be pursued operating side by side with the dividend imputation system.

2.128 The ASX submission considered that Option 2.1B can complement either Option 2.1A or Option 2.1C by ensuring that FSI that flows through Australian multinationals to foreign shareholders does not reduce the value of franking credits paid out of Australian income to their Australian shareholders. It noted also that Option 2.1B would correspondingly reduce the effective marginal tax rates imposed on the FSI that foreign shareholders earn through Australian multinational companies.

2.129 The ASX stated that Option 2.1B would improve national welfare by reducing the current disincentive for foreign shareholders to invest in other countries via Australia and reduce the incentive for mature Australian multinationals to shift their operations offshore. This, it noted, would help to add depth and liquidity to domestic capital markets; and reduce the disincentive for foreign multinationals to establish their regional headquarters in Australia.

2.130 The TIA submission stated that Option 2.1B would greatly benefit Australian companies with a relatively large proportion of non-resident shareholders and foreign income. In such circumstances, it would effectively reduce the bias against offshore investment and promote policy objectives. Further, it noted that it has been argued that where companies with foreign shareholder and operations are encouraged to grow and invest, other Australian based businesses will benefit from the 'tag along' upside of economic growth. It noted, however, that Option 2.1B would not assist Australian-owned companies during the crucial initial years of their offshore operations when they would not have any significant foreign shareholder base.

2.131 In its submission, Deloitte Touche Tohmatsu supported further consideration of Option 2.1B on the basis that it directly addresses the issue of preserving scarce franking credits for Australian resident investors who place most value on them. The submission noted that the option also mitigates the inefficiencies caused by the current inability of companies to stream FDA credits.

2.132 Prafula Fernandez's submission indicated that Option 2.1B would only benefit companies with foreign investments and foreign shareholders, however it may save companies from creating dual listing structures in order to stream dividends.

2.133 The ABA submission supported Option 2.1B, stating that streaming would be expected to result in improved earnings for internationally focused companies. The submission stated that enabling Australian multinationals to stream foreign profits directly to foreign shareholders should enable foreign investors to benefit under their local tax rules (such as access to local imputation or foreign tax credit benefits) in ways that would not be available for an equivalent Australian dividend. Further, it stated that not having to repatriate foreign income to Australia could also potentially result in significant savings in foreign dividend withholding tax. Such tax benefits according to the ABA should lower the cost of raising equity capital in foreign countries, without directly impacting the Australian revenue collected.

2.134 The AICD submission similarly sought that all restrictions that currently make stapled stock arrangements unattractive should be removed.

2.135 The submission by the joint 10 companies supported Option 2.1B. The submission noted that the proposal provides additional flexibility in regard to enabling Australian corporate groups to distribute foreign income directly to foreign shareholders to enable them to qualify for benefits under the tax laws in their home countries, such as stapled stock arrangements. In addition to this, the submission stated that allowing stapled stock arrangements relieves the pressure on Treasury to negotiate amendments to Australia's double tax treaties in respect of dividend withholding tax.

2.136 Several submissions did not support Option 2.1B. The submission by Barkoczy/De Zilva suggested that allowing streaming for payments to non-residents while retaining streaming for payments to residents would create imbalances in the tax system.

2.137 The submission by Wayne Mayo considered that Option 2.1B offends basic imputation and taxation principles as shareholders receiving something other than their share of a company's value with ad hoc practical effects, such as that no benefits arise to domestic shareholders if there are no foreign shareholders.

2.138 KPMG supported Option 2.1B because it considered it addresses the wastage of franking credits on dividends paid to non-residents.

Dual listed structures

2.139 Several submissions noted that even if Options 2.1A and 2.1B were implemented there is potential for Australian companies to continue to consider dual listed structures for non-tax reasons. However, it is likely to remove taxation as an important factor in the assessment of these structures.

2.140 The Rio Tinto submission noted that due to the bias against international investment and the more attractive UK treatment of non-UK source income and capital, investment from the UK provides a better return for all RT Group shareholders through the DLC structure.

2.141 The CPA Australia submission stated that dual listed company structures provide a solution to this matter only in specific circumstances and are not practical, relevant or viable in every instance.

Option 2.1C

2.142 Most submissions did not support Option 2.1C because the availability of franking credits for any withholding tax on repatriated dividends to Australia will lose importance given the trend to reduce withholding tax rates in new treaty negotiations (for example, US Protocol and treaties containing most favoured nation provisions).

2.143 PriceWaterhouseCoopers and the TIA submissions endorsed the integrity concerns expressed in the consultation paper (that is, excess imputation credits and dividends routed through Australian conduit companies, and Australia's limited scope to obtain verifiable information from offshore jurisdictions) as reducing the attractiveness of Option 2.1C.

2.144 The Westfield Holdings Ltd submission considered that Option 2.1C would be of limited benefit and should not be pursued.

2.145 Similarly, the AICD viewed imputation credits for dividend withholding tax as a much less preferred option than the others suggested in relation to dividend imputation, as double tax agreements and developments overseas make it less relevant.

2.146 Prafula Fernandez's submission stated that Option 2.1C will only benefit around 20 per cent of Australian direct investment being investment in foreign countries that have deducted withholding tax from the dividend.

2.147 The CPA Australia submission did not support Option 2.1C. It noted that dividend withholding tax has been eliminated or significantly reduced in recent years on dividends. It considered that the option is not likely to be effective in accelerating the repatriation of FSI as it requires that a company must have first been liable for foreign dividend withholding tax. Option 2.1C, according to CPA Australia has limited potential application for an Australian holding company with a multi tier offshore ownership structure as the option does not give relief for tax paid by lower level subsidiaries.

2.148 The submission by Wayne Mayo noted that Option 2.1C is no longer as significant due to the recent Australia/US double tax protocol.

2.149 In its submission, PriceWaterhouseCoopers stated that Option 2.1C provides limited ongoing benefit given the preponderance of investment by Australian companies into businesses in jurisdictions which either do not levy a withholding tax, or there it is eliminated by a DTA.

2.150 The ICAA submission similarly noted that Option 2.1C is not attractive because:

- it provides no benefits or credits for underlying basic corporate income taxes paid overseas;
- many countries impose no dividend withholding tax; and
- the trend in developing tax treaties is to reduce dividend withholding tax.

2.151 The BCTR and Deloitte Touche Tohmatsu submissions stated that the global trend towards reducing withholding taxes means that Option 2.1C is unlikely to represent the best tax policy approach.

2.152 The BCA/CTA submission did not support Option 2.1C. It took the view that providing imputation credits in respect of foreign dividend withholding tax is unlikely to significantly address the bias against Australian companies investing in foreign operations. The major impediment to repatriating accumulated foreign profits according to the BCA/CTA submission is the charge to earnings at the company level when those profits are repatriated. In the US in particular, it stated that this has significantly inhibited the repatriation of the accumulated US earnings of Australian companies. Providing credits at the shareholder level the BCA/CTA stated does nothing to address this problem.

2.153 The BCA/CTA stated that the recent developments in relation to the Australia-US Protocol will have a significant impact on profit repatriation out of the US. The submission noted that most Favoured Nation clauses in other treaties to which Australia is a party should also result in reductions in dividend withholding taxes between Australia and other countries in the foreseeable future. While efforts to reduce withholding taxes should continue, the BCA/CTA said, the bias in the future will arise almost exclusively from underlying foreign taxes.

2.154 This option was one of the Review of Business Taxation recommendations taken up by the Government, the BCA/CTA submission pointed out. The submission noted that it was factored into the overall revenue neutral business tax reform package which has been implemented progressively over the last few years. This means according to the submission that a potential revenue cost of $200 million per annum has already been factored into the forward budget estimates. If the effect of the imputation bias is to be addressed, this amount (but not necessarily only this amount) should be earmarked for that purpose, the BCA/CTA submission stated.

2.155 The Minerals Council did not support Option 2.1C as it is not likely to significantly address the bias against Australian companies investing in foreign operations.

2.156 KPMG stated that Option 2.1C would not be particularly effective because many of Australia's major trading partners do not impose withholding tax on the repatriation of non-portfolio dividends.

2.157 The ASX submission supported the implementation of Option 2.1C. It noted that Option 2.1C also offers some relief to companies operating in jurisdictions with high rates of dividend withholding tax; although recognising that tax treaties could be designed to reduce this impost (such as that recently negotiated with the US).

2.158 The ASX considered that Option 2.1C would:

- reduce the effective marginal tax rate imposed on FSI,
- thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;
- encourage the repatriation of profits back to Australia; and
- potentially involve a lower revenue cost than Option 2.1A, since no credit would be provided for the underlying company tax paid.

Other recommendations

2.159 The IBSA submission recommended that 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 to both foreign-owned subsidiaries and to permanent establishments that issue equity interests to Australian shareholders, stated the submission.

2.160 IBSA noted that franking credits are available to domestic entities but not to foreign entities that are wholly-owned by non-residents.[6] This means, the IBSA stated, 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.

2.161 The IBSA submission outlined the following potential benefits for its proposal to allow foreign-owned entities to frank distributions to residents who hold equity interests in entities that are issued in Australia:

6 That is, companies in which non-residents own more than 95 per cent of the accountable shares on issue.

- a better balanced and more competitive tax regime for foreign entities;
- a more broadly based capital market that would increase investment options for local investors (including rapidly growing superannuation funds) and shift some overseas investment opportunities into Australia;
- greater international business through a more competitive tax regime for foreign institutions, that could raise equity locally and avoid currency exposure and related hedging costs on equity infusions from offshore;
- greater flexibility for business financing; and
- enhanced opportunities for foreign companies to develop employee share schemes for their Australian employees.

Cost of capital comparison of options

2.162 The ABA submission contains detailed calculations that compare the cost of capital for an Australian company assuming that the company has profit before tax of $1 billion of which 30 per cent is foreign sourced and 25 per cent of its shareholders are foreign shareholders. The modelling work compares what the companies cost of capital would be at present to its cost of capital under Options 2.1A and Option 2.1B and under Option 2.1A and Option 2.1B combined and under a dividend exemption model. The calculations show that under the current law the cost of capital of the company is 10 per cent and reduces or increases depending on the reform option adopted as follows:

Option	Current position	With Option 2.1A	With Option 2.1B	With Options 2.1A and 2.1B	With full dividend exemption
Cost of capital per cent	10	11.5	9.6	9.6	9.5

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

Summary of Submissions

Many submissions focused extensively on this chapter. Submissions highlighted the potential for tax disincentives to outweigh Australia's other advantages as a location for international companies. The complexity of the controlled foreign company (CFC) regime and unfavourable taxation of conduit income received particular attention.

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

Submissions noted that Australian multinationals often seek to restructure for various reasons. The lack of capital gains tax (CGT) rollover relief can make this difficult.

Submissions supported the expansion of CGT rollover relief. Suggestions for expansion included allowing:

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

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

Many submissions noted that the tainted services income rules also attributed active income rather than targeting passive income resulting in excessive compliance costs. Submissions reported that growth in the services industry, and increased enforcement of the transfer pricing rules make the tainted services income rules inappropriate and excessive in scope.

Suggested solutions in submissions included:

- excluding the provision of services between CFCs on an arms length basis from the scope of the CFC rules;
- excluding services that do not have a direct connection with Australia;
- confining their scope to genuinely passive income;
- confining their scope to services provided by CFCs to resident associates; and
- excluding CFCs that are undertaking an active business of providing services.

Option 3.3: To consider whether additional countries could be included on the broad-exemption country list, and to clarify the criteria for inclusion

Submissions reported that an insufficient number of comparably taxed countries are included on the BELC list. This leads to high compliance costs for business, and a bias against investment in a number of countries that do not qualify for BELC status. Many submissions called for clear criteria to determine BELC status.

Submissions generally supported the development of objective criteria for BELC status, and expansion of the BELC list. Suggestions for inclusion in the list included all comparatively taxed countries, all countries with a DTA with Australia, and specific inclusions such as the Scandinavian countries and others.

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

Submissions noted that anomalies and overlap with other regimes contribute to complexity and compliance costs under the CFC rules. Many submissions referred to a list of CFC issues maintained by the Foreign Source Income Subcommittee of the

National Tax Liaison Group over a number of years. The fact that these issues have remained unresolved was criticised. Submissions requested resolution of the outstanding issues on the list as a priority.

Some submissions supported a complete rewrite of the CFC provisions. However, of these, many acknowledged that this is a long-term project and that in the shorter term specific problem areas should be addressed.

Additional option: Exemption from attribution for BELCs

Many submissions considered that no attribution should occur where a company is resident in a BELC. Some of these submissions also suggested that no attribution occur for subsidiaries of CFCs resident in a BELC or where 90 percent of the income of a CFC is sourced in a BELC or similar country.

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

Submissions generally welcomed the lower withholding taxes in the US Protocol and sought that it be applied to other DTAs. A range of other issues that were considered to warrant incorporation in future DTAs were also raised.

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

Submissions noted that the proposal is impractical to implement and will harm Australia's international competitiveness.

Some submissions stated that normal business transactions could be affected by the tax implications of this proposal.

Submissions requested that the Government not proceed with this proposal.

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

Many submissions suggested that priority be given to holding tax treaty negotiations with major trading partners with Treasury focusing more resources on its Treaty program. Several submissions sought the renegotiation of treaties with countries with which particular companies had significant business interests.

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

Submissions stated that the current consultation process for tax treaties is ineffective. They noted that there is a lack of opportunity to comment at the appropriate stage in the development of new or revised tax treaties, and that businesses often receive better information from sources other than the Government.

Submissions generally supported more effective, transparent consultation processes. Specific suggestions included actively involving the Tax Treaties Advisory Panel, or forming a new Treasury Treaties Working Group.

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

According to submissions, the current distinction between listed and unlisted countries for non-portfolio dividends creates complexities and anomalies. This discourages companies from repatriating profits from unlisted countries. Submissions generally supported implementation of Option 3.9.

Option 3.10: To consider options to provide conduit relief for Australian regional 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

Submissions highlighted that Australia is not an attractive location for international holding companies or regional headquarters. Multinational companies are often advised to restructure to avoid using Australia as a conduit, mainly due to tax disincentives. This results in a loss of opportunities to Australia according to submissions.

Submissions generally supported an exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business. Many submissions also supported the development of a specific conduit holding company regime. Few submissions commented on the proposal to provide conduit restructure relief, although several submissions that commented on this proposal did not support it.

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

Submissions generally supported the proposal to proceed with the FIA rules recommended in the RBT and also to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies.

Some submissions expressed concerns if the FIAs operated in the same way as current FDAs as they considered that FDAs do operate effectively in practice. Other submissions highlighted the interaction between this Option and Options 2.1 and 3.10.

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

Submissions stated that the central management and control element of the company residence test creates problems. A number of submissions noted that the test forced Australian companies with foreign subsidiaries to appoint local directors in lieu of Australian residents to avoid the subsidiaries being treated as Australian residents.

A number of submissions noted that the test forced Australian directors to travel overseas to participate in directors' meetings rather than participating from Australia via telecommunications hook-ups.

Most submissions suggested using place of incorporation as the sole test of residency for companies. Several noted the risk of artificial 'inversions' of companies, as seen in the US but considered generally that this would not have any real impact on the effectiveness of the test. A number of submissions proposed clarifying the central management and control test.

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

Implementation, or at least further consideration, of this proposal was generally supported by those who commented on this option.

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

Problem with current law

3.1 PricewaterhouseCoopers stated that Australia's CFC regime is amongst the most complex in the world. The complexity and inequitable outcomes in many areas are a serious disadvantage for Australian companies.

3.2 CPA Australia stated that there is often the need to undertake corporate reorganisations due to acquisitions, business combinations, amalgamations, corporate streamlining and/or in advance of divestments. It noted that there is an inability to do so in a tax effective manner except in some cases where the CFCs are resident in the same foreign country. The ABA and the BCTR submissions agreed with this view.

3.3 The ICAA stated that Australian based companies are unable to change inefficient structures without having current Australian tax payable on unrealised profits. This leads to inefficient international operations solely because of outdated and inflexible Australian tax law.

3.4 The TIA stated that the complicated CFC rules involve high compliance costs and that they also impede the efficient restructuring of Australian corporate groups.

3.5 Problem areas identified by the TIA included:

- the potential application of CGT to the disposal of CFC tainted assets;
- that countries with comparable tax systems to Australia are excluded from BELCs and LELCs; and
- second order issues concerning the control tests, foreign exchange, and the treatment of start-up companies.

3.6 Deloitte & Touche NZ stated that the CFC rules result in significant ongoing compliance costs, which deters New Zealand companies from investing directly through Australia.

3.7 Deloitte Touche Tohmatsu noted that the current CFC rollover is so narrowly confined that many reorganisations cannot be undertaken due to CFC attribution costs. The submission highlighted the current tax disadvantage that exists in selling shares in a foreign company instead of assets of the foreign company.

3.8 The BCA/CTA stressed that Australian-based multinationals continually need to reorganise asset holding structures to improve efficiency. It noted that these reorganisations do not result in any realised gains for the group. However, according to the submission, CFC rollover relief is so narrowly confined that many reorganisations cannot occur because of the attribution cost. It noted that this severely restricts the ability of Australian based multinationals to rearrange their offshore holding structures in the most efficient manner.

3.9 Ernst & Young submitted that the inability to restructure and enter joint ventures overseas without attribution under the CFC measures puts Australian companies at a competitive disadvantage compared to other businesses operating in the same jurisdiction.

3.10 KPMG stated that rollover relief available under CFC provisions may not align with the type of relief available in the country where a CFC may be resident which disadvantages Australian corporate groups with offshore operations that are in competition with local entities or subsidiaries of multi-nationals of countries with no CFC rules or with less prohibitive rules than Australia. It also noted that there was uncertainty in accessing recent CGT relief (scrip-for-scrip and de-merger) provisions through the CFC rules.

Evidence of existing problem

3.11 Deloitte Touche Tohmatsu noted that recognition under the CFC rules of tax free reorganisations undertaken in broad-exemption listed countries does not extend to rollover relief. The submission noted that CFCs undertaking scrip-for-scrip transactions in most cases do not qualify for CFC rollover relief.

3.12 The BCA/CTA considered that common restructuring situations generally do not qualify for rollover relief, including joint ventures, transactions in BELC countries, scrip-for-scrip transactions between non-wholly-owned foreign companies, interposing new foreign holding companies and New Zealand qualifying amalgamations.

3.13 KPMG stated that when an Australian multi-national restructures its offshore entities additional Australian tax can sometimes arise when an election to access roll-over relief offshore gives rise to additional income being attributed to the Australian parent. Accordingly, it noted that restructures either don't occur or are substantially re-worked.

Solution

3.14 The BCTR stated that rollover relief should be expanded.

3.15 PricewaterhouseCoopers proposed exempting from the CFC rules any gain arising to a CFC on a disposal of a non-portfolio interest in a non-resident company with underlying active assets in pursuit of a corporate reorganisation, merger or demerger. It sought a blanket exemption for all BELC rollovers.

3.16 CPA Australia suggested allowing all forms of corporate reorganisation currently allowed under the CGT provisions (including demergers). Any proposed transaction that is undertaken at fair value and with a dominant commercial purpose should be permitted because Division 13 and Part IVA provide sufficient integrity.

3.17 The ABA proposed allowing Australian taxpayers to utilise Australian capital losses to offset attributable capital gains of a CFC.

3.18 The ABA and IFSA submissions stated that the CFC rollover rules should be expanded to include CGT rollover relief for the disposal of assets where rollover relief is provided under the laws of any foreign country. If the BELCs remain subject to CFC rules, the concept of EDCI for BELCS should be limited to specific items of concessionally taxed income, the submission stated.

3.19 The IFSA recommended extending roll over relief to all CFCs in wholly-owned groups irrespective of the jurisdiction of the CFC.

3.20 The joint 10 companies proposed:

- providing a general exemption for the sale of all foreign non-portfolio interests in foreign companies; and
- that the dividend exemption (proposed above) should be supported by an exemption from capital gains tax for capital gains from the sale of non-portfolio interests in foreign companies. This would harmonise the treatment of dividend income with the treatment of capital gains resulting from the sale of a foreign company that have retained profits. However, the submission did not propose the granting of a foreign dividend account credit in respect of such capital gains (except to the extent they arise from the sale in a BELC or have actually been taxed in a foreign country). This change it noted is important to ensure that Australia remains competitive with other countries' international taxation arrangements. For example, UK and Germany.

3.21 The ICAA submission sought that:

- capital gains tax should not be imposed on reorganisations of lower-tier subsidiaries in CFC chains. This it stated could be implemented using participation exemptions, or a mechanism of rollovers such as:
  - allowing tax deferred rollover of assets between CFCs that are members of the same wholly-owned group, irrespective of the residence of the CFCs; and
  - allowing relief for a CFC in a BELC where the relief is consistent with relief provided by the BELC; and
- scrip-for-scrip transactions be allowed in certain circumstances.

3.22 The TIA believed a better solution is an exemption from the disposal of a non-portfolio interest in a non-resident company with underlying active assets. Sales of shares should have the same tax treatment as the sale of the underlying assets.

3.23 Deloitte & Touche NZ supported all proposals to reduce the impact of the Australian CFC rules for foreign investors investing into an Australian conduit.

3.24 Deloitte Touche Tohmatsu proposed a focused expansion of the existing CFC rollover provisions to cover situations where:

- a CFC resident in a BELC undertakes a transaction that qualifies for rollover relief under the taxation laws of that BELC;
- CFCs transferring shares in exchange for shares;
- Australian residents transferring shares in a CFC to another CFC in the same wholly-owned group; and
- CFC transferring assets to another CFC that are part of the same wholly-owned group.

3.25 If a blanket exemption is not accepted, Rio Tinto suggested that CGT should only apply if an asset is disposed of or a gain is actually realised. Rollover relief should be allowed on any CGT event occurring within a wholly-owned group, it stated. Scrip for-scrip transactions not involving wholly-owned corporate groups should not result in attributable capital gains, stated the submission.

3.26 The Minerals Council submission sought improved rollover relief for corporate restructuring. It proposed that Australian rollover relief should be allowed on any CGT event between CFCs that are members of the same wholly-owned group, regardless of the jurisdiction. Additionally, it sought that scrip-for-scrip transactions not involving wholly-owned corporate groups should not result in attributable capital gains.

3.27 The BCA/CTA considered that CFC rollover relief should be introduced as a medium term priority (12-18 months). In its submission it proposed two potential options:

- introduce a series of specific rollover reliefs to situations such as:
  - a CFC resident in a BELC undertaking a transaction that qualifies for rollover relief in that country;
  - assets transferred between CFCs that are members of the same wholly-owned group (regardless of residency);

  - a CFC transfers shares in another company to another CFC in exchange for shares, or transfers shares in a CFC to a non-controlled foreign company in exchange for shares;
  - an Australian resident transfers shares in a CFC to another CFC, where all companies are members of the same wholly-owned group; and
  - a company is eligible for a New Zealand tax concession for qualifying amalgamations.

  or

- provide a general exemption for group restructures that are treated as tax-free in the foreign jurisdiction or jurisdictions where they are undertaken, provided there is no dominant purpose of Australian tax avoidance associated with the restructure.

3.28 The BCA/CTA submission noted that particular care would need to be taken to prevent unwarranted tax free cost base uplifts, and ensure that the provision of wholly-owned group rollovers regardless of the residence of the CFCs did not result in a material cost to the revenue.

3.29 Possible more immediate solutions suggested by Ernst & Young prior to a full review of the CFC rules included:

- allowing rollover relief for asset disposals for all CFCs in a BELC equivalent to the relief allowed under the domestic law of the BELC, regardless of whether there is rollover relief in the Australian context;
- providing rollover relief for the transfer of assets within a wholly-owned group and ensuring that the gain on subsequent disposal of the asset is dealt with under the CFC measures; and
- allowing scrip-for-scrip relief where the CFC exchanges scrip in a company for scrip in a CFC resident in a BELC or a non-BELC, or alternatively a non-CFC.

3.30 KPMG suggested aligning the rollover relief available through the CFC rules with that available under the domestic tax law of the country of residence of the CFC, especially in broad exemption listed countries and clarifying availability of scrip-for-scrip and demerger relief under the CFC provisions.

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

Problem with the current law

3.31 The AICD stated that there is considerable bias against services compared with goods in the CFC rules.

3.32 The joint 10 companies considered that problem arise from the attribution of active services income under the tainted services income rules.

3.33 Ernst & Young stated that the tainted services income definition was developed for a different purpose in the CFC rules. It noted that the services income rule (and the other CFC rules) were developed with one of their aims being to act as quasi transfer pricing provisions, despite the development of the administration of the transfer pricing rules since 1990.

3.34 The ICAA stated that many companies have an international focus on providing services as an 'active business' rather than having a product based business. These services are not activities designed to shift income from one jurisdiction to another.

3.35 According to the TIA, the impact of tainted service rules on Australian companies with active income from substantial offshore businesses in services is a key problem area.

3.36 Deloitte & Touche NZ highlighted significant ongoing compliance costs, which deters New Zealand companies from investing directly through Australia.

3.37 Deloitte Touche Tohmatsu stated the current rules cause income attribution for essentially active business income (for example, services or knowledge based businesses), inhibit the establishment of shared services centres outside Australia, and create excessive tax compliance obligations.

3.38 Rio Tinto stated that the current definition of 'tainted services income' inhibits the mining business activities where a local entity is established specifically to market and administer the mining operation, which is a usual industry practice.

3.39 The BCA/CTA considered that the current rules:

- attribute income that is essentially 'active' business income and thereby hinder the growth of Australian-based service and knowledge companies;
- inhibit Australian based multinationals from establishing shared services centres, placing them at a disadvantage compared to major international competitors which treat services income far less severely; and

- create excessive tax compliance obligations.

3.40 The Insurance Council of Australia stated that the CFC regime is extremely complex; section 446(4) of the 1936 Act treats passive income as active for determining CFC attribution, a useful concession in the insurance industry. However amendments, especially section 446(2), require complex calculations and create high compliance costs it noted. The submission noted that the CFC regime does not recognise that insurance companies need to hold capital in jurisdictions to allow them to expand business and provide additional capital if investment markets slump.

3.41 Telstra stated that the tainted services income rules:

- disadvantage Australian companies operating in service industries, especially telecommunications;
- discourage the provision of shared services within a multinational group;
- create costly compliance burdens; and
- impede growth into offshore markets.

3.42 KPMG stated that the broad coverage of the tainted services rules were intended to support Australian transfer pricing rules. It considered that the recent focus of revenue authorities globally on profit shifting through transfer pricing has decreased the rationale for the broad coverage and that unnecessary duplication of transfer pricing rules is an additional burden on an Australian attributable taxpayers.

Evidence of existing problem

3.43 The Australian Institute of Company Directors submitted that the late 1980s justification for the tainted services income rules that the transfer pricing rules are inadequately enforced is no longer valid.

3.44 From an integrity perspective, the IFSA noted that the transfer pricing rules have become an important element in targeting any potential profit shifting that could occur by under or overpricing for goods and services between CFCs, particularly more so since the introduction of the CFC rules in 1991. This is also reflected globally in many jurisdictions which have implemented or improved their own transfer pricing rules (for example, India) to counter any profit shifting arrangements.

3.45 Deloitte Touche Tohmatsu cited the inappropriateness of CFCs assisting their Australian parent to perform contracts between that parent and non-resident third parties deriving tainted services income. It noted that shared services centres operating active businesses through a CFC generate tainted services income. Telecommunications ventures also get caught under these rules, stated the submission.

3.46 The BCA/CTA's view was that the tainted services income rules were initially based upon the view that services income was not 'core' income and was highly mobile and difficult to value. Rapid changes in the global economy now make this inaccurate it stated. It noted also that there was now the capacity for tax authorities to rigorously assess the value of cross border services making the original basis for the tainted services rule unsound.

3.47 The BCA/CTA gave a number of examples of situations in which the tainted services rules impact including:

- that the establishment by telecommunications companies of offshore joint ventures being invariably treated as CFCs; and
- that the setting up of centralised or shared service centres in one company by a multinational group for efficiency purposes will automatically attract CFC attribution.

3.48 The Insurance Council of Australia stated that although amendments to section 446 of the 1936 Act were intended to prevent potential abuse, there is no evidence of attribution from the application of the amended formula.

3.49 Ernst & Young stated that it may not be feasible for an 'active' business to carry on all services from Australia. For example, management services logically provided from Singapore to Malaysia, manufacturing activities in China, but Hong Kong resident company provides management services. Similarly, it noted that for regulated industries, activities must be provided by a separate company to the company holding the assets and also commercial imperatives may dictate separation of assets and the operating business. However, despite the commercial reasons for the separation of activities the tainted services rules apply in an arbitrary manner, Ernst & Young stated.

3.50 KPMG reported that fee income from funds management could be regarded as tainted income.

Solution

3.51 The AICD requested that Option 3.2 should be implemented as a priority. The submission stated that consideration should be given to a total review of tainted services and tainted sales definitions to narrow the scope of their operation.

3.52 The IFSA submission considered that:

- services provided between CFCs on an arms length basis should be outside the scope of the CFC rules; and

- provision of services without a direct connection to Australia (that is, they are not provided directly to or from an Australian resident entity) should also be excluded.

3.53 The joint 10 companies suggested solution was to redefine the scope of attributable income. In particular, the submission proposed confining the scope of tainted services income to truly passive income, and aligning tainted services income rules with their tainted sales counterparts.

3.54 The ICAA submission proposed that:

- the tainted services income definition should be revised to exclude the operations of a CFC when it is undertaking an active business of providing those services to non-associates and limiting its operation to services provided to Australian resident associates; and

- there should be no application of tainted services or passive income to BELC CFCs.

3.55 The TIA argued that implementation of this option is crucial due to growth in services trade.

3.56 Deloitte & Touche NZ supported all proposals to reduce the impact of the Australian CFC rules for foreign investors investing into an Australian conduit.

3.57 Deloitte Touche Tohmatsu argued the solution is to amend the definition of tainted services income by confining its operation to services provided by CFCs to Australian resident associates. Another addition could be an exclusion for all services provided by a CFC to Australian resident associates where the CFC is undertaking an active business of providing services directly to non-associates.

3.58 Rio Tinto proposed that service income should be excluded from the definition of tainted service income where there is an underlying active business. It also noted that the transfer pricing rules apply the anti-avoidance mechanism.

3.59 The Minerals Council sought redefinition of the scope of attributable income. In particular, it proposed that the scope of tainted services income be confined to truly passive income.

3.60 The BCA/CTA recommended abolishing the tainted services income rules immediately. It considered that if this was not possible then the following changes to the rules should be made:

- confine its operation to services provided by CFCs to resident associates, and;

- add an exemption excluding from attribution all services provided by a CFC where the CFC is undertaking an active business of providing those services to, or directly for the benefit of, non-associates.

3.61 The Insurance Council of Australia sought to amend section 446 of the 1936 Act with the aim of continuing to prevent revenue leakage, but doing so in a simpler and more equitable manner.

3.62 BHP Billiton in its submission proposed excluding tainted services from the scope of passive income.

3.63 Telstra in its submission proposed that tainted services income should be limited to services CFCs provide to Australian resident associates. The submission considered that Australian transfer pricing rules and Schedule 25A reporting obligations are robust enough to ensure the tax base is not eroded. Finally, the submission sought that income from services a CFC provides should be outside the CFC rules if those services are part of an active business.

3.64 Ernst & Young proposed:

- removing the category of tainted services income. This should not lead to significant scope for diversion of income according to Ernst & Young; or
- if there is a perception that the rule needs to bolster the transfer pricing rules, then restrict the category to certain services provided to certain associates. It considered that the risk to revenue of transfer pricing between non-associate parties is minimal and can generally be left to transfer pricing rules.

3.65 Ernst & Young considered that on the basis of its proposed rules, changes to the definition of tainted services income would not impact on any other option for consultation.

3.66 KPMG suggested excluding income derived from related parties that occur within the same type of country (for example, BELC, LELC or unlisted) and also providing an exemption for service companies where the active business of the CFC is solely the provision of such services to related entities.

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

Problem with the current law

3.67 The BCA/CTA considered that the requirement to make attribution calculations under the CFC rules was designed originally to deal with attribution from tax havens or low-tax countries. However, it stated that the reduction of the original list of broadly comparably taxed countries to a BELC list now of 7 countries, results in the need to attribute income under the CFC rules for a wide range of countries that have comparable tax rates to Australia. The submission noted that this change has created excessive compliance requirements and the need to attribute income without significant benefit to the Australian tax revenue.

3.68 The Australian Institute of Company Directors stated that the only common characteristic of the current BELC list is that their tax systems have a certain level of integrity.

3.69 CPA Australia stated that the CFC rules imposed a very large tax compliance cost on conducting business in countries other than then current broad exemption listed countries (BELCs).

3.70 The IFSA stated that there are too few BELCs. Most EU countries it noted are treated like tax havens.

3.71 The joint 10 companies cited the lack of a list of criteria for BELC (and LELC) selection.

3.72 The BCTR believed there is an inappropriate balance between the integrity of the CFC regime and the management of compliance costs.

3.73 The TIA considered that a key problem area is the exclusion of countries with comparable tax systems from BELCs and LELCs.

3.74 Deloitte Touche Tohmatsu considered that the removal of countries from the list in 1997 has created excessive compliance requirements without material benefits to Australian revenue.

3.75 KPMG stated that list of broad exemption countries was compiled in 1997 and is quite small.

Evidence of the existing problem

3.76 The TIA stated that there is a bias for investment in broad exemption listed countries and bias against investment in emerging Asian and Pacific markets.

3.77 The BCA/CTA pointed out that, although, the majority of Australia's outbound investments are located in BELCs, Australia's largest outbound groups have also made significant investments in other countries, either directly or as participants in joint ventures. It noted that there is also significant intra-group transactions that take place between broad and limited-exemption listed and unlisted countries.

3.78 KPMG considered that there was scope to add countries with comparable tax systems and corporate tax rates to the current list of BELCs.

3.79 Ernst & Young stated that the focus of extending the BELC list should not necessarily be on major trading partners because:

- statistics on trade have no necessary relationship with the level of investment through companies resident in that country, as demonstrated by the inclusion of Japan on the BELC list. Also, Australia may not have a significant level of trade with the foreign country;
- a country may be a significant final destination for investment by Australian multinationals, but this may not be apparent from empirical evidence as data on Australian investment in foreign countries only discloses the immediate destination of the capital; and
- the historical pattern of trade does not fully reflect growth of trade in new markets and the increase in investment in particular countries.

Solution

3.80 The BCA/CTA considered that criteria for establishing whether countries should qualify as BELCs should include, amongst other things, those countries that are attracting or have the potential to attract the largest share of Australian outbound investment, excluding those (if any) whose tax systems are self-evidently not comparable to the Australian system. The submission considered that the criteria should include:

- the degree of access to information by the Australian Taxation Office (ATO) and Treasury as to tax concessions in those jurisdictions that are potentially applicable to passive income or tainted income and the ability to conduct investigations in an open and transparent manner;
- the foreign jurisdiction has a comparable approach to monitoring and responding to tax planning and tax avoidance arrangements; and
- the constraints that the country faces in granting significant new passive income tax concessions.

3.81 The Property Council proposed adding to the existing BELC list.

3.82 Prafula Fenandez proposed rewriting the CFC rules to give favourable treatment to certain countries.

3.83 Australian Institute of Company Directors suggested that additional countries should be included on the BELC list, particularly where Australia has DTAs with those countries.

3.84 PricewaterhouseCoopers believed that pending a broader CFC review, a useful criteria for BELCs could be whether a country taxes business income at no less than 80 per cent or 90 per cent of the Australian rate.

3.85 CPA Australia proposed that the broad exemption country list be expanded to include most countries with which Australia has a DTA. It considered that there is a need for a commitment that the BELC list be updated on an annual basis and that Option 3.2 needed to be addressed regardless of the implementation of Option 3.3.

3.86 The IFSA proposed that:

- countries should be added to the BELC list based on: comparable tax rates; existence of a DTA; existence of anti-deferral rules; and extent of any substantive structural tax concessions or objectionable features of the country's tax system;
- consistent with the pre-1997 approach, countries which are presently LELCs (refer Schedule 10 of the Income Tax Regulations) should all be reconsidered for inclusion; and
- to the extent that any of the countries are not included on the revised BELC list, any objectionable features of the tax system should be specified in the legislation. This is consistent with the pre 1997 approach. Such an approach would ease compliance with the CFC rules and simultaneously achieve the integrity concerns of the revenue.

3.87 The joint 10 companies proposed that objective criteria be developed and published for Treasury to utilise when classifying countries as BELCs, LELCs and unlisted countries.

3.88 The ICAA proposed establishing a durable process with input from external stakeholders for defining 'comparably taxed', with a view to the expansion of the broad exemption list. It considered that determining if countries are comparably taxed should be done on an ongoing and transparent process. The submission considered that any expansion of the BELC list should not be accompanied by measures designed to attribute specific income. It considered that such additional rules would over-complicate the legislation.

3.89 The BCTR suggested implementing a transparent and ongoing process to examine the criteria for countries on both the broad exemption and limited exemption lists.

3.90 The Minerals Council proposed expanding the list of countries deemed as highly comparable to include most of the countries with which Australia has a DTA and, particularly Australia's major trading partners in the Asian region. It also sought to exempt entities operating in non-comparable tax jurisdictions where the underlying activities of the business are active. The determination of the degree of activity in these cases should, according to the Minerals Council, be supported by the audited accounts with no statutory adjustment and based on a reasonable ratio. An additional measure it noted would be to allow companies to apply for a CFC exemption on an entity-by-entity basis.

3.91 The TIA suggested the order of the criteria for the CFC regime should be comparability, level of trade, an overall level of general taxation and tax administration, and the existence of a CFC regime. The Scandinavian countries with more comparable tax systems could be added to broad exemption listed countries it stated.

3.92 Deloitte & Touche NZ supported all proposals to reduce the impact of the Australian CFC rules for foreign investors investing into an Australian conduit.

3.93 Deloitte Touche Tohmatsu proposed adding a short-list of countries to the list of BELCs. It stated that priority should be given to those countries that will attract Australian outbound investment (excluding those not comparable to the Australian tax system).

3.94 Rio Tinto believed a simple expansion of BELCs or LELCs would not reduce compliance costs. However, if expansion of the list is to be adopted, it should include most of Australia's DTA countries, particularly those within Asia region. Non-comparable tax jurisdictions should also be exempt if the underlying business activities are active.

3.95 NZ Corporate Taxpayer Group suggested expanding the number of broad exemption listed countries to reduce compliance costs and tax inefficiencies for New Zealand based companies that invest in Australia.

3.96 KPMG considered that the criteria for expanding the BELC list should be clearly defined.

3.97 The Victorian Government Department of Innovation, Industry and Regional Development stated that the BELC list should be expanded to include, particularly Asia-Pacific countries with comparative tax systems giving priority to those that attract the largest share of direct outbound investment from Australia.

3.98 Ernst & Young considered that there was scope for expanding the number of BELCs in order to reduce the compliance burden of the CFC rules without reducing their integrity. It set out potential criteria for determining BELC eligibility including:

- countries with headline corporate tax rates at least 80 per cent of the Australian rate;
- countries with suitable transfer pricing rules;

- countries with comprehensive income tax bases, but countries need not have a CGT or a CFC system;
- Australia and the country must have DTA; and
- avoiding political considerations when making decisions.

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

Problem with the current law

3.99 The Australian Institute of Company Directors stated that improvements in Australia's transfer pricing program have led to overlap with the CFC regime. The CFC, FIF and transferor trust regimes overlap and lack symmetry in the way they are applied. It stated that rules are applied indiscriminately to large and small Australian based investors. The measures are overly complex and there is a huge compliance burden on business.

3.100 CPA Australia stated that many inadequacies of the existing CFC rules have been identified for some time via ATO's NTLG FSI subcommittee. However, the forum has not had the resources to deal with them.

3.101 Also, CPA Australia was of the view that the current law is biased against the conduct of active service businesses compared to other sales or manufacturer based businesses. This reflects the changes in the way that business is conducted since the CFC rules were developed in the late 1980's.

3.102 Westfield America Trust stated that the CFC rules impose compliance costs, and impediments to conducting business.

3.103 The BCTR stated that a major rewrite of the CFC rules is supported in the long term, but specific pressing issues should be resolved in a more timely manner.

3.104 The IFSA stated that the CFC rules in general are distortionary; anti-competitive; complex and unwieldy; and have high compliance and administration costs. It noted that the economic and business environment has moved on since the rules were enacted in 1991.

3.105 The IFSA also stated that the CFC rules are inadequate in a number of ways in their treatment of capital gains.

3.106 The ICAA noted that the CFC and related rules are riddled with errors and ambiguities, but only the glaringly obvious mistakes have received priority for amendment.

3.107 The TIA stated that the complicated CFC rules involve high compliance costs. They also impede the efficient restructuring of Australian MNEs.

3.108 The TIA considered that two key problem areas were:

- the potential application of CGT to the disposal of a CFC's tainted assets may impede the restructuring of an Australian multinational or regional holding company's offshore operations and thereby adversely affect the competitiveness of Australian companies; and
- second order issues such the control tests, foreign exchange, and the treatment of start-up companies.

3.109 Barkoczy and De Zilva (Monash University) stated that the present regime is complex and the cost of compliance is high.

3.110 Ernst & Young stated that the taxation of shares under the CFC regime is not consistent with the taxation of underlying assets, creating a preference for asset sales rather than share sales.

3.111 Deloitte Touche Tohmatsu stated that Australian businesses rarely have resources to manage the application of compliance measures designed for tax havens to their operation in the Asia-pacific region. Complexity of the rules creates uncertainty, impeding cost effective operation. The submission noted that the CFC rules apply to many joint ventures.

3.112 The BCA/CTA noted that:

- ascertaining whether the income of a CFC in a BELC is attributable under the CFC rules requires detailed understanding of the law of the relevant country. It is a difficult, time consuming and expensive process;
- in some cases (in particular joint ventures) the CFC rules capture foreign companies where the requisite degree of control does not in fact exist;
- indiscriminate application of the transfer pricing rules to CFCs creates unnecessary compliance costs;
- the quarantining of losses results in separate calculations for each of the four classes of income, a CFC having attributable income despite an overall loss, inability to offset CFC's losses against income attributed from other CFCs;

- there may be retrospective attribution where shares are bought midway through a statutory accounting period; and
- the current rules relating to attribution of capital gains create a bias in favour of operating through a branch rather than a subsidiary.

3.113 A supplementary submission by the BCA/CTA/ABA provided several case studies which evidenced that Australia's tax laws including its CFC provisions inhibit the potential for Australia to attract regional holding companies.

3.114 The Telstra submission considered that the CFC provisions contain too many complex provisions and have too broad a focus. It noted that complexities arise because the regime taxes income from conducting an active business and attempts to tax income derived in jurisdictions other than recognised tax havens.

3.115 The Property Council stated that the CFC rules create massive compliance costs. It considered that attribution of capital gains is problematic as the rules give rise to deemed capital gains and also that the CFC rules disadvantage local entities.

3.116 The Property Council submission cited anomalies in the CFC rules including:

- treatment of limited partnerships as companies, despite UK and US limited partnerships generally being treated as look through entities in their home jurisdictions;
- treatment of certain non portfolio dividends paid to companies as exempt income for Australian tax purposes;
- functional currency rules for CFC attribution calculations;
- risk that the ATO could recognise the existence of the nominee or bare trust in applying CFC rules; and
- high compliance costs in applying the branch profit exemption.

3.117 Specifically, the Property Council noted that listed property trusts must distribute all their income (both local and foreign sourced) to unit holders in the year it is derived. Despite this the submission stated that the CFC rules still apply to these entities.

3.118 KPMG outlined a range of issues with the CFC provisions including the definition of associate, transfer pricing provisions, implications of the consolidation regime's interaction with international tax measures, and the attributable income status of notional exchange gains and losses, and the interaction of CFC provisions with debt/equity, capital gains, exemptions.

Evidence of existing problem

3.119 The Australian Institute of Company Directors and CPA Australia referred to the extensive list of CFC problems that has been compiled by the National Tax Liaison Group Foreign Source Income Sub-Committee.

3.120 Westfield America Trust stated that the CFC rules mean that Australian investors in CFCs resident in BELCs are at a competitive disadvantage compared to local entities and other foreign investors.

3.121 The IFSA referred to the operation of the CGT provisions in the CFC rules and stated that attribution can occur where an active business is disposed of through a sale of shares, yet no attribution occurs if the same sale is effected through a sale of the underlying assets. Any capital gains that are attributed under the CFC rules lose their character as capital gains because it is treated as other statutory income. This, it noted, prevents Australian capital losses from being offset against those capital gains.

3.122 In addition under the current CFC rules, the IFSA noted that capital gains and losses can be crystallised due to foreign exchange movements, even though economically there may not have been any capital gain or loss. The IFSA gave an example of this. It referred to a situation in which a CFC buys an asset for US$100 (forex rate $1AUD = $0.55US) and later disposes of the asset for US$100 (forex $1AUD = $0.50US). For Australian CGT purposes, the CFC will have made a capital gain, on which the Australian entity will be taxed yet the CFC has made no economic gain.

3.123 The ICAA stated that the CFC National Issues Register contains 80 recognised issues, and the TLIP-FSI rewrite list contains more than 120 items. Key items on these lists include the definition of 'associate', the need for a wider range of rollovers, and the inappropriate way changes in the value of foreign currency can give rise to assessable income.

3.124 The TIA stated generally that the application of CGT to the disposal of CFC tainted assets results in Australian companies stripping foreign assets out of CFCs before sale, or placing those companies at the bottom of the global chain in a restructure. Also, the definition of 'tainted services' includes certain telecommunication activities. The submission considered that there is a bias towards investment in BELCs and a bias against investment in emerging Asian and Pacific markets.

3.125 Deloitte & Touche Tohmatsu NZ considered that the CFC rules impose ongoing compliance costs, which deters New Zealand companies from investing directly through Australia.

3.126 The BCA/CTA raised the following matters:

- Australian multinationals are obliged to design detailed compliance manuals and questionnaires for their CFCs. Australian tax managers must meet with accountants and lawyers in other jurisdictions. Many large corporations have found that time managing CFC obligations has increased by up to 50 per cent since the 1997 amendments;

- the problems for joint ventures under the CFC rules are particularly important as Australian companies are often forced to use them because of the regulatory environment of the foreign jurisdiction, or to obtain sufficient critical mass to penetrate foreign markets;

- where funds are moved between CFCs, there is often deemed to be a notional gain under the transfer pricing rules;

- where a CFC carries on (for example) a banking business, dividends derived by the CFC would be passive income, but fees and interest income would be 'other income'; and

- over the past decade, numerous technical issues have been brought to the attention of the ATO, resulting in the development of a list of outstanding issues that are yet to be addressed.

3.127 The BCA/CTA/ABA supplementary submission noted that the US Administration is very likely to propose substantial changes in its CFC and foreign tax credit regime because of a perception that the US (like Australia) is not a preferred tax regime due to the nature of its international tax rules.

3.128 The BCA/CTA/ABA submission referred to a decision by an Australian company and its joint venture partner to establish a regional holding company outside Australia. The decision reflected the uncompetitive international tax environment in Australia which the submission indicated was partially due to Australia's CFC regime which tops up taxes to the Australian rate on passive and tainted income.

Solution

3.129 The Australian Institute of Company Directors suggested:

- a rewrite of the provisions;

- acknowledgment at the policy level that the CFC and FIF measures are anti avoidance measures and not general taxation measures, allowing design to meet specific policy intention; and

- considering exempting from attribution income earned in BELCs.

3.130 CPA Australia stated that there needs to be a timely and agreed consultative process to identify and deal with the remaining CFC policy issues. Ideally, the CFC rules should be completely rewritten, reflecting that since the CFC rules were introduced the transfer pricing rules and general anti-avoidance rules have been applied in a more robust way by the ATO.

3.131 BHP Billiton suggested that the CFC rules should be limited to their original policy intent which was dealing only with passive income in tax havens. The submission noted that the CFC rules did not require a complete rewrite but needed amendment in a number of specific areas.

3.132 Westfield America Trust proposed that:

- if the review of international taxation arrangements proposed more favourable outcomes for entities established and carrying on activities in BELCs then taxpayers should be able to avail themselves of this outcome. The submission noted that under the current law limited partnerships in the US and UK are treated as residents of no particular country (TD 2001/D14);
- dividends should remain exempt when distributed by an interposed trust;
- CFC rules should be amended so that all capital gains and capital loss calculations are done in the functional currency of the CFC and only the net capital gain is converted to $A; and
- the existence of nominee arrangements or bare trusts should be recognised in applying the CFC rules, as under the FIF rules.

3.133 Telstra proposed that the accruals regime should be redesigned and redrafted to remove features that limit Australian companies' global competitiveness, to simplify its language and compliance obligations; and reduce costs for taxpayers. The submission considered that the regime should be restricted to discouraging taxpayers from diverting passive income into offshore havens in accordance with its original policy objective.

3.134 British American Tobacco stated that the CFC rules should be revised to take into account the purpose of the provisions and reflect similar laws in other countries.

3.135 The BCTR suggested implementing an open and transparent process for resolving outstanding foreign source income issues on an individual basis.

3.136 The IFSA's preferred solution was a wholesale comprehensive rewrite of the CFC rules with substantially revised taxation policy objectives. However, in the interim it proposed:

- excluding BELC CFCs from the CFC rules;
- an entity-based active business exemption;

- a motive exemption from the CFC rules;
- life insurance companies and their subsidiaries should be exempted from the CFC rules.
- allowing offset of attributable income of one CFC against the attributable losses of another;
- excluding any attribution of income where in fact a CFC is in a loss position (despite the active income test having been failed);
- reforming the FTC rules in relation to CFCs when the CFC reform proposals have been developed further;
- allowing flow through taxation of LLP/LLC (however, where an LLP/LLC is established and carries on its activities in a BELC and the Australian resident investor's share of the income of the LLP/LLC is subject to tax in a BELC, there should be an election to treat the LLP/LLC as a CFC resident in the BELC); and
- bare trusts should be ignored for CFC purposes.

3.137 The present *active income exemption* included in the CFC rules, whilst designed to exempt active businesses from attribution is not fully effective in achieving that objective, the IFSA stated. For example, it noted that the current CFC rules can result in passive income earned by an active business in the early years of operation to be attributed, presenting a major issue for many start-up companies. In addition, it pointed out that the active income exemption is transactional based and carries significant compliance obligations, for example, record keeping and annual tainted income ratio calculations (compared with the active income exemption).

3.138 In addition to the above, the IFSA recommended that as a third full exemption, a CFC be exempted from attribution if on the basis of the *motive exemption*, the CFC was not engaged in transactions to minimise Australian tax. It noted that a motive exemption is contained in the UK CFC rules as well as the recently introduced Italian CFC regime. This test could focus on the underlying rationale for why the CFC was established in the particular jurisdiction in the first instance.

3.139 The IFSA submission stated that given the substantive regulatory environment in which life insurance companies operate they are unlikely to be used as tax deferral vehicles. For example, significant regulatory requirements have to be met before a company can be registered under the relevant foreign legislation as a life company.

3.140 For CGT CFC rules, the IFSA's preferred solution is to exclude capital gains from the CFC rules altogether (for example, UK regime). Alternatively, in relation to share sales of active business this anomaly could be removed by granting a CGT exemption if the majority of the underlying assets are not 'tainted assets' it noted.

3.141 The IFSA stated that in relation to the alteration of the character of attributed capital gains — the policy justifications for this is not clear. Clearly, the treatment of attributed capital gains derived by CFCs is much more onerous than domestic capital gains. The IFSA recommended that attributed capital gains should retain their nature. Whilst this may add some complexity in relation to identifying the portion of attributed income that is capital gains, the submission considered that the ability to use Australian capital losses against such income would be a significant advantage.

3.142 In relation to the functional currency issue, the IFSA considered that the provisions needed to be introduced to ensure that capital gains are calculated in the local currency and then converted subsequently. This issue is also being progressed via separate consultation.

3.143 The ICAA proposed the following solutions:

- do not rewrite the CFC rules;
- review technical and policy issues, establish a permanent International Working Group (IWG) of ATO/Treasury and external stakeholders, a process of 'shortcuts' or 'carve outs' for SMEs, an updating of the de minimis exception from the CFC rules;
- committing to ensuring that recommendations for legislative changes are supported with Office of Parliamentary Council resources and a slot in the Parliamentary program; and
- the IWG should be established immediately.

3.144 The Property Council suggested that the following reforms be introduced:

- amend the treatment of limited partnerships so they become look through entities subject to finalising the review of international tax arrangements in case it provides a better solution;
- ensure that dividends retain their character as exempt on distribution by an interposed trust regardless of whether the trust is a bare trust or a unit trust;
- amend CFC rules so that all capital gains and capital losses are based on the functional currency of the CFC;
- nominee or bare trust arrangements be ignored for the purposes of CFC rules (see Ralph Review); and

- the branch profit exemption in section 23AH and in the CFC provisions should be extended to exempt all profits derived from conducting a business in a BELC.

3.145 The Property Council also proposed that collective investment vehicles which distribute all their income should be exempted from the CFC rules. The submission also proposed that the CFC rules not apply to attribute income under the CFC rules for companies that distribute a stated proportion of their income to Australian controllers within a given period. Such a rule the submission noted applies in the UK CFC rules.

3.146 The TIA supported a complete rewrite combining the CFC and FIF regimes. If a rewrite is not possible, technical and small policy changes should be done by 1 July 2003 to simplify compliance obligations it stated. The three main issues are it stated to:

- increase the tainted income ratio under the active income test,
- amend section 47A; and
- review the interrelationship between some new tax measures and the CFC regime.

3.147 Deloitte & Touche Tohmatsu NZ supported all proposals to reduce the impact of the Australian CFC rules for foreign investors investing into an Australian conduit.

3.148 Deloitte Touche Tohmatsu suggested focusing in the short term on dealing with the major problems in the current CFC rules, and then to undertake a more comprehensive review with the benefit of the knowledge obtained from short term work.

3.149 The longer term solution according to Deloitte Touche Tohmatsu would be to consider whether, for instance, it is possible to create a set of rules that reverse the current approach — that is, provide wide-ranging exemptions with limited but targeted attribution rules.

3.150 Rio Tinto would prefer a comprehensive review rather than a band aid approach to reforming the rules.

3.151 Barkoczy/De Zilva proposed that the CFC rules should be redrafted as one discrete regime specifically targeting anti-avoidance cases.

3.152 The Minerals Council noted that while a rewrite of the CFC rules is a long term aim, there are pressing issues that need to be dealt with in the short term. The submission referred to a number of issues raised on other options in Chapter 3. It also sought the removal of companies operating in BELCs and all underlying investments from the operation of CFC rules, together with the resolution of a number of policy and technical issues.

3.153 The BCA/CTA proposed:

- that outstanding technical issues already brought to the attention of the ATO be immediately addressed;

- introducing 2 additional 'safe harbour' measures to improve the operation of the CFC rules: an active business test (possibly modelled on the FIF provisions, or the exempt activities rule in the UK CFC provisions) and a purpose test (where any reduction in Australian tax is minimal or incidental) (medium term — 12-18 months), These measures, the BCA/CTA stated, would make the rules more effectively targeted and significantly reduce the compliance burden on Australian businesses that is created by the comparatively indiscriminate approach that underlies the present system;

- allowing Australian companies to invest in strategic international joint ventures without unnecessary CFC constraints. The submission proposed modifying the CFC rules so that 50/50 joint ventures are excluded from the CFC rules and noted that such an amendment would place Australian companies on a more even footing with foreign competitors in building strategic international alliances (medium term — 12-18 months);

- narrowing the application of the transfer pricing rules for CFC attribution purposes so that they are targeted only to those areas where they are required from a CFC integrity perspective (medium term — 12-18 months). The submission stated that if the section 23 AJ exemption is retained, transfer pricing should be limited to cross border related party transactions that would allow value to be shifted from unlisted countries to BELCs or LELCs. The submission considered that such an amendment would reduce needless tax compliance obligations and allow Australian based multinationals to better manage foreign tax costs;

- eliminate the quarantining — by class of income and by CFC — of losses incurred by CFCs (medium term — 12-18 months). The submission considered that if under the CFC rules a CFC makes a loss, that loss should be allocated to the attributable taxpayers in the same way as attributable income is allocated, and it should be possible to deduct the loss from attributable income of other CFCs or from other foreign source income of the taxpayer;

- repeal section 47A of the 1936 Act (medium term — 12-18 months) or at the very least, it should be amended to have no application to arm's length transactions, such as loans made on arm's length terms and the subscription for shares at an arm's length price;

- attribute income derived by a CFC only to taxpayers who own shares in the CFC at the time the income is derived; (medium term — 12-18 months). The submission sought that consideration should also be given to ensuring that the cost base of assets held by a CFC is based on market value at the time the CFC is acquired; and

- attribute capital gains made by CFCs as capital gains rather than as income and similarly if an attributable taxpayer has a capital loss, the taxpayer should be allowed to offset the capital loss against the attributable capital gain and include only the net capital gain (if any) in assessable income.

3.154 The BCA/CTA proposed that in the longer term over 2 to 4 years that there should be a wider review of the CFC rules giving consideration to the benefits of specific reforms to the rules that have been implemented.

3.155 KPMG considered that reform to the accrual taxation measures should focus on achieving its original intention of preventing Australian taxpayers from escaping tax on passive investment income by shifting investment to low tax countries. This would result in the CFC provisions achieving greater simplicity of compliance. However, it also sought that the numerous technical deficiencies contained in the CFC provisions should also be corrected.

3.156 Ernst & Young suggested that immediate attention should be directed to identified problems in the CFC rules rather than commencing a protracted rewrite with the latter being attempted in the medium term.

3.157 In terms of specific issues, Ernst & Young sought an exemption under the CFC measures for profit or gain on the disposal of companies with active assets, where a profit on the disposal of the underlying assets would not be subject to attribution under the CFC rules and any dividend paid out of those profits would be exempt.

Additional option: Exemption from attribution for Broad Exemption Listed Countries (BELCs)

3.158 An exemption from attribution under the CFC rules for BELCs was raised as an alternative to the options in the Treasury paper in a large number of submissions.

Problem with the current law

3.159 Ernst & Young stated that due to differences in tax treatment of income, profits or gains in different BELCs, an amount may be treated as subject to a reduction in tax even though the treatment is consistent with the country's general tax system. In addition, the submission referred to the high compliance costs the CFC rules impose despite the fact that little or no tax generally arises under the CFC rules in BELCs.

3.160 Barkoczy and De Zilva (Monash University) stated that the present regimes are complex and the cost of compliance is high.

3.161 The ABA stated that CFCs in BELCs are comparably taxed yet they are still subject to accruals taxation tests and rules, requiring appropriate information systems and calculations which create large and unnecessary compliance costs.

3.162 The BCA/CTA advised that, although almost all the income and gains derived by CFCs resident in a BELC will be exempt from attribution, confirming that they are exempt is a difficult, time-consuming and expensive process. It invariably calls for a detailed examination of the tax treatment in the relevant foreign country of each type of income and each type of gain derived by a CFC, as well as a detailed examination of the deductions, rebates and credits that may be granted in the foreign country.

3.163 The Victorian Government Department of Innovation, Industry and Regional Development cited the complexity of the current CFC rules and associated compliance costs.

3.164 The BCTR pointed out that BELCs have comparable tax systems to Australia. The CFC rules for these countries lead to a low amount of revenue collection, with high compliance costs.

Evidence of the problem

3.165 The ABA claimed that the ATO tax statistics suggest around $50 million in revenue relating to BELC CFCs (and around $50 million relating to FIFs which are companies that is, non-controlling interests) was collected from around 100 Australian companies in the last two years — thus revenue collected is not proportional to the compliance costs incurred by affected taxpayers.

3.166 The BCA/CTA stated that Australian multinationals are obliged to design detailed compliance manuals and questionnaires for their CFCs to confirm that they are not subject to attribution even if those CFCs are resident in broad exemption listed countries. Because of the complexity of the CFC rules and their interaction with foreign tax laws, in many instances Australian tax managers are obliged to travel to foreign countries and to meet with accountants and lawyers in those countries to confirm that the relevant CFC's income and gains are not attributable.

Solution

3.167 Ernst & Young suggested that no attribution should occur where a company is resident in a BELC. Also, the submission stated that where a CFC is resident in a BELC with a comprehensive CFC regime there should be no attribution or gains of any subsidiary CFC. Ernst & Young also suggested that if it was considered necessary to ensure that capital gains of certain BELCs were taxed then it would be possible to have a very limited list in the Regulations listing certain types of capital gains as subject to attribution.

3.168 The IFSA suggests excluding BELC CFCs from the CFC rules.

3.169 Similarly, the BHP Billiton submission proposed exempting all companies in BELCs from the CFC rules.

3.170 The Minerals Council sought to exempt entities operating in non-comparable tax jurisdictions where the underlying activities of the business are active. The determination of the degree of activity in these cases should, according to the Minerals Council, be supported by the audited accounts with no statutory adjustment and based on a reasonable ratio.

3.171 The Property Council submission proposed that the CFC rules should not apply to companies that are residents of BELCs where 90 per cent of the income of an entity is derived in that country or other listed country.

3.172 Barkoczy and De Zilva (Monash University) suggested totally removing both CFCs and FIFs in broad exemption listed countries from the accruals regimes.

3.173 The BCA/CTA proposed that the CFC rules should not apply to companies that are residents of BELCs. The submission noted that it would be necessary to consider whether the extended exemption would enable CFCs in broad exemption listed countries to be used as conduits for entry into non-broad exemption listed countries so as to take advantage of the exemption. If additional countries were classified as broad exemption listed countries and those countries did not have CFC rules, it may be necessary to build integrity measures into this extended exemption.

3.174 The ABA suggested a complete exemption of BELC CFCs and branches (and FIFs which are companies) from the CFC regime/accruals taxation.

3.175 The BCTR suggested there should be a general exemption from the CFC rules for BELCs.

3.176 Westfield Holdings suggested providing a full exemption for BELC CFCs where not less than 90 per cent of their income is locally sourced income or foreign source income subject to tax at an average rate of tax nominated by the Australian government (or the average worldwide tax rate on its local and foreign sourced income where it is not less than the Australian government average rate).

3.177 Westfield America Trust proposed that a total exclusion from the CFC rules apply for a CFC that is:

- resident or created under the laws of a BELC; and
- derives substantially all of its income (say 90 per cent) from operations or assets located in a BELC.

3.178 Deloitte Touche Tohmatsu proposed that CFCs resident in countries on the broad-exemption list should be entirely excluded from the attribution rules.

3.179 The Victorian Government Department of Innovation, Industry and Regional Development stated that the CFC rules should entirely exclude CFCs resident in BELCs.

3.180 The joint 10 companies suggested removing companies operating in BELCs and all underlying investments from the operation of the CFC rules.

3.181 KPMG proposed completely exempting BELCs from the CFC provisions. It was of the view that this would reduce the level of complexity, tax planning and structuring issues for Australian companies investing in our major trading partners.

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

Problem with the current law

3.182 The IBSA cited the absence of non-discrimination clause in treaties, withholding tax and the current re-negotiation process for DTAs as problems.

3.183 PricewaterhouseCoopers stated that the current treaty policy is unclear to business.

3.184 The ABA stated that their members are concerned about the US Protocol. Banks are unable to compete effectively unless interest paid by banks is free from interest withholding tax.

3.185 British American Tobacco stated that Australia's DTAs are outdated and can affect the free flow of capital and investment returns.

3.186 The BCTR raised concerns about DTAs which allow foreign jurisdictions to levy 15 per cent withholding tax, producing inequitable results for Australian companies with foreign subsidiaries.

3.187 The ICAA stated that the US treaty is 20 years old and should have been fully re-negotiated at least 10 years ago. It noted that there are many issues not dealt with in the US Protocol.

3.188 The TIA stated that most DTAs are old and that Australia's investment pattern has been changing rapidly. Continuing a source based treaty model must be questioned it stated. The submission stated that the Government has responded slowly and idiosyncrasies of Australian wording leads to wide divergence from the OECD Model.

3.189 Goodman Fielder commented that it is penalised when it repatriates profits from New Caledonia due to charging of withholding tax on dividends.

3.190 Deloitte Touche Tohmatsu referred to the following problems with the US Protocol:

- equipment rentals are excluded from the royalty definition, but there is a concern that Australia would expand its interpretation of when such rents can be taxed as business profits;
- inadequate definition of 'fiscally transparent entities' in Article 7; and
- the new limitation of benefits article does not fully recognise certain aspects of Australian commercial structures (for example, Dual Limited Companies).

3.191 The BCA/CTA outlined the following issues:

- the treaty process is not responsive to rapid changes economically or commercially;
- Australia's emphasis on source-country taxing rights inhibits mutual treaty negotiations;
- uncertainty surrounding CGT treatment under tax treaties negotiated before the introduction of the CGT regime in Australia; and
- the US Protocol represents a significant modernisation of Australia's treaty approach but still contains flaws and shortcomings.

3.192 EFIC reported that loans that it has made to overseas borrowers would be subject to withholding tax if Australia did not have DTAs with the relevant countries. It also considered that the terms used in DTAs are not uniform and often result in ambiguity and uncertainty.

3.193 Ernst & Young stated that traditionally Australia has been a net importer of capital. However, it noted that Australian residents are increasingly directing investments offshore. High levels of withholding taxes restrict capital inflows and outflows.

3.194 KPMG stated that Double tax agreements have been negotiated at various times so differences in approach and outcomes have developed.

Evidence of existing problem

3.195 The IBSA stated that in recent years an effective non-discrimination article would have inhibited outcomes discriminating against foreign-owned entities conducting business in Australia. Existence of withholding taxes in Australia can restrict the conduct of some international business from Australia, due to concern about obtaining a tax credit for the withholding tax. Current renegotiation processes do not utilise industry experience.

3.196 CPA Australia stated that the current limitation of benefits article in the US Protocol (to deal with treaty shopping, for example, by interposing an Australia resident entity between an offshore location and the US to achieve better outcomes than if the ownership was made directly from the US) could inhibit the operation of domestic provisions if applied without restriction.

3.197 The ABA referred to the fact that James Hardie has moved offshore to support their claim for lower dividend withholding tax.

3.198 The BCA/CTA cited as evidence of problems with the Australian-US DTA: Article 7 introducing fiscally transparent entities, concern over the taxation of rents for 'substantial equipment' as business profits, and the limitation of benefits article renegotiated in the US Protocol.

3.199 EFIC cited the inconsistent use of terms used in different DTAs. For example:

- Italian DTA — IWT exemption for a 'body exercising public functions';
- Indonesia DTA — IWT exemption for a 'monetary institution of the Government';
- Thailand DTA — IWT exemption for interest derived from the 'investment' of certain official reserves.

3.200 EFIC considered that these different terms used in different DTAs are vague and lack uniformity and consistency.

3.201 Ernst & Young stated that many trading partners do not have a two-tiered withholding rate that differentiates between dividends paid from taxed or untaxed profits. In many cases the submission noted that an Australian resident shareholder would receive a dividend which has already been subject to full rates of foreign tax at the corporate level and also be subject to a further 15 per cent dividend withholding tax on remission to Australia. Ernst & Young noted that when dividends are repatriated, the resident shareholder may not be able to obtain a credit, as the income may be exempt as a non portfolio dividend or if the foreign taxes paid exceed Australian tax on the dividend.

3.202 Ernst & Young stated that anecdotal evidence from their clients indicated that the level of withholding taxes imposed by Australia's trading partners has impacted on investment and profit repatriation decisions.

Solution

3.203 The IBSA believed that DTA negotiations should:

- seek the inclusion of a non-discrimination clause;
- target the removal of interest and dividend withholding taxes; and
- develop and modernise international tax rules on an ongoing basis.

3.204 PricewaterhouseCoopers recommended developing a clear framework for Government consultation on treaty negotiation with parameters for a review and a rewriting of Australia's 'model' treaty. The US Protocol should not be the model, although zero withholding tax on interest and royalties would be welcome.

3.205 CPA Australia considered that:

- future DTAs should incorporate contemporary aspects of treaties and protocols; and
- any limitation of benefits article (to deal with treaty shopping by interposing an Australia resident entity between an offshore location and the US to achieve better outcomes than if the ownership was made directly from the US) should be subject to a purpose based test limiting its application to circumstances with dominant tax abuse motives.

3.206 The ABA agreed with the US approach generally. However, it noted that the protocol potentially provides US banks with access to Australian markets on a tax-free basis from 1 July 2003 (as interest paid to US resident financial institutions will not be subject to Australian interest withholding tax). Accordingly, the ABA proposed that Australian banks be entitled to compete on an 'even playing-field' and therefore should have access to tax deductible tier 1 capital.

3.207 In addition, the ABA sought that future renegotiations of DTAs should proceed on the basis that interest paid by financial institutions should not be subject to interest withholding tax. This it submitted would enable Australian financial institutions to compete effectively with foreign financial institutions in the Australian market and to raise cost effective funds from offshore sources.

3.208 The BCTR favoured bilateral negotiations that reduce withholding taxes, as in the US Protocol. Other aspects of the Australia — US tax treaty require further consideration it stated. A non-discrimination clause should be included in all Australia's DTAs.

3.209 British American Tobacco considered that modernising treaties with major trading partners is a priority. The submission noted that DTAs should reduce the impact of withholding tax and eliminate CGT on gains that businesses derive that are residents of countries that are our major trading partners.

3.210 The IFSA stated that the US Protocol is a start, but further changes are needed. It considered that Australia is moving towards being a capital exporter and accordingly its source based treaty model must be questioned. Other recommendations made by it included:

- confirming that section 3(11) of the *International Tax Agreements Act 1953* and similar articles in DTAs do not apply to managed investment funds;

- provide for equal treatment between portfolio and non-portfolio investments; and
- allow the 'banking' interest concession to be extended to other institutional investors as well as group finance entities.

3.211 The ICAA considered that:

- the US Protocol should not be a model for future treaty negotiations;
- the reduction of withholding on dividends and royalties should be a significant aim for all future treaty negotiations; and
- early input of external stakeholders, specialists and Department of Foreign Affairs and Trade officials was needed.

3.212 The TIA stated that the US treaty is a step in the right direction especially given the reduction or elimination of dividend withholding tax. However, the submission was of the view that given the developing trends in investment, Australia needs to move away from its source based treaty model to a model which is residency based. The model that needs to be adopted is the 2000 OECD model. This can be changed by modifying the current Australian DTA model to:

- remove source taxation from the 'Other Income' Article (also known as 'Income not expressly mentioned' Article);
- eliminate the 'Source of Income' Article and enact the rules in domestic law;
- confine 'Tax relief' articles (for example, Methods of elimination of double tax' Article) to domestic law;
- use OECD definitions to reduce interpretative problems and unintended consequences. An example of the problems that can occur is where there are currently departures from the OECD model, for example with Australia's version of the tie breaker test. The use of OECD definitions would also speed up negotiations as the terms will be familiar to other contracting States;
- remove some rules which should be in the domestic law;
- where there is a need for a special offshore Article in a DTA, Australia could use the UK, Netherlands or Irish models rather than modifying the 'Permanent Establishment' (PE) Article's substantial equipment test;
- change other variations on the OECD PE test in the Australian model which can be addressed either by other Articles (for example, the 'processing' modification can be caught by the 'separate enterprise' test in the 'Associated enterprise'

Article) or are not sustainable in a world market (for example, the 'construction sites' variation away from the OECD 12 month test);

- remove information requirements variation from the OECD model in the 'Business Profits' and 'Associated enterprise' Articles, as despite their existence the information is still unattainable;
- insert the OECD 'Non-discrimination' Article as recommended by RBT. Australia is the only country that refuses to adopt the article. Further, all the work to prove the acceptability of the non-discrimination article was carried out in 1995 paving the way for its inclusion;
- review the portfolio/non-portfolio distinction in dividend withholding tax relief. Many substantial investments may, given the size of companies' share registers, be portfolio and adversely treated when compared to smaller non-portfolio investments in smaller companies;
- review withholding tax approaches on interest in light of the exclusion from withholding under section 128F;
- review withholding tax approaches on royalties in order to increase the competitiveness of Australian technology/software entities;
- review approach to capital gains;
- do not adopt the US treaty solution to change in residence, in which Australia gave up source rights;
- eliminate the 'Independent personal services' Article in accordance with changes to the 2000 OECD treaty;
- remove the subject to tax provisions from the 'Dependent personal services' Article;
- solve superannuation issues in tax treaties rather than social security agreements; and
- do not adopt US specific clauses such as the 'Limitation on Benefits Article' (which dramatically increase the length of treaties) and the 'fiscally transparent entity' concept in a revised 'Business profits' Article. These issues can be dealt with under Part IVA.

3.213 Deloitte & Touche NZ and NZ Corporate Taxpayer Group supported the direction taken in the US Protocol.

3.214 The Victorian Government Department of Innovation, Industry and Regional Development supported the recent US Protocol model and considered that Australia should continue re-negotiation of its DTAs with major trading partners to obtain more competitive rates of dividend withholding tax.

3.215 Goodman Fielder supported a similar approach to that taken in US Protocol. In particular it proposed:

- no tax chargeable in the source country on dividends where the beneficiary entitled company resident in the other country holds 80 per cent or more of the voting power of the company paying the dividends and satisfies public listing requirements for that country;
- a limit of 5 per cent withholding tax applies where the resident company holds less than 80 per cent of the voting power; and
- that the above 80 per cent threshold test be reduced to 50 per cent.

3.216 The BCA/CTA believed that the US Protocol is a good start to a new approach but should not represent the upper limit of Australia's position. The BCA/CTA supported the adoption of a model tax treaty, which it stated need not be based on the Australia/US Protocol. The submission considered that Treaty negotiation processes should adapt more quickly to changes in the law and Australia should be more prepared to give up on source-country taxing rights (including CGT rights).

3.217 Clough Ltd argued comprehensive treaties are often not necessary. Just negotiating withholding tax reductions or other simple issues would help as a starting point it stated.

3.218 The Minerals Council considered that the recent US Protocol is a major step forward in modernising Australia's DTA network. Despite this the Council is of the view that further consideration should be given to the specific aspects of the US Protocol that are an appropriate basis for future DTA negotiations and whether aspects of other DTAs should be incorporated.

3.219 Westfield Holdings believed the negotiation processes for the US Protocol should be extended to other tax treaties negotiations. Withholding tax on dividends, royalties and other payments of the foreign country to Australia should be eliminated.

3.220 EFIC proposed:

- removing withholding tax levied by foreign countries on interest payable to EFIC or under a loan guaranteed by EFIC for other Australian borrowers;
- ensuring consistency in the terminology of treaties used to describe the same or similar concept; and

- supplementing general definitions with non-exhaustive lists of entities or activities that fall within the general definitions.

3.221 The AICD sought the renegotiation of DTAs as rapidly as possible to achieve substantial reduction in the taxation of cross border transactions.

3.222 Ernst & Young was strongly supportive of the use of the US Protocol as a model for future treaty negotiation and moving towards reducing or eliminating withholding taxes. It did not agree that a limitation of benefits (LOB) article should necessarily be included in future treaty negotiations as it would hinder the aim of reducing withholding taxes. If a LOB must be included, it should contain a carve out for regional headquarter companies, the submission stated.

3.223 KPMG supported the reduction of withholding tax rates on non-portfolio dividends in treaty negotiations.

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

Problem with the current law

3.224 The ICAA argued the RBT proposal is flawed from a policy perspective, would be difficult to comply with in a practical sense and would harm Australia's international competitiveness. It would necessitate complex legislation.

3.225 PricewaterhouseCoopers stated this option is fundamentally flawed, impracticable to apply and a disincentive for inbound investment.

3.226 CPA Australia stated that:

- the suggested proposal does not reflect the practical or commercial realities of global corporate ownership restructures;
- the potential tax cost may prevent such transactions;
- establishing appropriate values for assets in structures with combinations of underlying assets in different countries is not practical in many circumstances; and
- for Australia to have jurisdiction to collect the tax there would be a need to deal with this via Australia's DTA network.

3.227 The joint 10 companies believed implementation of this measure would be extremely difficult.

3.228 The ICAA stated that the proposal will be difficult to implement and enforce. It adds another layer of complexity to the tax system.

3.229 Deloitte & Touche NZ believed it would be contrary to the general policy to reduce taxes on foreign investment (for example, changes in the US Protocol). It is unclear how the proposed rules would apply to non-wholly-owned groups, and which taxpayer would be liable for the Australian tax (for example, the entity sold, the vendor of the entity or the entity holding the Australian investment).

3.230 Deloitte Touche Tohmatsu argued it would be an extraordinary extension of Australia's taxing rights. It is fundamentally flawed. It would create unwarranted complexity, cause inadvertent breaches and create hidden tax exposures for investors. It would make Australia a far less attractive investment destination for a relatively small revenue gain.

3.231 The BCA/CTA stated that:

- the measure would need to be extremely carefully targeted in order not to create havoc. Given the necessary range of exclusions, it would become one of the most complex in our tax system;
- the deeming of a tax liability would create problems in determining the outcomes of a change of ownership within a chain;
- valuations would be required in many situations; and
- it would not sit comfortably with Australia's DTAs and would create a strong impression that Australia is not an attractive destination for foreign investment.

3.232 NZ Corporate Taxpayer Group stated that imposing an additional tax would detract from Australia as a location for international investment. Enforcement would also be difficult.

3.233 KPMG pointed out that there are significant practical difficulties in collecting tax on a transaction between two non-resident entites. It considered that the requirement to prepay Australian tax before realisation of Australian assets and associated compliance costs may deter investment in Australian assets.

3.234 Ernst & Young's submission recognised that the current definition of 'necessary connection with Australia' excludes shares in foreign companies, and that the option is aimed at solving this.

Evidence of the existing problem

3.235 The ICAA's evidence was that underlying assets will be subject to CGT if ultimately sold, and Australia still retains absolute rights to tax the capital gain when it is realised by the interposed entity. There is no need to tax underlying assets. Deloitte Touche NZ also pointed this out.

3.236 CPA Australia's evidence was:

- global businesses organise themselves along regional structures to provide flexibility for capital raising, joint venture activities etc; and
- many business combinations occur today by mergers or acquisitions of public companies in the foreign parent location.

3.237 Accordingly, CPA Australia considered that the potential tax cost may prevent reorganisations and mergers and acquisitions.

Solution

3.238 The ICAA, PricewaterhouseCoopers, IFSA, the joint 10, ICAA, Deloitte & Touche US, British American Tobacco, Deloitte & Touche NZ and Deloitte Touche Tohmatsu, Rio Tinto, BCA/CTA and NZ Corporate Taxpayer Group recommended abandoning this proposal.

3.239 CPA Australia did not recommend this proposal but if after further discussion it is introduced then the ATO must first establish a dominant tax benefit exists before the measure applies.

3.240 The TIA suggested adopting the OECD model and/or the model similar to that operating under the US Foreign Investment in Real Property Tax Act.

3.241 Deloitte & Touche US strongly opposed this proposal, as it considered that it was flawed from a policy perspective, difficult to comply with in practice and would harm Australia's international competitiveness.

3.242 KPMG does not support the RBT proposal on the basis that it is too difficult to ensure compliance. Also the submission stated that it is inconsistent with global trends on the taxation of non-residents.

3.243 Ernst & Young did not believe that the 'problem' is significant, and argued that any proposed solution will be complex and act as a deterrent to inbound investment. It noted that many countries do not have such a regime and those with it face significant compliance issues. Any solution would need to address problems such as appropriate targeting, valuation of gain, anti-overlap measures, administration, information and enforcement it stated.

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

Problem with the current law

3.244 The BCA/CTA stated that the treaties unit (transferred from the ATO to the Treasury) has been under-resourced resulting in the tardiness of tax treaty negotiations and the lack of necessary skills required in treaty negotiation processes.

3.245 KPMG noted that the recent US-Australian protocol will trigger most favoured nation clauses with various countries on withholding tax rates, so Australia needs to prioritise its treaty negotiations.

Evidence of existing problem

3.246 The BCA/CTA reported the list of priorities current at May 2000 has not been materially advanced.

Solution

3.247 CPA Australia noted that Most Favoured Nations clauses in some Australian treaties may influence the priority given to renegotiating treaties but otherwise priority should be given to countries with high levels of trade or investment links with Australia. Priority should be given to concluding the German DTA as negotiations have been ongoing for many years.

3.248 The ICAA stated that priority should be given to major trading partners, for example, UK and Germany. Resources within Treasury should be increased.

3.249 The TIA and the IFSA stated that current negotiation with the UK should be halted until a new approach is settled.

3.250 Deloitte & Touche NZ stated that the NZ DTA does not contain a MFN clause, but the treaty negotiation with New Zealand would be a priority, given that New Zealand is the third highest destination for Australian direct investment.

3.251 Goodman Fielder supported a tax treaty with New Caledonia to allow a more equitable international taxation treatment.

3.252 Clough Ltd believed that comprehensive treaties are often not necessary. Just negotiating withholding tax reductions or other simple issues would be a helpful starting point.

3.253 The Rio Tinto Group has significant interests in Indonesia and proposed the re-negotiation of that treaty.

3.254 The BCA/CTA argued that the Treasury needs to focus on its treaty program and ensure it maintains meaningful, modern and relevant treaties with major trading partners rather than simply extending the number of treaties. It cited the renegotiation of treaties with Japan and the Netherlands as overdue for renegotiation.

3.255 KPMG proposed concentrating on treaty negotiations with those countries with most favoured nation clauses with Australia. After that process, it considered that Australia should focus on renegotiating any remaining double tax treaties with significant trading partners before addressing any pre-CGT treaties.

3.256 Ernst & Young was supportive of Option 3.7 with the aim of considering which countries be given priority in treaty negotiations. It noted that Most Favoured Nations clauses in some Australian tax treaties will act as a springboard to advance future negotiations.

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

Problem with the current processes

3.257 The CAA expressed disappointment that the National Tax Liaison Group-Tax Treaties Advisory Panel has not met more frequently since created in 1997.

3.258 The BCTR stated that current Australian consultation processes are not effective.

3.259 The BCA/CTA stated that the Tax Treaties Advisory Panel meets too infrequently. It considered that whilst the meetings have so far been constructive, they tend to have had 'show and tell' characteristics on the part of the Treaties Unit, and sometimes the consultative questions put to the Panel are too late for the answers to be useful.

3.260 KPMG considered that previous consultation on negotiating tax treaties has been limited.

Evidence of the current problem

3.261 The IBSA stated that current renegotiation processes do not utilise industry experience.

3.262 CPA Australia noted that it participates in the current Treaty panel but is generally only invited to comment after the negotiation process is complete or as part of a general discussion of potential issues prior to negotiations.

3.263 The BCTR cited as evidence that Australian businesses received better information on the recent Australia-US Protocol from US sources than from Australian government officials.

3.264 The BCA/CTA stated that only six meetings of the Tax Treaties Advisory Panel have been held in five years. The submission noted that the draft of the US Protocol was presented to Panel members for discussion when it was clear that the process was so far advanced that these issues would not actually be further negotiated with the US.

Solution

3.265 The IBSA recommended that DTA negotiations should be conducted on an open basis with industry consultation afforded to the fullest extent possible, within the parameters of the negotiation process.

3.266 PricewaterhouseCoopers stated that the proposal for open consultation is welcome.

3.267 CPA Australia recommended greater participation in the formative aspects of treaty positions to optimise the degree of commercial input.

3.268 The BCA/CTA proposed that the Tax Treaties Advisory Panel should meet more frequently, at least twice each year. The submission considered that diplomatic 'secrecy' concerning treaty negotiations should be set aside, and the value of transparency and consultation should be agreed in advance with treaty partners, as exemplified by the current UK negotiations.

3.269 The BCTR recommended effective consultation processes to improve transparency.

3.270 The IFSA supported the recommendation in the consultation paper.

3.271 The ICAA suggested forming a new Treasury Treaties Working Group.

3.272 The TIA stated that the consultation process needs more transparency and wider/early consultation in the process.

3.273 The NIA urged considering the extent of confidentiality in bilateral negotiations on a negotiation by negotiation basis. Any consultation process should, it stated, involve the Treaties Advisory Panel, Foreign Source Income Subcommittee, and Transfer Pricing Subcommittee of the ATO National Tax Liaison Group.

3.274 Westfield Holdings believed consultation processes must involve real issues and not be confined to technical tax issues.

3.275 Rio Tinto considered that the Tax Treaties Advisory Panel should be used in a more regular basis as a consultation forum.

3.276 The Minerals Council supported effective consultation arrangements with business and other parties to achieve successful and timely agreement negotiations. Accordingly, it supported options to improve the transparency and effectiveness of current processes. To further enhance consultation arrangements, the Minerals Council proposed that:

- the Tax Treaties Advisory Panel continue to operate as a formal consultation mechanism;
- the Panel meet more regularly (for example, twice a year); and
- consideration be given to reducing the confidentiality arrangements surrounding such consultations.

3.277 KPMG proposed that a dedicated consultative body be established to negotiate tax treaties or expand the role of the Tax Treaties Advisory Panel to enable consultation with the business community.

3.278 Ernst & Young suggested that increased consultation is desirable to ensure maximum input from the public. It noted that this option should be approached with caution, however, as treaty negotiations must necessarily be confidential.

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

Problem with the current law

3.279 The IFSA stated that the listed/unlisted distinction for repatriated non-portfolio profits creates a lot of complexities in the legislation.

3.280 The AICD stated that improvements in Australia's transfer pricing program have led to an overlap with the CFC regime. The CFC, FIF and Transferor trust regimes overlap and lack symmetry in the way they are applied. Rules are applied indiscriminately to large and small Australian based investors. The measures are overly complex and there is a huge compliance burden on business.

3.281 The ABA believed that the listed/unlisted distinction for repatriated non-portfolio profits creates a lot of complexities in the legislation. It also has a bias against repatriation of income from low taxed countries.

3.282 The joint 10 companies stated that the removal of the listed/unlisted distinction for repatriated non-portfolio profits would allow significant simplification to the CFC regime as a part of a package of reforms.

3.283 The ICAA reported that tax disincentives result in companies retaining pools of profits offshore.

3.284 The TIA stated that the existing exemption reduces compliance costs only for a limited range of non-portfolio dividends. It also provides an effective conduit regime at the Australian company level for income from direct investment offshore. It expressly excludes non-portfolio interests held through flow-through entities (for example, custodians, nominees, trusts).

3.285 The BCA/CTA also stated that:

- the existing legislation is complex, leading to high compliance costs; and
- repatriation and subsequent investment of profits to Australia is discouraged.

3.286 Ernst & Young reported that the practical application of the law creates significant compliance burdens to prevent tax avoidance in circumstances where little tax is being raised. It noted that deemed dividend provisions affect genuine business activities in circumstances where there is no reasonable prospect of avoidance.

3.287 KPMG noted that even though the tax rates within the 56 limited-exemption countries vary significantly, an exemption for non-porfolio dividends and certain branch profits is available. The submission stated that this exemption reduces the compliance burden to the relevant Australian taxpayer substantially. However, it advised that although only around 5 per cent of non-portfolio dividends arise from unlisted countries, they are subject to tax in Australia. KPMG questioned whether it was worth the effort of collecting this relatively small amount of tax.

Evidence of existing problem

3.288 CPA Australia stated that no significant amounts of dividends from unlisted countries are currently repatriated to Australia. Hence the implementation of the option would not have large revenue implications.

3.289 The ABA stated that compliance costs reported by ABA members are high. According to the Treasury Paper, it noted that only 5 per cent of all non-portfolio dividends are received from unlisted country subsidiaries.

3.290 Deloitte Touche Tohmatsu stated that an Australian company owning foreign companies resident in unlisted countries must determine for each of those companies how much of its profit consists of exempting profits, attributed profits and other profits. This entails difficult tracking, complex calculations and apportionments. Such complexity and compliance costs discourage the repatriation to Australia of profits earned by companies resident in unlisted countries and the investment of those profits in Australia.

3.291 The BCA/CTA stated that under the current rules Australian companies must keep at least 3 notional accounts for each foreign company to track exempting profits, attributed profits and other profits. The submission noted that where a foreign company carries on an active business in a non listed country, such as Hong Kong, and does not derive exempting receipts, non-portfolio dividends paid by the foreign company to an Australian company will be taxable in Australia. This means that the foreign company would tend not to repatriate profits to Australia.

3.292 Ernst & Young reported that treatment of non-arms length loans under the deemed dividend provisions can create taxation disproportionate to the transfer of economic value. For example it noted that if a CFC resident in an unlisted country provides a non-arms length loan to a CFC resident in a listed country then the whole loan is a deemed dividend to the extent there are profits in the company. Economically, no profit has been detached it stated.

3.293 Ernst & Young also pointed out that countries may stipulate that a person cannot own 100 per cent of the shares in a company. If a group makes additional investment in a subsidiary, a deemed dividend may result the submission stated. Similarly, it stated that an investment may require a local owner, and the capital injection may give rise to a deemed dividend.

Solution

3.294 The IFSA supported implementing Option 3.9. Further, it stated that the non-portfolio dividend exemption should be able to be traced through a trust to a company where the company has a beneficial interest amounting to a non-portfolio interest.

3.295 The AICD supported implementing Option 3.9.

3.296 PricewaterhouseCoopers stated that the solution in this option is welcomed and could result in repatriation of significant profits from offshore. The Board should fully assess the interaction with other parts of the package.

3.297 CPA Australia stated that the proposed option would result in a simplification of the current law.

3.298 The ABA supported implementing Option 3.9.

3.299 BHP Billiton supported Option 3.9. It also proposed that the option should be supported by an exemption from CGT for gains derived from the sale of non-portfolio interests in foreign companies. However, it noted that a foreign dividend account credit for such capital gains should not be granted (except to the extent they arise from the sale of a company in a BELC or have been taxed in a foreign country).

3.300 The joint 10 companies recommended implementing Option 3.9. It noted that this option links with the earlier CFC options.

3.301 The ICAA supported this proposal, to be implemented in conjunction with Option 2.1.

3.302 The TIA agreed with the proposal but believed that the exemption should also encompass non-portfolio interests held through flow-through entities.

3.303 Deloite Touche Tohmatsu considered that the exemption in section 23AJ should be expanded to cover all foreign non-portfolio dividends received by an Australian company.

3.304 Rio Tinto supported this general exemption option.

3.305 The BCA/CTA proposed expanding section 23AJ to cover all foreign non-portfolio dividends received by an Australian company and amending section 23AJ to exempt profits derived by an Australian company from carrying on business through a branch in an unlisted country.

3.306 Ernst & Young suggested considering an exemption for all non-portfolio dividends as part of a more general review. This would remove much of the complications of the foreign tax credit system and simplify the rules intended to prevent shifting of profits from unlisted to listed countries. A short term solution it noted for non-arms length loans could involve not deeming a dividend provided the borrower has capacity to repay, and it is reasonably likely the loan will be repaid. It also suggested a short term solution for the deemed dividend provisions and their application to equity investments.

3.307 KPMG proposed abolishing the limited exemption list for the purpose of providing Australian companies with a general exemption for foreign non-portfolio dividends, foreign branch profits and capitals gains. It considered that this was a high priority issue.

Option 3.10: To consider options to provide conduit relief for Australian regional 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

Problem with the current law

3.308 The IBSA stated that the current tax treatment of foreign source income earned by the foreign subsidiaries of foreign-owned entities conducting business from Australia inhibits the use of Australia as a regional hub.

3.309 The ICAA stated that regardless of whether a regime is residency or source based it is not correct to seek to tax non-residents on income which is not sourced in Australia.

3.310 The AICD stated that Australia lacks the ability to attract and retain international holding companies or regional headquarters.

3.311 British American Tobacco noted that Australia's current tax rules do not help establish Australia as a destination for setting up regional holding companies because of the cost of selling shares in subsidiaries Australian companies own.

3.312 PricewaterhouseCoopers stated that Australian continues to be an unattractive location for holding companies because of its international taxation regime.

3.313 CPA Australia argued that the current foreign dividend account rules, and the expanded rules proposed by the RBT recommendations, do not provide conduit relief for:

- the CFC consequences of offshore intra group activity such as reorganisations; and
- Australian CGT on the disposal of regional subsidiaries or the shareholdings in the Australian conduit entity.

3.314 This discourages the use of Australia as a regional holding company location due to the higher tax cost compared to alternative locations, stated CPA Australia.

3.315 A J Baxter & Associates believed Australia is unattractive as a regional headquarters for a number of reasons including:

- CGT applies on the disposal of any interest in a foreign entity and on disposal of the Australian regional headquarters;
- CFC/FIF rules are enormously complex; and

- conduit relief is incomplete.

3.316 The ABA believed current conduit taxation discourages establishment of Australian conduit companies.

3.317 The BCTR stated that Australia is not being used as a regional holding company due to its taxation treatment of capital gains earned by foreign subsidiaries of foreign-owned Australian companies.

3.318 The ICAA considered that Australia sought to tax regional holding companies too harshly. It noted that Australia is attractive as a research location, but misses out on a level of interaction and relevance concerning regional holding companies.

3.319 Deloitte & Touche NZ believed that it was not correct to seek to tax non-residents on income that is not sourced in Australia.

3.320 The BCA/CTA said that the current tax arrangements provide a strong disincentive for non-residents to hold their non-Australian investments via an Australian company which in turn provides a disincentive for using Australia as a regional headquarters location.

3.321 Rio Tinto highlighted the fact that where a CFC sells its assets, the CFC rules do not require attribution of profit until repatriation of the profit, which then is exempt if tax has been paid in a listed country. Where an Australian company realises a gain from the disposal of an interest in a non-resident company Rio Tinto noted that the profit is taxable even if such a profit is not taxable under the CFC or FIF rules. This disparity encourages the disposal of assets rather than shares. According to Rio Tinto this has significant commercial ramifications, especially for intangible rights over mining assets.

3.322 The Victorian Government Department of Innovation, Industry and Regional Development stated that if a foreign investor owns regional subsidiaries through an Australian holding company, CGT rules will tax any gains on subsequent sales of the shares in those subsidiaries, even though the gains are not generated in Australia and are not attributable to Australian shareholders.

3.323 NZ Corporate Taxpayer Group believed that non-residents should not be taxed on income not sourced in Australia.

3.324 KPMG stated that the existing CGT and withholding tax rules apply an unnecessary layer of tax on income that is essentially foreign sourced.

3.325 Ernst & Young highlighted that Australia has highly skilled labour and other advantages, but is disadvantaged in terms of regional geography, high marginal individual tax rates, the corporate tax rate and the scope of the tax regime especially concerning capital gains. Foreign companies, it stated, gauge willingness of a nation to do business by tax incentives offered. In the region, neighbours are offering significant incentives, but Australia sends few positive signals according to the submission. The other options in the Treasury Paper do very little to encourage head office services it noted.

3.326 Ernst & Young considered that Australia would:

- struggle to attract and retain high value head office functions;
- gradually lose some of the functions and risk taking activities, which occur here already;
- potentially lose some natural advantages such as a skilled workforce, low cost infrastructure etc., as other regional hubs grow; and
- be disadvantaged as other measures being considered in the Treasury Paper do little to encourage head office services to remain in Australia.

Evidence of existing problem

3.327 The ICAA members are often required to advise their clients to avoid the establishment of a base in Australia unless justified by significant commercial opportunities.

3.328 The TIA noted that the application of CGT to the disposal of tainted assets results in Australian companies stripping foreign assets out of CFCs before being sold, or those companies are placed at the bottom of the global chain in a restructure.

3.329 The AICD cited evidence that professional advisers generally recommend foreign multinationals do not structure investments around an Australian holding company. Australia's CGT provisions add substantially to the tax burden in this case.

3.330 The BCA/CTA referred to evidence of foreign companies either not using Australia as a location for their regional holding company, or of foreign groups 'dismantling' an existing Australian based international holding company once the foreign group acquires an Australian entity.

3.331 A supplementary submission by the BCA/CTA/ABA provided a case study which supported the view that Australia's tax laws including specifically the imposition of CGT on the disposal by foreign subsidiaries strongly disadvantages Australia as a location for setting up regional holding companies. The submission noted that international companies seeking to conduct business in the Asia/Pacific region are advised not to consider Australia as a location for regional holding companies, resulting in places like Singapore and Hong Kong benefiting.

3.332 CPA Australia stated that when foreign multinationals undertake an acquisition of an Australian holding company they generally restructure any foreign subsidiaries so that they are no longer owned via Australia. There are many examples of this in recent years. This results in a loss of economic activity in Australia in the financial sector. Other countries have benefited from using conduit tax regimes to attract such activity.

3.333 A J Baxter & Associates reported that when practising in tax, professionals often encounter situations where Australia is rejected as a base for regional headquarters, based entirely on tax considerations. This is a high priority for reform.

3.334 The ABA offered anecdotal evidence that foreign acquirers of Australian multinationals remove subsidiaries downstream of Australian holding companies from the structure.

3.335 The joint 10 companies reported that Australian companies with CFCs are forced to consider complex asset sale structures for the disposal of their CFC businesses. In addition, Australian companies find it increasingly difficult to compete for corporate assets in many European countries with CGT exemptions, because European based competitors are able to take into account potential tax-free gains on a subsequent sale which Australian companies cannot under our CFC rules (many other countries provide CGT exemptions for disposals of direct interests in foreign companies). Also, offshore commercial restructures are impeded.

3.336 The ICAA stated that a foreign-owned global organisation may consider that Australia is the best place to do business but:

- Australia imposes CGT on disposal of assets;
- CFC rules impose tax liabilities on lower-tier disposals;
- income of lower tier disposals must be attributed; and
- the income of foreign branches or other foreign income is taxed in Australia.

3.337 The ICAA considered that the above issues limit growth and management opportunities in Australia.

3.338 The TIA complained that Australian tax is imposed on conduit income arising at the entity level or on distribution. This prevents Australia being an effective regional headquarters.

3.339 Deloitte Touche Tohmatsu believed the existing CFC and CGT rules do not provide tax relief to non-resident investors investing in foreign assets through Australia, other than limited relief provided via the foreign dividend account (FDA). As a result, non-resident investors are likely to be subject to Australian tax on profits that would not be taxable if they established their holding company outside Australia through for example Hong Kong or Singapore.

3.340 Deloitte Touche Tohmatsu stated that Australia is not regarded as an attractive regional headquarters.

3.341 Ernst & Young reported that Singapore has become the most popular location for US companies to base high value regional hubs. There is evidence that in doing this it noted that, activities are being moved from countries such as Australia, to the regional hub. Where an Australian multi-national becomes a joint venture partner in a regional operation, the propensity is to move functions and risks out of Australia into a more competitive tax location stated Ernst & Young.

Solution

3.342 The IBSA suggested a comprehensive conduit regime be developed in order to provide access to regional headquarters' roles in global structures, as these structures would not otherwise arise.

3.343 The ICAA proposed:

- progression of the conduit holding company scheme as discussed in Option 3.10 with it being available at least to all non-portfolio investors; and
- capital gains tax exemption for sales of non-portfolio interests in a non-resident company with an underlying active business.

3.344 The AICD sought a review of current impediments including FDAs, CGT provisions and CFC rules. In particular to limit the operation of CGT provisions where investments are in business activities and where there is majority foreign ownership.

3.345 PricewaterhouseCoopers stated that the solution in this option is welcomed and could result in repatriation of significant profits from offshore. It considered that the Board should fully assess the interaction of this option with other parts of the package. The general policy that tax on conduit income should be avoided is sound it stated.

3.346 British American Tobacco proposed that gains on the sale of shares in Australian owned overseas companies which are conducting active business should be exempt.

3.347 The Victorian Government Department of Innovation, Industry and Regional Development supported a carefully targeted concession to encourage holding companies located in Australia.

3.348 CPA Australia suggested a conduit holding company regime to resolve the current problems. Key features of such a proposal proposed included:

- exempting the conduit holding company (CHC) from CGT on the sale of non-portfolio interests in foreign companies. It noted that the exemption need not be proportionate to the level of non-resident shareholding thus eliminating the need to identify non-resident shareholders at the time of each disposal. Alternatively the exemption could be proportional to the level of foreign ownership in the CHC;

- where the non-resident disposes of the interest in the CHC before disposing of the foreign shareholding then allowance should be made for a cost base adjustment to the non-resident's interest in the CHC;

- the proposal should not be limited to 100 per cent or 50/50 joint venture arrangements but rather could be set at 20 per cent level (this would ensure that three parties with equal interests would qualify); and

- the mechanism used for distribution of profits to resident and non-resident shareholders need not be proportional to the level of shareholding — refer the suggestion for alternatives A and B of Option 2.1.

3.349 A J Baxter & Associates suggested a simple definition of a 'regional headquarters' (RHQs). For example, any Australian resident company in which at least 80 per cent of the interests are ultimately owned by non-residents and which owns a minimum of at least one foreign operating entity.

3.350 The A J Baxter & Associates submission proposed the following concessions for RHQs:

- disregarding capital gains made on disposal of interests in foreign subsidiaries where this is an effective disposal of operations, the disregarded gain would then be included in the foreign income account;

- CFC/FIF rules deemed not applicable for qualifying RHQs;

- capital gains made on the disposal of interests disregarded if otherwise taxable;

- the central management and control test not to apply to entities in which an RHQ holds a qualifying interest;

- all foreign income and capital gains from qualifying foreign entities would go into a foreign income account;

- RHQs should pay company tax at normal rate and can fully access Australia's tax treaty network; and

- a safe harbour mark up (possibly 7.5 per cent) on fees and charges when providing services to group non-resident companies.

3.351 The ABA stated that in order for Australia to provide internationally competitive conduit relief, the following measures need to be introduced:

- a full participation exemption for income and capital gains. This approach would remove the current inconsistent treatment of foreign dividends and capital gains;
- an expansion of the existing FDA regime to encompass all foreign income rather than only foreign dividends, and allowing the full flow-through of credits (as is currently the case for franking credits). This approach it noted was recommended by the Ralph Review of Business Taxation; and
- an exemption from CGT for foreign shareholders to the extent their gain is attributable to foreign investments of a conduit company.

3.352 The ABA also suggested that the above CGT exemption for foreign shareholders of conduit companies be achieved as follows:

- registration of companies as conduit companies;
- eligibility based on some level of foreign ownership, say 80 per cent;
- a concession to be available to non-resident shareholders of conduit companies in the form of a tax exemption for a proportion of capital gains derived from the disposal of conduit companies shares; and
- the proportion would be determined by the relative value of foreign investments. For example, if shares in foreign subsidiaries represent 80 per cent of the value of the conduit companies shares, then 80 per cent of the gain would be exempt from Australian tax.

3.353 The BCTR proposed:

- a broad flow-through regime for all foreign profits and gains to foreign investors in Australian companies;
- relief to apply equally to dividends and capital gains extending well below the 100 per cent ownership level, with an eligibility threshold to be the subject of further consultation;
- an extension of capital gains tax relief for disposal of foreign subsidiaries to Australian owned companies, possibly in a UK-style participation exemption; and
- that special incentives and benefits should not be introduced that are not available to resident taxpayers.

3.354 The joint 10 companies sought the implementation of a CGT exemption for the sale of directly or indirectly held non-portfolio interests in foreign companies.

3.355 The ICAA considered that:

- the conduit concession must extend beyond CGT treatment of foreign investments. In particular, the ICAA considered that the conduit concession ought to flow through to an enhanced CFC environment, without application of CFC rules to foreign subsidiaries;
- there is little point in attributing the income of CFC's international activities to Australian designated conduit companies when these are in turn owned by global companies. To introduce a CGT concession without CFC concessions is incomplete and would have no real impact; and
- conduit benefits must be conditional on the establishment of a significant scale of activities in Australia by the global groups. That is, the ICAA considered that Australia has no need to deliver conduit tax concessions to mere shell companies or 'post box' companies. Conduit concessions can be restricted to substantial activities in Australia or associated with substantial activities of global companies in Australia.

3.356 The TIA supported all three proposals, but cautioned that there should be no revenue loss and that these changes alone may fail to attract a physical presence and investment. Incentives such as R&D concessions could complement this.

3.357 Deloitte & Touche NZ supported the proposal to either establish a conduit holding company regime or to exempt capital gains from the sale of a non-portfolio interest in a non-resident company with an underlying active business. The submission considered that Australia should also consider expanding the proposals by implementing a conduit tax relief regime similar to New Zealand's conduit tax relief regime.

3.358 Deloitte Touch Tohmatsu believed that as regional competitors offer highly attractive tax packages, a marginal solution would be a waste of time and effort. At a minimum, it stated that a holding company regime would require a tax free-flow through of foreign dividends, and a CGT exemption for gains on sales of shares in foreign subsidiaries, together with a tax-free distribution of those gains from Australia.

3.359 Rio Tinto believed a conduit holding company regime should allow the foreign income and gains of regional holding companies to flow through to their foreign shareholders free from the imposition of Australian tax. The UK model could be examined (participation exemptions based on substantial holdings of more than 10 per cent). Rio Tinto supported the proposal that where an Australian company has a portfolio interest in a foreign company, a profit made from the sale of that interest should be exempt from Australian CGT.

3.360 The BCA/CTA proposed:

- the immediate introduction of an exemption for the sale of non-portfolio interests in foreign companies from capital gains tax, whether the Australian taxpayer is foreign-owned or not. The submission noted that this would follow the strong lead of European countries and

- to not pursue the proposal that provides relief to corporate restructures allowing a conduit structure to be unwound, by providing a rollover to allow an Australian company to transfer a foreign subsidiary to its foreign parent without Australian CGT. This does not provide genuine relief for regional holding companies and runs counter to Australia's national interest. This option should be considered only if other options are rejected.

3.361 NZ Corporate Taxpayer Group suggested either establishing a conduit holding company regime or exempting CGT from the sale of a non-portfolio interest in a non-resident company with an underlying active business.

3.362 Ernst & Young proposed that conduit relief should be available:

- where a foreign group establishes a Conduit Holding Company to act as a regional or similar international holding company and that Conduit Holding Company disposes of an interest in a foreign company; and/or
- where the foreign investor disposes of an interest in the Conduit Holding Company that has foreign assets.

3.363 Ernst & Young considered that the proposal in Option 3.10 for conduit restructure relief would not provide genuine relief for regional holding companies and should only be considered if all other options were rejected.

3.364 Ernst & Young also sought a 'jobs based' incentive for establishing a Conduit Holding Company. Further work is needed on a properly designed and targeted incentive. Suggestions in the submission included:

- minimum dollar threshold of Australian based Headquarter Qualifying Services;
- qualifying services including both 'back office' and 'front office' style services rendered from Australia;
- rebate style incentive akin to the qualifying films incentive, without refundability;
- consider 'ring fencing' the incentive to non-resident owned companies;
- if made available to Australian owned International Headquarter companies (IHC), consider whether it should only be available for 'new' services;
- as an alternative, make the incentive available for all qualifying services, whether new or old. A high dollar threshold was considered to assist with revenue leakage from existing services operations;

- charges made by IHCs for services should be within commercial boundaries;
- conditional CGT exemption for IHC's sale of active non-portfolio investments;
- CGT exemption for sale of non-resident's interest in a IHC if the interest is 50 per cent or more; and
- general exemption on all non-portfolio dividends received by a IHC. With Australia's foreign dividend account or expanded foreign income account this should enable foreign investor to repatriate profits to Australia withholding tax free.

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

Problem with the current law

3.365 The ICAA noted that the existing Foreign Dividend Account (FDA) provisions, and the proposed Foreign Income Account (FIA) provisions under the RBT, have limitations. These provisions do not encourage joint Australian and foreign ownership of Australian companies with foreign subsidiaries. The apparent benefit of the FDA provisions is whittled away to the extent of any Australian shareholders, due to the inability to stream dividends with franking credits to Australian shareholders and FDA credits to foreign shareholders.

3.366 The ICAA stated that FDA credits are of no value to Australian shareholders, the same as receiving an unfranked dividend. Franking credits are an inefficient means to eliminate dividend withholding tax for foreign shareholders, particularly if FDA credits could have otherwise been used. At present the submission noted that an Australian company with both Australian and foreign shareholders generating both franking credits and FDA credits must favour the dividend preferences of one shareholder group, resulting in tax inefficiencies for the other.

3.367 The IFSA considered that the problems with the current foreign dividend account are:

- the limitation of credits to non-portfolio dividends;
- the payment of the credit is subject to pro-ration across all shareholders, and;
- the non-recognition of non-dividend forms of foreign income which gives rise to the issues and problems discussed in relation to Option 2.1.

3.368 The TIA believed the current rules provide conduit tax relief only to dividends, not other forms of foreign income resulting in double taxation. They also often operate to dilute the FDA benefits and prevent full utilisation of franking credits by resident taxpayers.

3.369 KPMG stated that the withholding tax exemption currently provided by the foreign dividend account is limited by nature and does not provide appropriate relief for foreign income derived by Australian entities being distributed to foreign shareholders. It also considered that the current definition of income too narrow.

Solution

3.370 Subject to decisions in Option 2.1, the ICAA strongly supported the proposal to introduce the new FIA allowing relief for all foreign sourced income. Relief it considered, should be provided to ensure that credits can flow through a chain of domestic companies. The ICAA believed this option should be considered in conjunction with options 3.10 (conduit relief) and 2.1 (dividend imputation/streaming).

3.371 The ABA suggested implementation of the foreign income account measures, ensuring that the credits fully flow through Australian chains of entities.

3.372 The IFSA stated that it had concerns with the FIAs if they are structured like the current FDAs which in practice do not work. The wastage of those credits in relation to domestic shareholders is particularly problematic. The IFSA strongly recommended that companies have the ability to stream the Foreign Income Account amounts to foreign shareholders. As an adjunct or alternative to this, the impact of the FIA credit could be extended to domestic shareholders.

3.373 The IFSA noted that similar treatment would need to be afforded to investors in managed funds products to the extent that foreign tax credits do not currently flow through to those investors.

3.374 The TIA strongly supported the establishment of FIAs to provide conduit tax relief for all foreign tax. The TIA has some concerns, however, about FIAs operating in the same way as the current FDAs do as it is considered that FDAs do not provide benefits in practice.

3.375 Deloitte & Touche NZ supported this proposal.

3.376 Rio Tinto supported this option, but believed it should be expanded to interact with Option 2.1B. DWT relief should also be extended to all types of foreign income including portfolio dividends, foreign branch profits and capital gains.

3.377 The BCA/CTA believed an exemption should be provided where an Australian company is wholly or partly owned by non-residents by using FIAs.

3.378 NZ Corporate Taxpayer Group supported expanding the FDA to provide a withholding tax exemption for all conduit income an Australian company distributes.

3.379 KPMG considered that any decision to establish foreign income accounts needs to be considered in light of the options canvassed in Option 2.1 and Option 3.9.

3.380 The Association of Grant Thornton Firms in Australia supported the proposal for the foreign dividend account regime to more broadly encompass exemption for all conduit income that an Australian holding company distributes to non-resident shareholders.

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

Problem with the current law

3.381 The ICAA considered that where Australian residents in Australia exercise board roles in relation to foreign-incorporated subsidiaries, or supervisory activities, or top-level management responsibilities consistent with their headquarters responsibility, then the foreign-incorporated subsidiaries might be treated as resident in Australia and subject to Australian tax on their worldwide income.

3.382 The AICD stated that the current test for residence creates difficulties in a global business where foreign companies have Australian based management participation. Mere participation in a video conference may trigger a central management and control issue.

3.383 PricewaterhouseCoopers reported that foreign subsidiaries of Australian companies have to deal with complex administrative arrangements to ensure they are not inappropriately regarded as Australian residents.

3.384 CPA Australia stated electronic forms of communication make it easy for important company decisions to be made without the decision makers being at the same location.

3.385 The BCTR believed the scope of the central management and control test is very broad, involves a high degree of uncertainty, and imposes a limitation on companies genuinely carrying on business outside Australia.

3.386 The TIA believed the residency rules are inefficient, complex, unfair and in urgent need of reform.

3.387 Deloitte Touche Tohmatsu argued the current definition of 'resident' deems a foreign company to be Australian resident if the foreign company holds its board meetings in Australia.

3.388 British American Tobacco noted that the concept of residence is fundamental to Australia's tax regime and that any change needs to be approached with caution.

3.389 KPMG considered that the existing definition causes uncertainty and confusion, and creates opportunities for companies to restructure to bypass the test of central management and control.

3.390 The BCA/CTA advised that the current test is uncertain and potentially onerous. From a policy perspective, the submission considered that the current test raises a number of practical uncertainties, including:

- where directors are located in more than one country;
- where board meetings are held by phone or video conference;
- the implications of the use of circular resolutions, board sub-committees, alternative directors etc;
- the interaction between management and board functions;
- the extent to which commercial activity can constitute a carrying on of business in Australia, and thus residence, where central management and control or voting power is located in Australia; and
- problems created through the establishment of dual listed company (DLC) structures.

3.391 Ernst & Young reported that the central management and control test is confusing and unclear. The submission considered that the central management and control rules are becoming obsolete as they are duplicated by other provisions such as attribution rules, transfer pricing, and the CGT regime. It also noted that they are increasingly outdated as business and trade is becoming internationalised. It was considered that the rules inhibit the growth of Australian enterprises. The controlling shareholder test was also considered to be subject to uncertainty.

3.392 The Victorian Government Department of Innovation, Industry and Regional Development stated that the operation of the current residency rule potentially reduces the scope for regional headquarter involvement by Australians and creates management issues for locally owned international groups.

3.393 In its submission Telstra stated that the current central management and control test:

- raises uncertainties;
- forces Australian executives to locate offshore to avoid the risk of a majority Australian owned offshore subsidiary being found to carry on business in Australia;
- forces offshore travel for board meetings;
- promotes the appointment of non Australian executives to management and board positions in offshore subsidiaries and joint ventures; and
- detracts from Australia as a regional hub.

Evidence of existing problem

3.394 The ICAA noted that its members, when advising companies on the operation of their offshore subsidiaries, regularly recommend that:

- board meetings should be conducted offshore;
- boards of foreign subsidiaries should have a majority of foreign directors; and
- Australian residents should limit their involvement in the day to day or supervisory activities of the foreign subsidiaries where that involvement occurs in Australia.

3.395 The AICD stated that professional advice has been given to directors that they may run the risk of overseas operations being deemed to be based in Australia by participating in an overseas meeting from Australia via video link.

3.396 CPA Australia cited the February 2001 OECD paper (*The Impact of the Communications Revolution on the application of Place of Effective Management as a Tie Breaker Rule)* discussed the difficulties with the central management and control test.

3.397 The BCTR said that using modern technology it is increasingly possible to participate in management from anywhere in the world. Technology alone should not give rise to central management and control problems.

3.398 The TIA states that to avoid triggering Australian residency, board meetings have to be held offshore.

3.399 The BCA/CTA stated that Australian based directors are not being appointed to boards of foreign subsidiaries, are forced to travel to offshore board meetings, or have to avoid board meetings when they cannot travel offshore. This reduces the involvement of an Australian parent company in the activities of foreign subsidiaries.

3.400 Ernst & Young stated that electronic communications such as telephone and email, make it very easy for important decisions to be made without decision makers being in the same location. It noted also, that small or medium enterprises seeking to expand offshore tend do so via a foreign subsidiary company and are impacted by the residency test. There is evidence, the submission noted, from income tax audits of clients that tests of residency cause issues for taxpayers and the ATO.

Solution

3.401 The ICAA suggested amending the central management and control test to either exclusive use of place of incorporation for determining residency or greater emphasis on place of incorporation. The preferred solution is to enable foreign incorporated subsidiaries not to be residents in Australia. The risk of inversions is not great. Any additional integrity measures could be limited to companies incorporated in countries that are not comparably taxed.

3.402 The AICD suggested the central management and control test should be legislatively limited to avoid current problems with modern technology.

3.403 PricewaterhouseCoopers suggested proceeding with Option 3.12.

3.404 BHP Billition proposed that Australian company residency should be based on incorporation as this approach is more consistent with today's globalised environment.

3.405 Telstra supported Option 3.12 but considered that the proposal did not go far enough. It proposed that the residence test be based on country of incorporation. The submission considered that such a test would not necessarily cause integrity problems.

3.406 CPA Australia believed Option 3.12 alone will not remedy the ambiguity with the company residence test. Any solution must be as consistent as possible with discussions on related issues that are occurring within the OECD. The residency issue needs to be considered in conjunction with CFC reform.

3.407 The BCTR sought clarification of the current residency test to provide certainty for business and remove impediments to involvement in management.

3.408 The TIA advised that it was necessary to avoid a piecemeal approach. It considered there was a need for a clear articulation of Australia's taxation jurisdictional claims. The central management and control test creates severe practical difficulty. The exercise of central management and control should not alone constitute the carrying on of a business.

3.409 Deloitte & Touche USA supported either an exclusive use of the place incorporation test for determining residency or greater emphasis on place of incorporation. Concerns in the US about the possibility of companies expatriating to jurisdictions outside the US for tax purposes are noted. Moving to a more objective test as recommended will reduce uncertainty and compliance costs.

3.410 Deloitte & Touche NZ supported a move to either an exclusive use of the place of incorporation, or a greater emphasis on the place of incorporation — an objective test that will reduce uncertainty and compliance cost.

3.411 Deloitte Touche Tohmatsu supported the proposal to clarify the existing law ensuring that central management and control alone will not create Australian residency. Replacing the central management and control test with an incorporation test — a simple test. Any concerns of possible US 'inversions' are more imagined than real it stated.

3.412 The NIA believed a large body of legal precedent can clarify the company residency test, and the issue does not need clarification through legislative change.

3.413 Westfield Holdings believed company residency should be determined by reference to a place of incorporation.

3.414 Rio Tinto proposed a place of incorporation tests as the sole test, with transitional or grandfathering rules.

3.415 The BCA/CTA recommended a residence test based on place of incorporation. Such a test would allow Australian groups operating globally to engage in supervisory activities for their offshore subsidiaries and operations without the risk of those subsidiaries being treated as Australian residents. Australia's CFC regime, CGT, transfer pricing, withholding tax, and thin capitalisation rules would remove any potential revenue risks for Australia it stated. Given these measures, Australia does not need any additional integrity measures to the incorporation residency test. Further, the US concern about 'inversions' (interposing a tax haven holding company over a US company) are misplaced, it stated.

3.416 The BCA/CTA considered that a possible move to a place of 'effective management' test creates similar definitional issues to the central management and control test.

3.417 The Association of Grant Thornton Firms in Australia supported amending the residency definition to specify that central management and control in Australia does not of itself result in the carrying on of a business in Australia.

3.418 The Minerals Council proposed two options for reforming the current place of residence test:

- amending the statutory definition of residence to ensure that a company is not deemed to be carrying on business in Australia simply because it has its central management and control in Australia; or
- moving to a simple 'place of incorporation' test. Such a test would it stated be significantly more certain than the current test.

3.419 Ernst & Young did not support Option 3.12. The submission considered that as a bare minimum, the Board should recommend Treasury examine options for a more robust, clear-cut statutory test for establishing central management and control. However, Ernst & Young were of the view that a test for corporate residency relying solely on a place of incorporation test would simplify the issue significantly and should be evaluated. It noted that the implication of such a change would need to be carefully considered, including any revenue risks and potential for averting Australian residency by changing place of incorporation. It stated that Australia has elaborate source based taxation measures and hence it did not believe there was much (if any) risk from such a change.

3.420 KPMG suggested clarifying the company residence test and how this interacts with the central management and control requirements.

3.421 The Victorian Government Department of Innovation, Industry and Regional Development stated that the current rule should be amended by changing the definition of residence to provide that a company shall not be deemed to carry on business in Australia solely because central management and control is exercised 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

Problem with the current law

3.422 PricewaterhouseCoopers stated foreign subsidiaries of Australian companies have to deal with complex administrative arrangements to ensure they are not inappropriately regarded as Australian residents.

3.423 The ICAA believed the current complex operation of the treaty tie-breaker rules are a problem.

3.424 The BCA/CTA considered that the current the treaty tie-breaker rules have a complex operation and have an impact domestically.

3.425 The TIA considered that complexity arises from the current dual residency provisions in our DTAs.

3.426 KPMG noted that as Australia's DTAs contain different tests for residency, depending on the outcome of the particular treaty negotiations, there are a number of treaties with a test for residency that is different from the 1936 Act. The submission considered that this inconsistency creates an unnecessary level of compliance for those companies that may be treated as a non-resident for other domestic tax purposes.

Solution

3.427 PricewaterhouseCoopers believed Option 3.13 needs further consideration.

3.428 The ICAA agreed with the proposal to consider this issue.

3.429 The TIA supported the change proposed in this option (that is, adoption of the UK and Canadian approaches of amending the domestic definition of residency so that it is overridden where a company is taken to be a non-resident as a consequence of applying a treaty tie-breaker).

3.430 The BCA/CTA supported Option 3.13 as it considered it would harmonise the residency rules in treaties with domestic rules.

3.431 The Association of Grant Thornton Firms in Australia supported using the treaty tie-breaker rule in determining the company residency to avoid many difficult issues arising from DLCs.

3.432 Ernst & Young stated that in view of its support for a residency test based on place of incorporation (Option 3.12) it supported removing the dual residency provisions in the tax law to reduce complications.

3.433 KPMG supported this option, proposing that a company that is non resident for treaty purposes be treated as non resident for all purposes of the Australian tax law. This is a high priority issue, noting that it would simplify compliance obligations and would reduce the cost to affected companies from carrying on business both in Australia and overseas.

CHAPTER 4: PROMOTING AUSTRALIA AS A GLOBAL FINANCIAL SERVICES CENTRE

Summary of Submissions

Submissions referred to the significant economic benefits to Australia that could be achieved from enhancing its attractiveness as a global financial centre. Submissions considered that current taxation arrangements act as an impediment to Australia developing its funds management industry in the region and limit its potential to market its products to foreign investors.

There was a general view in submissions that the Foreign Investment Fund (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. Many submissions considered that the FIF rules should be totally rewritten with some submissions proposing that some specific problems should be resolved as a more immediate focus.

Submissions noted that more onerous tax consequences arise for investments made by overseas investors in Australian managed funds compared to direct Australian investments by overseas investors.

Option 4.1: Longer term replacement of the current Foreign Investment Fund rules

Submissions were supportive of a longer-term replacement of the current FIF rules. A number of submissions stressed the importance of an effective consultative process with business to ensure that the large number of existing technical problems with the current FIF rules are addressed.

Submissions contained a range of specific proposals to reform the FIF rules. A common theme was that the rules should be much more targeted than is currently the case. A number of submissions considered that a general exemption should apply to managed funds whilst some other submissions proposed that the FIF rules should only target accumulation entities.

Option 4.2: Increasing the 5 per cent balanced portfolio exemption threshold in the FIF rules

Submissions supported an increase in the threshold for the balanced portfolio exemption. They noted that the low threshold currently results in funds engaging in non-commercial year end trading in order to qualify for the exemption. The costs of this trading reduce the returns received by investors in managed funds.

A number of submissions proposed that the balanced portfolio exemption should include the total value of all of a taxpayer's investments and not just be confined to interests in FIFs. Submissions proposed several different threshold levels at which the threshold should be set, ranging from 20 per cent to 50 per cent.

Some submissions considered that if the FIF rules were more targeted or excluded managed funds then Option 4.2 would not be needed.

Option 4.3: Exempting Australian managed funds that follow widely recognised indices from the FIF rules

Submissions noted that the FIF rules should not apply to Australian managed funds that track widely recognised indices because such funds would be unlikely to be used for tax deferral purposes. A number of submissions considered that the proposal had the potential to reduce compliance costs for affected funds.

In contrast, other submissions considered that there should be a broader exemption that would not only include index funds but would extend more broadly to widely held Australian managed funds or alternatively that the FIF rules would only target offshore accumulation entities thus removing the need for Option 4.3.

Option 4.4: Exempting complying superannuation funds from the FIF rules

A number of submissions supported this proposal, noting that it had the potential to reduce compliance costs for affected funds. In contrast, other submissions considered that there should be a broader exemption that would not only include complying superannuation funds but would extend more broadly to widely held Australian managed funds. The submissions proposed that such widely held funds would broadly be registered managed investment schemes that are fixed trusts or life companies registered by the Australian Prudential Regulation Authority (APRA).

Option 4.5: Amending the FIF rules to allow fund management services to be an eligible activity under the rules

Submissions supported allowing fund management services to qualify as eligible activities under the FIF rules. They noted that it would ensure that Australian investors in offshore active fund management businesses would not have their income treated as passive income under the FIF rules.

Option 4.6: Exempting from Capital Gains Tax (CGT) gains to which non-resident beneficiaries are presently entitled to for assets without the necessary connection with Australia

Submissions noted that the CGT provisions currently treat non-resident investors who invest directly, or through offshore managed funds, in certain Australian assets more favourably than if they were to invest via Australian managed funds. This results in a bias against Australian-based managed funds. This occurs because non-resident investors in Australian managed funds are effectively subject to CGT on underlying disposals of interests in assets by such funds that do not have 'the necessary connection with Australia' (see also Option 4.7). Non-residents directly disposing of such assets are not subject to CGT in Australia.

Submissions supported the exemption from the CGT provisions. Some submissions sought that the exemption allow a trace-through to the final investing entity given that multi-layer trust structures are common in the industry.

Option 4.7: To consider the feasibility of exempting gains from CGT 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

Submissions noted that the CGT provisions produce a more favourable outcome for non-resident investors who invest directly, or through offshore managed funds, in certain Australian assets compared to non-residents who invest via Australian managed funds (see also Option 4.6). The bias occurs because non-resident investors who dispose of non-portfolio interests in Australian managed funds are subject to CGT on underlying unrealised gains of the fund on disposal of their interest in such funds where the unrealised gains are on assets that do not have 'the necessary connection with Australia'.

Submissions supported the exemption from the CGT provisions. Some submissions sought that the exemption allow a trace-through to the final investing entity given that multi-layer trust structures are common in the industry.

Option 4.8: Amending the CGT rules so that a distribution of income to which a non-resident is presently entitled, but is not assessable because the income has a foreign source (or is a CGT exempt gain from Option 4.6), does not reduce the investor's cost base in a unit trust

Submissions supported this proposal and noted that this option would remove the inherent tax distortion (as noted in Options 4.6 and 4.7) and encourage foreign investment through Australian managed funds.

Option 4.9: To consider proceeding with the recommendation of the Review of Business Taxation (RBT) rationalising the application of the current rules to foreign trusts

Submissions acknowledged the complexity of the current rules that apply to foreign trusts. The submissions generally supported proceeding with the RBT recommendation to rationalise the application of the current rules to foreign trusts.

Option 4.10: To consider proceeding with the recommendation for the Review of Business Taxation in relation to transferor trusts

There was a range of different views expressed on this option. Views ranged from opposition to aspects of the RBT recommendations to support for general reform to provisions that deal with foreign trusts.

Option 4.11: To consider specific tax issues where the lack of separate entity treatment inappropriately impedes the use of branch structures

There was wide support in submissions for a move towards separate entity treatment of branches. A number of submissions noted that the current approach to the taxation of branches is uncertain and inconsistent and fails to deliver a tax neutral outcome.

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

Problem with current law

4.1 The Investment & Financial Services Association (IFSA) considered that the FIF rules create unnecessary compliance costs and are poorly targeted.

4.2 The Business Coalition for Tax Reform (BCTR) was of the view that the current FIF rules are complex, and impose high compliance costs for taxpayers and managed funds affected.

4.3 The Institute of Chartered Accountants in Australia (ICAA) believed that the FIF rules extend beyond the original intention of preventing the avoidance of Australian tax on the accumulation of passive income in offshore entities.

4.4 The National Institute of Accountants (NIA) cited the very high compliance costs and complexity of FIF rules.

4.5 Barkoczy/De Zilva believed that the present regime is complex and the cost of compliance is high.

4.6 The Business Council of Australia and the Corporate Tax Association (BCA/CTA) considered that the existing FIF rules are overly complex, apply to investments beyond those intended and result in high compliance costs.

4.7 Corporate Super Association noted that multi-member super funds make portfolio investments in offshore companies and trusts to diversify exposure. This diversification, the submission noted, includes exposure to a range of economies from developed to emerging markets, and geographical exposure. However the submission considered that the FIF laws operate to inhibit investment diversification.

4.8 The Property Council considered that the FIF rules inhibit offshore expansion by the Australian property industry because they impose high compliance costs and create tax barriers.

4.9 KPMG stated that the FIF regime acts as a barrier to Australia being a global financial centre. It considered that the regime is complex and outdated and results in the double taxation of the same income and creates an unnecessary bias against foreign non-Australian investments. KPMG viewed the issue as warranting a very high priority for resolution.

4.10 Ernst & Young considered that the FIF rules were introduced with a specific policy rationale that has not been achieved (that is, to deal specifically with avoidance involving vehicles that were likely to be accumulation vehicles or mechanisms for conversion of income to capital gains).

4.11 Prafula Fernandez stated that complying with the current anti-avoidance rules is too complex.

Evidence of existing problem

4.12 Axiss Australia noted that a number of OECD countries have FIF rules. The US, UK and New Zealand are currently reviewing their FIF related rules. However, the

Australian rules are very complex, with high compliance costs for taxpayers and managed funds that invest offshore. Also, some active foreign businesses may attract the rules.

4.13 Axiss Australia in its submission noted that fund managers who wish to offer international equity investments to Australians without attracting the FIF rules must establish Australian fund structures that mirror their international fund offerings. However, the submission points out that the smaller Australian funds have higher costs than their international counterparts, and so have lower returns. They also offer a smaller range of investment opportunities according to the submission. Axiss Australia stated that foreign fund managers also consider costs and administrative complexity associated with the FIF rules to be a deterrent to offering products in Australia.

4.14 Corporate Super Association stated that a spread of overseas investment in a variety of sectors and vehicles enables funds to provide better returns over time. Over 80 per cent of Australian super savings are in domestic investments but the small local market means a substantial amount can be invested overseas it noted. The FIF rules treat investment in a foreign company or trust as a potential tax deferral vehicle and are extremely complex and compliance costs are high the submission stated.

4.15 The Association of Superannuation Funds of Australia (ASFA) reported that funds consider alternative investments to shield themselves from the FIF rules.

4.16 The IFSA cited the poor targeting of the FIF rules as evidenced by the application of the rules to the following as though they were offshore accumulation entities:

- entities that are not carrying on business activities whether they accumulate or not;
- entities that are listed on an exchange other than one listed in legislation;
- entities in respect of which the stock exchange classification or international sectoral classification is inappropriate;
- entities whose published balance sheet is not timely or not sufficiently descriptive;
- banks where the investment is in a form other than shares;
- entities whose principal business activities are financial intermediation without being a bank;
- entities whose business activities consist of diversified financial services but are not banks;

- entities whose principal business activities consist of the management of real estate.

4.17 IFSA also cited a case study of the ING Group NV demonstrating the complexities of establishing if an investment in ING is exempt from attribution. It noted that a few of the questions required to be answered in the analysis of the particular ING Group company in which the interest is held are:

- what assets on the company's balance sheet, as distinct from the consolidated balance sheet of the group, are used for business activities other than those listed in the legislation?
- what assets on the company's subsidiaries' balance sheets are used for business activities other than those listed in the legislation?
- what percentage of each of those subsidiaries does the company own?
- are the balance sheet values in accordance with commercially accepted accounting principles giving a true and fair view of the company's financial position?
- is the company itself a 'bank'? What is a 'bank'?
- what is the place of residence of each wholly-owned subsidiary? Are any of them authorised under the law of that place to carry on a banking business or a life insurance or general insurance business?

4.18 The IFSA provided the following case study of the impacts that the FIF regime has on funds managers in Australia.

IFSA case study

A large fund manager has a 10 billion Euro fund of international equities operating in Europe into which money from various countries is invested. The investors receive regular distributions of the income and realised capital gains derived by the fund. The size of the fund means that the fixed and operating costs are quite small per investor.

The fund manager now wishes to offer the same investment style to Australian customers through an Australian unit trust. If the Australian unit trust invests in the European fund there will be FIF attribution each year of all of the increase in the value of the fund. This would be uncompetitive against the existing international equity products in the Australian market so this is not viable. The Australian trust instead contracts with the fund manager to run a separate pool for it.

The product is successful in the Australian market and raises A$100 million in the first year. The cost per investor is significantly higher than it would have been if the trust had invested into the European fund. There are also additional costs being borne by the fund manager.

Solution

4.19 The IFSA suggested that the best approach was to completely repeal the FIF regime and replace it with a more targeted regime. The submission proposed that rules be developed that target entities as follows:

- entities that do not carry on a 'trading business' (term undefined); pay tax on worldwide income at a rate of less than 20 per cent and distribute less than 50 per cent of income and realised gains over a 3 year period;
- a balanced portfolio exemption should be available where greater than 20 investments are held of which more than 75 per cent are listed on approved stock exchanges, and all investments are included in the portfolio. If the threshold test is passed, then only those funds that constitute greater than 10 per cent of the total value of the fund should be subject to FIF attribution;
- investments in Broad-exempt listed countries (BELC) should be exempt from the FIF rules, unless the BELC entity is exempt and is not required to distribute income and capital gains;
- investments in entities that are required to distribute their income and realised gains should be exempt from the FIF rules;

- the A$50,000 de minimis exemption should be increased;
- attribution accounting should be kept at the trust level, but only if the trust is widely held or is a registered managed investment scheme;
- the current exemptions for certain visitors to Australia, interests in employer-sponsored superannuation funds, trading stock and certain interests of underwriting members of Lloyd's should be retained;
- the regime should recognise the difference between deferred income and unrealised capital gains, the latter of which should not be subject to attribution;
- if capital gains are attributed, then the attributed capital gain should receive the CGT discount;
- it should be made clear that the regime only applies where the investment is held in an entity that is not a company to which the control tests in the Controlled Foreign Company (CFC) regime are met. The regime should not apply just because there is zero attribution under the CFC regime.

4.20 The IFSA stated that if it was not possible to rewrite the FIF rules to target particular entities then consideration should be given to a 'carve out' for the funds management industry as follows:

- the taxpayer is a registered managed investment scheme or a life company regulated by the Australian Prudential Regulation Authority (APRA) or a fixed trust;
- the entity and responsible entity are resident in Australia;
- a trust, is not a public trading trust or corporate unit trust; and
- the Australian Taxation Office (ATO) has not given notice that the fund is not a genuine public offer vehicle.

4.21 The IFSA considered that if such a carve out was not possible, the minimum change required was to address the various anomalies in the current legislation.

4.22 The BCTR stated that consideration should be given to a fundamental reform of the current FIF rules in the medium term, using a transparent process to address numerous technical problems.

4.23 Axiss Australia called for a review of the FIF rules in the longer term. Potential options for reforming the FIF rules proposed in the submission included:

- replacing the FIF rules with a new regime, as part of a longer term exercise taking advantage of overseas reform experience; and

- developing an alternative approach to identifying foreign accumulation entities.

4.24 Some alternative approaches outlined in the Axiss Australia submission included:

- excluding foreign entities located in a comparably taxed country from the FIF rules; and
- an exclusion from the FIF rules based on whether the foreign entity distributes a significant proportion of its income.

4.25 Axiss Australia recommended that in the shorter term that the additional options in the Treasury Paper should be explored.

4.26 The ICAA put forward a solution involving extending the US exemption to the FIF rules to include investments from other comparably taxed jurisdictions.

4.27 Prafula Fernandez recommended that the FIF rules be replaced with a simpler regime.

4.28 Barkoczy/De Zilva suggested removing the FIF regime and focusing on the CFC regime. If this is not viable, the submission proposed limiting the operation of the FIF regime by increasing the de minimis exemption from A$50,000 to A$1 million.

4.29 The BCA/CTA stated that:

- the proposals in the Treasury paper concerning FIFs are a reasonable first step but the FIF regime needs to be replaced in the longer term. There needs to be a consultative process with business to establish how the numerous technical problems with the existing FIF rules can be addressed; and
- the Board should consult with the International Bank & Securities Association of Australia (IBSA), the IFSA, the Australian Bankers' Association (ABA) and their members.

4.30 The ASFA strongly supported Option 4.1.

4.31 Association of Grant Thornton Firms in Australia supported a total rewrite of the FIF rules focusing on minimising compliance costs. In the meantime, a broader exemption should be introduced it stated.

4.32 The Property Council considered that the FIF rules should not apply to investment vehicles that distribute all their income. It was of the view that the FIF rules should be rewritten and should target offshore accumulation of income.

4.33 Ernst & Young considered that the existing FIF rules should be repealed with effect from the income year ended 30 June 2003, irrespective of whether or not replacement measures can be implemented by 1 July 2003. The submission stated that the FIF measures should be re-written so that they target avoidance and do not have consequential adverse implications for investors that, on an objective basis, are not engaged in deliberate long term deferral, or conversion of income to capital gains.

4.34 Ernst & Young stated that the FIF rules should exempt all companies that are resident in BELCs. The submission noted that such an exemption already applies to investment companies resident in the US on the basis that the US will tax such companies on a comparable basis to Australia.

4.35 KPMG proposed a range of options including:

- the FIF regime should apply only to FIFs that carry on a passive investment activity;
- passive investment activity should not include investing in real property and hedge funds;
- FIFs resident in broad exemption listed countries should be excluded from the FIF regime;
- exclude from the FIF regime, any entity that is subject to a comparable or acceptable FIF regime in a foreign country; and
- eliminate the need for the current definition of eligible activity;

4.36 Australian Custodial Services made a number of suggestions including:

- excluding wholesale investors from the regime such as wholesale and retail unit trusts, widely held complying superannuation funds and life insurance companies. The rules should then target specific investments such as:
  - life insurance companies and complying superannuation funds investing in tax haven life insurance policies (that is, where the profits could otherwise be repatriated back to Australia tax free after 10 years); and
  - life companies taking more than a 10 per cent interest in investment companies resident in non-BELCS such as Luxembourg, Ireland and Singapore such that low taxed profits can be repatriated back to Australia tax free;
- an exemption similar to that adopted for US investments should be available for investments in the UK, New Zealand, Canada, Germany, Japan and France. The exemption should be extended to all entities that are taxed on their worldwide income in these countries and not just companies;

- the additional restrictions on exempting FIFs undertaking banking, life insurance, general insurance or active property business should be removed;
- the exempt activities should be extended to include financial services; and
- the balanced portfolios exemption should also be drafted to apply where the Australian taxpayer has taken reasonable care when classifying the investments based upon the information available.

4.37 Australian Custodial Services suggestions for administrative simplification include:

- making the CGT discount available for super funds and individuals on amounts calculated under the FIF rules;
- making the market value method available to Australian fund managers notwithstanding the foreign securities are not listed or there is no quoted buy back price;
- all non-exempt FIF unrealised losses should be available to offset all non-exempt FIF unrealised gains when calculating the amount attributable to Australian investors;
- the trust (as opposed to beneficiaries) should be the entity that is required to keep attribution accounts;
- any reversal of the deemed rate of return actually realised should be tax deductible rather than being a capital loss;
- any gains or losses made on the sale of second tier FIFs should be reduced by amounts that have previously been attributed in relation to those investments.

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

Problem with current law

4.38 The IFSA stated that the balanced portfolio exemption could be adjusted to alleviate compliance costs.

4.39 Deloitte Touche Tohmatsu considered that the current rules extend beyond their original anti-avoidance ambit and cause complexity and compliance costs.

4.40 The ASFA noted that working out each year if the 5 per cent balanced portfolio exemption applied for superannuation funds generates compliances costs. The submission noted that the rules are unclear and impede investment.

Evidence of existing problem

4.41 The IFSA noted that the balanced portfolio exemption results in funds commonly selling down investments immediately before year-end and reacquiring them after year-end resulting in significant transaction costs.

4.42 The ICAA stated that funds sell down to get within the 5 per cent balanced portfolio exemption before year-end.

Solution

4.43 Australian Custodial Services recommended that the balanced portfolio exemption should be changed to include the total value of all a taxpayer's investments (that is, including property and Australian securities) and not just FIF interests.

4.44 CPA Australia and the ICAA agreed with Option 4.2.

4.45 The IFSA proposed that in the absence of a more targeted FIF regime or the exclusion of managed funds that:

- the balanced portfolio exemption include all assets (not just FIFs);
- the percentage should be set at a level appropriate to the style of fund (for example, a high growth fund should have the percentage set at 50 per cent, reflecting the likely proportion of offshore investments held in that fund);
- funds should be able to deem, for tax purposes, a disposal and reacquisition at year-end.

4.46 Deloitte Touche Tohmatsu supported increasing the 5 per cent balanced portfolio exemption threshold.

4.47 Barkoczy/De Zilva suggested increasing the 5 per cent balanced portfolio exemption to 20 per cent.

4.48 Ernst & Young considered that in the absence of the repeal of the FIF measures, the 5 per cent threshold for the balanced portfolio exemption should be set at a reasonable percentage after consultation with industry. If this did not occur prior to 30 June 2003, the submission stated that the threshold should be raised in the interim pending finalisation of industry consultation.

4.49 KPMG supported a study to evaluate replacing the de minimus balanced portfolio exemption threshold of 5 per cent with a method that exempts genuine balanced portfolios.

4.50 The ASFA strongly supported Option 4.2.

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

Problem with current law

4.51 The ASFA stated that Australian funds with investments that follow recognised indexes are unlikely to invest in offshore accumulation entities.

Evidence of existing problem

4.52 Boyd International stated that Australian managed funds following recognised indexes would be unlikely to be used for tax deferral purposes. This is because the relevant index may contain FIFs that are companies with active business operations subject to entity level taxation. The submission noted that fluctuations in the index could affect reweighting of the index fund.

Solutions

4.53 The IFSA submission considered that there would be practical difficulties in implementing Option 4.3. In particular IFSA was concerned that there would be difficulty in determining criteria to define an index fund such as:

- does it include a fund that uses derivatives to replicate the index?
- is it restricted to funds with actual stock holdings?
- which indexes are relevant?
- how will the rules deal with new classes of fund indexes?
- how much deviation is permitted before a fund is no longer an index fund?
- if a fund uses two or more asset managers with different styles in order to minimise risk, and thus produces returns mimicking the index, is it an index fund?

4.54 Rather than an exemption for index funds, IFSA suggested that in the absence of the targeting of the FIF rules to offshore accumulation entities, that the following entities should be expressly excluded from the FIF regime:

- an entity that is a registered managed investment scheme or a Life Company registered by APRA;
- if the entity is not a Life Company it is a fixed trust. IFSA suggested a potential definition of a fixed trust;
- an entity that is a resident of Australia for tax purposes. Further if the entity is a managed investment scheme its responsible entity must also be an Australian resident and trust administration must be performed in Australia;
- if the entity is a trust it is not subject to tax under Division 6B or 6C of the 1936 Act; and
- the ATO has not issued a notice to the entity to the effect that the trust/life company is not considered to be a genuine public offer vehicle.

4.55 CPA Australia and the ICAA agreed with this option.

4.56 Deloitte Touche Tohmatsu believed Australian managed funds and complying superannuation funds should be exempted from the FIF rules.

4.57 Barkoczy/De Zilva supported an exemption for widely-held managed funds.

4.58 Ernst & Young supported this option. The submission stated that the current application of the FIF rules to index linked funds shows that the FIF rules are too widely targeted.

4.59 Boyd International strongly supported Option 4.3.

4.60 The ASFA supported Option 4.3.

4.61 Association of Grant Thornton Firms in Australia supported a broad exemption for widely held managed funds in Australia.

4.62 KPMG proposed that funds that follow a widely recognised index (such as the FTSE or Dow Jones) should be exempted. It noted that more work will need to be done to determine how this exemption could be defined.

4.63 The Property Council supported the exemption of index funds from the FIF rules, but sought that the exemption be widened to also include listed property trusts.

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

Problem with current law

4.64 The IFSA stated that the FIF rules create unnecessary compliance costs. It noted that an exemption for complying superannuation funds could be introduced to alleviate compliance costs.

4.65 The ASFA noted that the main difficulty applying to superannuation funds is the complexity of compliance with the FIF legislation. It stated that a superannuation fund must diversify its investments which will necessarily involve investing in both well-established markets and in developing economies and investing in a range of vehicles. The task of classifying the vehicles, identifying relevant exemptions, and accounting where appropriate for the attributed income becomes very complex, it stated.

4.66 The ASFA stated that the cost of compliance is high, but the risk of deliberate tax avoidance or deferral, amongst multi-member complying superannuation funds, is very low. In addition, it noted that the investment strategy of a multi-member complying superannuation fund is subject to significant controls and due diligence and is of necessity driven by the need to maximise return through the control and diversification of risk, rather than by tax avoidance motives.

4.67 Ernst & Young considered that a significant portion of the offshore investment income of complying superannuation funds is subject to the FIF measures.

Evidence of existing problem

4.68 The ASFA provided information showing that the potential gains from deferral are minimal for a complying superannuation fund. It noted that benefits for taxpayers from investment in offshore accumulation entities diminish as marginal tax rates and the CGT discount reduces. This suggested, the ASFA stated, that Australian superannuation funds would obtain relatively low tax benefits from such investment, and hence have little incentive to engage in behaviours that the FIF rules seek to discourage.

4.69 The available evidence, ASFA stated, indicates Australian superannuation funds are involved in minimal, if any, tax deferral of the type contemplated by the original policy intent behind the FIF rules.

Solution

4.70 CPA Australia agreed with this option.

4.71 The IFSA stated that Option 4.4 is an appropriate minor rule but on its own it does not go far enough to reduce the compliance burden borne by the Australian funds management industry. It noted that most Australian fund managers adopt a pooling approach whereby they invest superannuation monies and private investment monies jointly through a sector specific wholesale trust. Accordingly, IFSA stated that the entity investing offshore is not a superannuation fund but a wholesale trust, thus making the proposed exemption academic.

4.72 In lieu of the specific exemption for superannuation funds, the IFSA proposed that complete exemption be given to widely held managed funds.

4.73 Ernst & Young recommended that in the absence of the repeal of the FIF rules, complying superannuation funds should be exempt from the FIF rules given that the potential for deferral for such funds is substantially less than for high marginal rate or corporate taxpayers. The submission noted that exempting funds from the FIF rules would result in significant compliance cost savings.

4.74 The ICAA supported Option 4.4.

4.75 Deloitte Touche Tohmatsu suggested exempting Australian managed funds and complying superannuation funds.

4.76 Barkoczy/De Zilva suggested a complete exemption for complying superannuation funds.

4.77 The BCA/CTA considered that this recommendation is too limited. Consideration should be given, it stated, to a broader carve-out for funds management/collective investment vehicles from the FIF rules, based on the following criteria:

- the taxpayer is a registered managed investment scheme or a life company registered by the Australian Prudential Regulation Authority;
- if the taxpayer is not a life company, it is a fixed trust[1];
- the entity is a resident of Australia for tax purposes;
- if the entity is a trust, it is not subject to tax under Division 6B or 6C of the 1936 Act; and
- the ATO has not issued a notice to the entity to the effect that the trust/life company is not considered to be a genuine public offer vehicle.

1 Definition of fixed trust, Appendix 1, IFSA submission.

4.78 The Corporate Super Association suggested adopting Option 4.4, possibly stipulating that the concession be restricted to multi member funds if there are integrity concerns.

4.79 The ASFA strongly supported Option 4.4, and proposed that it also extend to pooled superannuation trusts.

4.80 The Association of Grant Thornton Firms in Australia supported broadly exempting complying superannuation funds in Australia.

4.81 KPMG supported excluding complying superannuation funds and other funds management entities such as life companies and registered managed investment schemes from the FIF regime.

4.82 The Property Council supported the exemption of complying superannuation funds from the FIF rules, but sought that the exemption be widened to also include listed property trusts.

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

Problem with the current law

4.83 The ICAA considered that it is inappropriate to treat the business activity of funds management as passive in nature, given the active nature of the business activity.

4.84 Boyd International considered that increasingly, funds management entities are becoming publicly owned and are investing in offshore companies that derive revenue from funds management services.

Evidence of the existing problem

4.85 The IFSA states the removal of funds management services from the FIF blacklist should allow investments in offshore 'All Finanz' entities like ING Group, Irish Life and Citigroup to be carved out from the FIF rules.

Solution

4.86 CPA Australia agreed with the option.

4.87 The IFSA considered that removal from the FIF blacklisted activities of funds management service businesses (with no concurrent holding of passive assets) is appropriate. Further, investments made by a 'manager of managers' in other funds should be treated as trading stock, and therefore exempt from the FIF rules according to the IFSA.

4.88 The ICAA was of the view that funds management services should be included as an eligible activity.

4.89 Deloitte Touche Tohmatsu proposed that the definition of 'eligible activities' be extended to include funds management services.

4.90 The BCA/CTA supported this recommendation. Such a change, it noted, would make it easier for a number of overseas companies to fall within the FIF exemption.

4.91 KPMG considered that if broader reform to the FIF rules do not proceed, the definition of eligible activities should be expanded to include fund management services as well as investment in real property and hedge funds.

4.92 Boyd International strongly supported Option 4.5, and extending all FIF exemptions to include unit trust/mutual funds to reflect investor interest.

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

Problem with the current law

4.93 Axiss Australia stated that it was not appropriate that Australian CGT should apply to foreign investors who invest in foreign assets via an Australian based fund manager.

4.94 The IFSA considered that the capital gains tax treatment of trusts creates a bias against investment by non-residents in Australian managed funds.

4.95 The IFSA also reported that the withholding arrangements that apply to non-resident beneficiaries under sections 98(3) and (4) of the 1936 Act are a problem.

4.96 The Taxation Institute of Australia (TIA) stated the CGT provisions treat non-resident investors investing directly or through offshore-managed funds in

Australian assets more favourably than if they were to invest through Australian managed funds.

4.97 Deloitte Touche Tohmatsu stated that the CGT rules create a distortion such that foreign investors are encouraged to either invest directly or through an offshore managed fund.

4.98 The Property Council noted that non-resident investors may be liable for CGT when a unit trust disposes of foreign capital assets such as shares or real estate due to the interaction of the Australian CGT rules and the withholding rules applying to distributions by trusts to non-residents.

4.99 Ernst & Young considered that there is a bias in the tax system against foreigners investing in Australian unit trusts resulting in this sector failing to reach its full potential.

4.100 The Victorian Government Department of Innovation, Industry and Regional Development stated that foreign investors who hold portfolio investment through unit trusts are taxed as residents on their investment returns in contrast to foreign direct investors. The submission considered that this did very little to encourage international involvement in the Australian managed funds industry.

4.101 KPMG noted that a non-resident holding an interest in an Australian resident fund as a vehicle to make an investment into Australian public companies incurs capital gains tax when that fund disposes of its investment. KPMG stated that the liability arises even though the underlying interest in the Australian public company is less than 10 per cent of the total paid up share capital. The submission pointed out that the taxation liability arises equally where the Australian fund holds a non-Australian investment. The foreign investor would not be taxed, however, if the investment in the Australian company was held through a non-Australian fund or the non-Australian investment was held directly. The Australian tax impact acts as a significant disincentive to attracting foreign investors into Australian managed funds, according to KPMG, and consequently Australian managed funds are not able to compete with global fund managers.

4.102 The BCA/CTA stated that the CGT provisions currently treat non-resident investors who invest directly, or through offshore managed funds, in certain Australian assets more favourably than if they were to invest via Australian managed funds. This results in a bias against Australian-based managed funds, stated the BCA/CTA. The bias, according to the BCA/CTA, occurs because non-resident investors in Australian managed funds are effectively subject to CGT on underlying disposals of interest in assets that do not have 'the necessary connection with Australia'. Non-residents directly disposing of such assets are not subject to Australian CGT, the submission noted.

Evidence of existing problem

4.103 The BCA/CTA stated that the prospect of incurring an Australian CGT liability creates a disincentive for foreign investors to invest in an Australian managed fund, particularly a fund that is newly established or in the process of developing a critical mass, or when the underlying fund assets do not have the necessary connection with Australia (such as funds holding foreign assets).

4.104 Ernst & Young cited that the same investment structured through an Australian trust gives rise to a different taxation outcome than would be the case for a direct portfolio investment.

4.105 The IFSA reported that Australian funds have lost the opportunity to manage foreign funds in various circumstances of A$1 billion, A$0.5 billion and A$0.5 billion respectively, attributable at least in part to the problem.

IFSA Case study 1

The prospect was a major institution in Singapore. There was a potential mandate for A$1 billion in indexed international equities, offered through a pooled investment vehicle (unit trust) managed by an Australian based fund manager. The prospects' investment requirements matched the investment strategy offered by the unit trust, and the prospect preferred this solution to a separately managed account. Due to the size of the mandate relative to the fund size, the fund manager was unable to offer the fund to the investor as the client would have exceeded 10 per cent of the units in the fund, and thus incurred a CGT liability on disposal, even though the underlying assets of the unit trust had no connection with Australia. Accordingly, the opportunity was lost.

IFSA case study 2

The prospect was a semi-Government corporation in New Zealand. The potential mandate was for A$500 million in indexed international equities, offered through a pooled investment vehicle (unit trust) managed by an Australian fund manager. Having dealt with the specific problems posed in offering Australian funds by New Zealand tax laws, the fund manager was still unable to offer the fund, due to the size of the mandate relative to the fund size. Once again, the investor would have fallen foul of the 10 per cent holding limit, and thus incurred a CGT liability on disposal, even though the underlying assets of the unit trust had no connection with Australia. The opportunity was lost.

IFSA Case Study 3

A New Zealand fund manager won a contract to manage an international portfolio of approximately A$500 million for a large institution. The obvious choice to perform the asset management role was its Australian associate where there is significant capability. However, for various tax reasons, it was decided that the services were better performed out of Europe. As a consequence, Australia lost out on significant amount of management fees that could have been generated. The key tax issues were:

- **the 10 per cent threshold would have been exceeded giving rise to CGT consequences that the client was not willing to accept; and**
- **there was a significant risk that given the presence of the asset manager in Australia, the gains arising on the sale of the international assets would give rise to an Australian sourced gain which would be subject to Section 98(3) and (4) withholding.**

The IFSA reported that rates of withholding are punitive and not internationally competitive. Non-residents seek to invest through other jurisdictions, where they are tax exempt or do not have to chase tax credits it stated. A significant proportion of international investments of the New Zealand managed investment industry is undertaken through the use of open-ended investment companies in the United Kingdom, rather than through Australia for this reason, it noted.

According to an IFSA survey, income other than capital gains distributed from non-property trusts is estimated by the IFSA to be less than 3 per cent of the total section 98(3) and (4) of the 1936 Act withholding payments annually. Of the total annual collection of A$14 million, this translates to A$420,000 per annum, noted the IFSA.

Solution

4.106 The IFSA supported implementation of Option 4.6. It noted, however, that in implementing the option there was a need to be able to trace through to the final investing entity, because of the multi-layer trust structures common in the industry.

4.107 The IFSA also suggested:

- extending the Option 4.6 exemption to specifically exclude unit trusts which satisfy the definition of a fixed trust from the withholding obligations imposed on Australian trusts under Section 98(3) and (4) of the 1936 Act;

- adopting a 15 per cent withholding on the taxable component of property trust distributions where the non-resident investor holds a portfolio investment in the property trust.

4.108 The IFSA noted that economic modelling by Econtech P/L suggested that an additional A$10 billion of funds under management would arise if Australian managed funds were exempted from section 98(3) and (4) of the 1936 Act together with:

- a reduction in the cost of capital for portfolio investment in Australia;
- boosting annual GDP by A$64 million;
- raising living standards by about A$10 million annually;
- costing annual budget revenue of A$6 million, with a direct cost of A$15 million partly offset by indirect savings of A$9 million;
- eliminating an inefficient tax with a high excess burden of about 65 cents in the dollar compared with efficient taxes such as GST and income tax on wages and salaries that have low excess burdens of 10 to 20 cents in the dollar;
- creating higher wage jobs with aggregate remuneration of approximately A$40 million; and
- increasing the scale of operation of Australian fund managers resulting in lower cost structures which would benefit resident and non-resident investors.

4.109 The TIA supported the proposals made in Options 4.6 to 4.8 as it considered that they remove a bias that restricts investment into Australia.

4.110 Axiss Australia recommended that Option 4.6 (and Options 4.7 and 4.8) be implemented.

4.111 Deloitte & Touche USA supported a CGT exemption on gains to which non-resident beneficiaries are presently entitled that relate to assets having no connection with Australia. If Australia proceeds with the proposal in Option 3.6, it is necessary, it stated, to extend this principle to ensure that no tax is levied to assets of the interposed entity that were not Australian based.

4.112 Deloitte & Touche NZ agreed with Option 4.6. It noted that it is incorrect from a policy perspective to seek to tax non-residents on income that is not sourced in Australia.

4.113 Deloitte Touche Tohmatsu supported all the CGT Options (4.6 to 4.8). It considered that they would remove the inherent tax distortion and encourage foreign investment through Australian managed funds.

4.114 The Property Council proposed that there be an exemption for non-residents from Australian tax on unit trust income from the disposal of assets that do not have the necessary connection with Australia. The submission proposed the introduction of a simple exemption test for unit trusts to determine whether the asset has the necessary connection with Australia as if the trustee of the unit trust is a non-resident.

4.115 Ernst & Young considered that Option 4.6 should be implemented. It also sought that revenue profits arising from the sale of assets that are exempt from capital gains tax under recommendations 4.6, 4.7 and 4.8 should be exempt from taxation. It considered that unless revenue profits were exempted under the CGT provisions they may inadvertently be subjected to Australian income tax under the ordinary income provisions. This issue was considered to have a high priority for resolution.

4.116 The BCA/CTA supported the option. It stated that:

- consideration be given to the provision of a further test to enable a 'look through' to the underlying assets of the unit trust where the application of the 'necessary connection with Australia' may result in an anomalous result; and
- benefits of the option include increased scale, by reducing the inefficiencies created by mirror funds, which will drive down costs for Australian investors. Further, these changes can be implemented by fund managers with very little change to existing systems.

4.117 The Victorian Government Department of Innovation, Industry and Regional Development proposed that the FIF rules be modified to remove the anomaly that the direct investment by a non-resident in an Australian portfolio investment is treated more favourably than identical investments via an Australian fund.

4.118 KPMG recommended that foreign investors be exempted from capital gains tax or withholding tax on any trust income that does not have the necessary connection with Australia. It noted that more work needs to be done to minimise any compliance costs for fund managers.

4.119 The Association of Grant Thornton Firms in Australia supported this exemption as it will prevent significant anomalies in the current system.

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 Australian

Problem with the current law

4.120 The IFSA stated that the capital gains tax treatment of trusts creates a bias against investment by non-residents in Australian trusts.

4.121 The ICAA reported that it is currently preferable to invest directly or through an offshore managed fund.

4.122 The TIA stated that CGT provisions treat non-resident investors investing directly or through offshore-managed funds in Australian assets more favourably than if they were to invest through Australian managed funds.

4.123 Deloitte Touche Tohmatsu stated that the CGT rules create a distortion such that foreign investors are encouraged to either invest directly or through an offshore managed fund.

4.124 The BCA/CTA referred to the anomalous treatment of non-residents being liable to CGT on disposals of non-portfolio interests in a unit trust relating to assets without the necessary connection with Australia. The submission also noted that, although a foreign investor may hold less than a 10 per cent interest in Australian public companies via an Australian managed fund, they may still incur a CGT liability on the disposal of their units in the fund. This will occur, the submission stated, where the foreign investor (together with associates) beneficially owns at least 10 per cent of units issued within five years of the actual date of disposal.

Evidence of the existing problem

4.125 The IFSA reported that Australian funds have lost the opportunity to manage foreign funds in various circumstances for A$1 billion, A$0.5 billion and A$0.5 billion respectively, attributable at least in part to the problem (see Option 4.6).

4.126 The BCA/CTA noted that the prospect of incurring an Australian CGT liability as outlined in the Treasury Paper creates a powerful disincentive for foreign investors to invest in an Australian managed fund. This is particularly the case it noted for a fund that is newly established or in the process of developing a critical mass, or when the underlying fund assets do not have the necessary connection with Australia (such as funds holding foreign assets).

Solution

4.127 The IFSA supported the implementation of Option 4.7. It noted, however, that the measure needs to be able to trace through to the ultimate investing entity because of multi-layer trust structures common in the industry. The submission noted that IFSA members tend to have sophisticated accounting systems, so tracking and classifying the underlying fund assets is a simple exercise.

4.128 Axiss Australia recommended that Option 4.7 (and Options 4.6 and 4.8) be implemented.

4.129 The ICAA supported this recommendation.

4.130 The TIA supported the proposals made in Options 4.6 to 4.8 because it considered they remove bias in investment into Australia.

4.131 Deloitte Touche Tohmatsu supported all CGT options as it was of the view that they will remove the inherent tax distortion and encourage foreign investment through Australian managed funds.

4.132 The BCA/CTA supported the recommendations and suggested consideration be given to the provision of a further test to enable a 'look through' to the underlying assets of the unit trust where the application of the 'necessary connection with Australia' may result in an anomalous result.

4.133 The BCA/CTA believed that implementation of the option would have a number of important flow-on benefits to the Australian economy, and Australian investors, in particular. These benefits, it stated, included increased scale, by reducing the inefficiencies created by mirror funds, which will drive down costs for Australian investors. Further, it noted that these changes can be implemented by fund managers with very little change to existing systems.

4.134 Ernst & Young considered that Option 4.7 should be implemented. It also sought that revenue profits arising from the sale of assets that are exempt from capital gains tax under Options 4.6, 4.7 and 4.8 should be exempt from taxation. It considered that unless revenue profits were exempted under the CGT provisions they may inadvertently be subjected to Australian income tax under the ordinary income provisions. This issue was considered to have a high priority for resolution.

4.135 KPMG recommended that foreign investors be exempted from CGT or any withholding tax on disposal of units in the Australian fund to the extent that the gain is attributable to assets (whether held directly or indirectly) that do not have the necessary connection with Australia.

4.136 The Association of Grant Thornton Firms in Australia supported the CGT exemption as it considered it would prevent significant anomalies in current systems.

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

Problem with the current law

4.137 The ICAA reported that it is currently preferable to invest in unit trusts directly or through an offshore managed fund.

4.138 The TIA stated the CGT provisions treat non-resident investors investing directly or through offshore-managed funds in Australian assets more favourably than if they were to invest through Australian managed funds.

4.139 Deloitte Touche Tohmatsu considered that the CGT rules create a distortion such that foreign investors are encouraged to either invest directly or through an offshore managed fund.

Solution

4.140 The ICAA supported this option.

4.141 The TIA supported the proposals made in Options 4.6 to 4.8 as it was of the view that they removed a bias against investment into Australia.

4.142 Deloitte Touche Tohmatsu supported all CGT Options on the basis that they would remove the inherent tax distortion and encourage foreign investment through Australian managed funds.

4.143 The BCA/CTA supported this recommendation.

4.144 KPMG supported implementing Option 4.8.

4.145 Ernst & Young supported implementing Option 4.8. Ernst & Young also sought that revenue profits arising from the sale of assets that are exempt from capital gains tax under Options 4.6, 4.7 and 4.8 should be exempt from taxation. It considered that unless revenue profits were exempted under the CGT provisions they may inadvertently be subjected to Australian income tax under the ordinary income provisions. This issue was considered to have a high priority for resolution.

4.146 Axiss Australia recommended that Option 4.8 (and Options 4.6 and 4.7) be implemented.

4.147 The IFSA supported Option 4.8. However, it was of the view that Options 4.6 to 4.8 did not go far enough. IFSA recommended that the fundamental taxation policy should be to treat non-resident investors in Australian unit trusts on the same basis as if they held the underlying investment directly. This would mean, the IFSA stated, that the following gains would not be subject to Australian tax:

- gains on disposal of foreign assets held by Australian unit trusts;
- gains on disposal of non-portfolio interests in Australian public companies held by Australian unit trusts.

Option 4.9: To consider proceeding with the recommendation for the Review of Business Taxation rationalising the application of the current rules to foreign trusts

Problem with the current law

4.148 CPA Australia considered that there is significant complexity concerning the taxation of foreign trusts because four regimes currently apply.

4.149 The TIA reported that the exemption provided under sections 515 and 96A of the 1936 Act have the effect of treating the holders of small exempt FIF trust interests harsher than larger FIF trust interests caught under the FIF measures. The submission noted that holders of exempt interests are required to ascertain their share of the net income of foreign trusts under the Australian tax law, yet the lack of information prevents them from properly complying.

4.150 KPMG stated that the treatment of foreign trusts causes significant uncertainty as conflicting tax regimes potentially apply and in establishing who the relevant taxpayer is and what rules apply in calculating taxable trust income.

Solution

4.151 CPA Australia stated that the four current regimes should be consolidated into one, having regard to the RBT recommendations and the FSI rules.

4.152 The TIA stated that there is a need to streamline the various provisions applying to non-resident trusts. It supported the removal of the deemed present entitlements rules.

4.153 Deloitte Touche Tohmatsu stated that this option merited further consideration.

4.154 Ernst & Young supported Option 4.9.

4.155 KPMG supported proceeding with the Review of Business Taxation's proposal to rationalise the application of the current rules for foreign trusts.

Option 4.10: To consider proceeding with the recommendation for the Review of Business Taxation in relation to transferor trusts

Problem with the current law

4.156 CPA Australia stated that there is complexity in the existing law because four regimes apply to foreign trusts.

4.157 The TIA stated that the exemption provided under sections 515 and 96A of the 1936 Act have the effect of treating the holders of small exempt FIF trust interests harsher than larger FIF trust interests caught under the FIF measures. It noted that holders of exempt interests are required to ascertain their share of the net income of foreign trusts under the Australian tax law, yet the lack of information prevents them from properly complying.

4.158 KPMG noted that it is inequitable that a non-resident who migrates to Australia and becomes a resident for Australian tax purposes may be subject to tax on undistributed (foreign) trust income which accrued prior to becoming a resident but is distributed to the individual after migration. The submission considered that the current system acts as a disincentive for such affected taxpayers to bring additional capital into Australia.

Solution

4.159 CPA Australia stated that the four current regimes should be consolidated into one, having regard to the RBT recommendations and the FSI rules.

4.160 The TIA had concerns about the practical impact of the proposals and whether they would have the desired effect of encouraging repatriation. The TIA stated that the Government needs to be more open on this issue in terms of consultation and legislative design. If this proposal is adopted, it stated that it needs to include an amnesty.

4.161 Deloitte Touche Tohmatsu stated that this option merited further consideration.

4.162 Ernst & Young supported Option 4.10.

4.163 The KPMG submission did not comment on all aspects of the RBT recommendations but it sought that the trust provisions in Divisions 6 and 6AAA of the 1936 Act be amended to ensure that any foreign income derived by a foreign trust prior to the time a non-resident becomes resident is exempt from Australian tax. This is in contrast to the RBT recommendation 20.10 which proposed extending the application of the transferor trust measures to a further range of pre-residence transfers.

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

Problem with the current law

4.164 The IBSA reported that Australia cannot successfully compete for global financial services business without an effective branch tax regime.

4.165 The IFSA stated that taxing branches otherwise than upon a separate entity basis can produce anomalies, particularly with foreign exchange gains and losses.

4.166 The BCTR considered that the domestic law is uncertain and inconsistent in taxing PEs, which fails to deliver a tax neutral outcome.

4.167 The TIA stated that PE structures (as opposed to subsidiaries) offer some commercial advantages to financial services businesses established by foreign multinational enterprises in Australia.

4.168 The BCA/CTA considered that domestic tax law provides an uncertain and inconsistent approach to the taxation of PEs, which fails to deliver a tax neutral outcome. In the absence of an effective branch tax regime, the submission noted that Australia will struggle to successfully compete for global financial services business. These issues affect all PEs to some extent, noted the BCA/CTA, not just financial institutions.

Evidence of the existing problem

4.169 The IBSA reported that PEs are part of the same legal entity as their parent, but tax authorities want to tax interactions with the parent. This fails it stated to deliver a consistent and certain outcome for PEs. The current rules according to IBSA have not kept pace with the development of the financial market and result in the tax laws inhibiting foreign entities from adopting the most efficient organisational structure for their operations.

4.170 The IFSA noted that foreign exchange exposures can generate real economic gains or losses, but nevertheless may fall outside the tax net[2].

Solution

4.171 The IBSA recommended:

- a co-ordinated package be implemented imposing a consistent approach to PEs across the various domestic tax laws (in accordance with RBT Recommendation 22.11(a));
- financial entities operating in Australia through PEs should be permitted to elect to group for thin capitalisation purposes, with any Australian entity with which they share 100 per cent common ownership (adjusted for qualifying employee share schemes);
- financial entities should be given separate entity treatment;
- separate entity treatment in respect of all financial asset and liability transactions, including securities, trading stock and all derivatives (including equity based);
- dividends received by a PE should be assessed on a net assessable income basis, and specifically excluded from the withholding tax regime;
- PEs should be entitled to franking credits in respect of dividends received from Australian resident entities;
- the goods and services tax legislation should be amended to apply separate entity treatment to PEs in respect of dealings with their parent entity; and
- the LIBOR cap in section 160ZZZA(1)(c) of the 1936 Act should be removed.

4.172 The IFSA suggested implementing a system of branch taxation that includes all economic gains and losses within the tax net.

4.173 The ICAA supported this recommendation, stating that as a general principle, PEs should be neither advantaged nor disadvantaged under Australia's tax regime.

4.174 The BCTR supported a move towards a separate entity treatment of branches.

4.175 The TIA supported treating PEs as separate entities for tax purposes, noting that this is the approach in New Zealand.

2 IFSA referred to the *Max Factor* case in support of this view.

4.176 Deloitte Touche Tohmatsu stated that this option warrants further consideration.

4.177 Ernst & Young and the BCA/CTA supported Option 4.11.

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

Summary of Submissions

Submissions considered that it was important that Australia's tax regime did not inhibit the ability of Australian businesses to attract educated and skilled foreign expatriates. However there was a general view that Australia's current tax laws dealing with foreign expatriates present an unfriendly and unwelcoming tax environment compared with some other developed countries. Submissions considered that additional measures to those contained in Chapter 5 of the Consultation Paper: *Review of International Taxation Arrangements*, August 2002 (Treasury Paper) were needed to address these issues.

Option 5.1: Departing residents to provide security for deferred capital gains tax liability

Submissions viewed any requirement to provide security for departing residents for deferred capital gains tax liability as further restricting Australia's ability to attract skilled expatriates. Submissions noted that the proposal would potentially force expatriates to sell assets to fund the security obligation or alternatively to take out loans against the assets. There was a general view that the proposal would significantly increase compliance and administrative costs.

A number of submissions noted that the option would worsen existing capital gains tax (CGT) problems for expatriates and may force Australian businesses to provide security on behalf of expatriates.

Option 5.2: Addressing the double taxation of employee share options

Submissions recognised the potential for double taxation to arise on employee share options (ESOs) because of the different approaches to taxing them taken by different countries.

Many submissions considered that the problem should be addressed through treaty negotiations, but a number of submissions thought that as this would take a significant period it should initially be addressed in domestic tax legislation.

Submissions contained a number of suggestions of how the problem might be addressed in Australia's domestic tax laws. Suggestions included taxing ESO gains:

- in the jurisdiction where they are exercised (Organisation for Economic Cooperation and Development (OECD) model);
- proportionally on the number of days of physical presence in Australia or days worked in Australia;
- if a taxpayer is a resident in a country at the time of granting the option regardless of the location where they exercise the option.

Option 5.3: Consideration of Review of Business Tax (RBT) recommendation to treat ceasing to be an Australian resident as a cessation event under Division 13A

Submissions did not generally support the Review of Business Taxation (RBT) recommendation. Submissions raised a range of potential problems that would arise from implementing the recommendation including that it:

- imposed additional compliance burdens;
- taxed unrealised gains; and
- could tax gains that are never realised, depending on share price movements.

Option 5.4: The establishment of a specialist Australian Taxation Office (ATO) cell to deal with the tax administration of foreign expatriates

Submissions supported the establishment of a specialist Australian Taxation Office (ATO) cell. The submissions noted that foreign expatriates and their employers faced complicated tax issues and at present there is no central area within the ATO that can assist them in resolving these issues.

Option 5.1: To consider whether to proceed with the RBT recommendation that residents departing Australia provide security for deferred capital gains tax liability

Problem in the current law

5.1 The Business Council of Australia and the Corporate Tax Association (BCA/CTA) did not consider that there were any problems as the current law covers any potential capital gain arising upon the eventual sale of the assets while a non-resident.

5.2 The International Banks & Securities Association of Australia (IBSA) stated that the current approach under the law of deeming a capital gain by departing residents where gains have not been realised is arbitrary and unfair. It also indicated that source countries are unlikely to allow relief for the Australian tax paid on the unrealised gain resulting in potential double taxation.

5.3 The Business Coalition for Tax Reform (BCTR) said that Australia's high tax rates make it difficult to convince overseas expatriates to accept employment in Australia.

5.4 Deloitte Touche Tohmatsu raised the following issues:

- cash flow problems;
- taxing gains that may never be realised;
- double tax on the same gain;
- taxing artificially inflated gains due to exchange rate fluctuation; and
- problems with market valuation.

5.5 Further, the Deloitte Touche Tohmatsu submission noted that the entire gain would be subject to Australian tax despite a portion of the gain accruing after the cessation of Australian residency. Other issues raised in the submission included the increased compliance burden and the practical difficulty of enforcement of the proposal.

5.6 Ernst & Young considered that the RBT recommendation would be at odds with virtually every other country with which Australia has a trading relationship. It noted that the Canadian model upon which the recommendation was based has only been intermittently imposed and no definite or easy to use system is in place there in order to provide the security.

5.7 KPMG stated that many expatriates are affected significantly by the deemed disposal rule making it hard to attract skilled foreign labour to Australia. The submission considered that the measure would impose significant hardship on affected taxpayers and increased the cost of hiring skilled labour.

Solution

5.8 The IBSA suggested that capital gains arising from the sale of assets that do not have the necessary connection with Australia and are held offshore by foreign expatriates should not be subject to CGT when they cease to be an Australian resident.

5.9 PricewaterhouseCoopers stated that this option should not proceed. PricewaterhouseCoopers stated that the proposal would create hardship by requiring departing residents to dispose of or alternatively provide security over assets which may already be fully encumbered. The submission noted that there would be considerable administrative procedures and costly legal fees. PricewaterhouseCoopers suggested the following alternatives:

- only apply the proposed rules to Australian assets;
- adopt the UK system where if a taxpayer is resident for four out of seven years before departure, and becomes a resident again after less than five complete tax years, the taxpayer is liable for capital gains tax (CGT) on assets sold after departure, provided the assets were owned prior to departure;
- maintain the 'deemed disposal' rule, with an exempt visitor's category for assets not having the necessary connection with Australia. Employee share and option plans should also be specifically exempt; or
- if adopted, use a de minimis rule as in Canada. If a departing resident returns within five years, the security is returned to the taxpayer.

5.10 PricewaterhouseCoopers indicated that no changes should be made until after Australia addresses the capital gains tax issues in all of its double tax agreements (DTAs).

5.11 BHP Billiton considered that the RBT recommendation should not be implemented. It proposed more broadly that the current law should be repealed to the extent that it deems the disposal of assets that a taxpayer held just before ceasing to be an Australian resident so as to avoid the taxation of unrealised gains.

5.12 The Investment & Financial Services Association (IFSA) strongly supported not proceeding with the recommendation. The IFSA stated that this option would increase compliance, complexity and enforcement burdens, and would also exacerbate existing capital gains tax problems for expatriates. Instead, it suggested reforming the existing provisions to ease the current burden on employers.

5.13 The BCTR, CPA Australia and the Institute of Chartered Accountants in Australia (ICAA) suggested not proceeding with this option.

5.14 The BCTR considered that a requirement to provide security would be a disincentive to highly skilled workers coming to Australia and would exacerbate current problems with the capital gains tax treatment of expatriates.

5.15 The ICAA thought that the proposal would be very costly from an administrative point of view, it may make Australia even less attractive a location for foreign expatriates and it may result in Australian businesses effectively providing security and cause undue delay for departing expatriates.

5.16 The BCTR noted that this option may force foreign expatriates to sell assets to provide security.

5.17 The Taxation Institute of Australia (TIA) recommended not proceeding with the RBT proposal. The TIA indicated that a mis-match of rules applying in different countries (for example, some tax on realisation of gains and others tax unrealised gains) would result in possible double taxation.

5.18 The TIA noted that the problem caused by CGT and exchange rate movements should be addressed in the domestic law, as it takes many years to renegotiate new treaties. A quicker solution it suggested would be to give section 457 of the 1936 Act visa holders exemption from CGT other than on Australian assets acquired and sold as a resident.

5.19 Deloitte Touche Tohmatsu suggested that this proposal should be set aside due to practical and logistical problems. It also cited the potential double tax impact, which the recent US Protocol attempts to avoid. Similar measures to those in the US Protocol should be adopted in other bilateral treaty negotiations.

5.20 The National Institute of Accountants (NIA) did not support the proposal, as it would involve considerable compliance and administrative costs without reducing complexity.

5.21 Rio Tinto opposed the RBT proposal. It noted that providing security for deferred liability would be unfair and add to compliance problems. Rio Tinto indicated that the RBT proposal was a significant disincentive for expatriates to remain in Australia for more than five years.

5.22 The BCA/CTA recommended not proceeding with this proposal. The submission noted that the proposed measures would be costly and a backward step in tax administration, and effectively eliminate any benefit to the individual in deferring the disposal of a capital asset and avoiding the cash flow impact that such a taxation event would create.

5.23 CPA Australia considered that a requirement to provide security would worsen the problems with the current capital gains tax treatment, and would involve large compliance and administrative costs. Further it would be contrary to the Government's policy goals.

5.24 Ernst & Young considered that the RBT recommendation should be removed from consideration.

5.25 KPMG recommended not to proceed with the RBT recommendation to make 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

Problem in the current law

5.26 The IBSA considered that Australia does not have rules to split taxation between onshore and offshore periods of employment as applies in the US and UK. This leads to uncertainty for individuals and their employers.

5.27 PricewaterhouseCoopers indicated that currently gains from ESOs can be subject to double taxation.

5.28 KPMG stated that the current laws dealing with ESOs are inadequate and complex.

5.29 The BCTR noted that double taxation of ESOs is a disincentive to expatriates working in Australia.

5.30 The ICAA stated that there is no tax relief for any foreign tax on ESOs paid prior to a foreign expatriate arriving in Australia. Further, there are no source rules and apportionment rules where the option period straddles periods of employment in more than one country.

5.31 The TIA identified that double taxation on benefits arising from ESOs arises due to different approaches to taxing them by different countries.

5.32 Deloitte Touche Tohmatsu suggested that ESOs relating to services in more than one country will cause tax problems as different countries have different rules on their sourcing, valuation/calculation of taxable amount and timing of derivation of gains.

5.33 Rio Tinto noted that double taxation arises for share options given the different treatment of taxing points and the nature of the income.

5.34 Ernst & Young considered that the current Australian tax treatment of share options is virtually unworkable in an international context. The submission noted that the inability to establish clearly what is taxable and what is not under the framework of the domestic law means that double taxation is inevitable.

5.35 The BCA/CTA identified that the current Division 13A of the 1936 Act is unworkable in an international context and creates double taxation. The treaty-based approach is also unworkable due to its inability to resolve the matter quickly and comprehensively.

Evidence of existing problem

5.36 The PricewaterhouseCoopers submission noted that an employee may be issued with share options offshore that are conditional on certain service, partly onshore and partly offshore. Some countries levy tax at the time the benefit is granted, whilst other levy tax when the option vests and still other tax the benefit under their own CGT provisions.

5.37 The IFSA considered that the tax treatment of ESOs was a significant issue and the cost Australian employers currently have to bear as a result of double taxation is significant.

5.38 Deloitte Touche Tohmatsu noted that problems arise where foreign expatriates are granted ESOs which relate to service in more than one country. Such grants may become subject to double taxation due to the different approaches to taxing the discount or profit element arising from ESOs. This, it noted, included differences in the sourcing, valuation/calculation of the taxable amount and timing of derivation of the gain.

5.39 To illustrate this point, Deloitte Touche Tohmatsu gave an example where a US expatriate, on assignment in Australia, exercises ESOs (and sells the underlying shares) granted prior to his/her arrival in Australia. For US tax purposes, the stock option gain will generally be sourced in the US based on the proportion of US workdays relative to the total workdays during the period from grant to exercise or vesting. However, for Australian tax purposes Deloitte Touche Tohmatsu noted that the gain will be computed based on the increase in market value since commencement of residence in Australian for tax purposes.

5.40 Further complications arise where the gain is subject to tax at different points in time, noted Deloitte Touche Tohmatsu. As an example, countries may seek to tax the ESO gain at any one (or a combination) of the following events:

- grant of the options;
- vesting of the options;

- exercise of the options;
- disposal of the underlying shares;
- departure from country; or
- in the case of Australia – a cessation time event.

5.41 According to the BCA/CTA, many countries (for example, UK, Singapore) allow a full exemption from tax for stock options granted prior to arrival. If the UK does not want to tax income sourced in UK, Australia should not use the treaty as a mechanism to pick up income tax to which it would not be entitled but for a domestic decision of the UK.

Solution

5.42 The IBSA proposed that ESOs be taxed in the jurisdiction where they are exercised.

5.43 PricewaterhouseCoopers suggested using the OECD approach to allocate full residence taxation to the treaty partner in which the share options are exercised.

5.44 The BCTR supported addressing the double taxation of ESOs through ongoing bilateral negotiations.

5.45 The BHP Billiton submission considered that Australia should have taxing rights on ESOs only to the extent of any discount sourced in Australia. The submission suggested that the source of the discount should be determined by a pro-rata calculation based on the number of Australian workdays of the employee and it noted that this was consistent with the OECD position on the issue. Finally in its submission BHP Billiton proposed that Australia should also ensure that its treaties were negotiated to ensure no double taxation arose concerning ESOs.

5.46 The IFSA supported the OECD model for taxing ESOs and suggested a review of domestic laws to make ESOs more flexible. It proposed that the issue should be left to wait until DTAs are renegotiated (for example use a most favoured nation clause) and also not to limit countries for DTA negotiations to those Australia already has a DTA with.

5.47 The ICAA suggested the rewrite of Division 13A to include specific source rules and consider situations involving changes in tax residence. Any gain should be apportioned on the basis of days of physical presence or days worked basis. The ICAA considered that changes to tax treaties could then relieve any continuing double tax problems.

5.48 The TIA suggested the OECD approach (full residence taxation to countries where the options are exercised) is able to deal with residence/source issues generally, but does not appropriately deal with situations where options are taxed in three or more countries on a different basis. It also agreed that ideally the problem should be addressed through treaty negotiations, but due to the lengthy period before DTAs are renegotiated, Australia should address the problem in its domestic legislation.

5.49 Deloitte Touche Tohmatsu suggested that the best solution is to deal with this problem on a country-by-country basis via bilateral tax treaty negotiations. The submission considered that negotiations needed to be integrated with domestic tax provisions providing certainty in determining the source of ESO gains.

5.50 Rio Tinto supported adopting the UK approach that if a taxpayer is a resident in a country at the time of granting the option they are liable to tax in that country when it is exercised regardless of the location where they exercise the option.

5.51 The BCA/CTA suggested that Australia should remove the taxing point on termination of a temporary resident's Australian resident status. Australia should allow a complete exemption from Australian tax on gains from holding pre-arrival stock options to provide consistency with other countries that treat them the same. Further, the BCA/CTA noted that Australia needs to resolve its domestic tax law through a comprehensive review of the stock option provisions focusing on the interaction between Division 13A and CGT concessions. Australia, it noted, should also remove the requirement for options and shares to be taxed at termination where employees obtain no economic benefit for an extended period after termination.

5.52 KPMG sought a review of Australia's domestic tax regime dealing with the taxing of ESOs and employee shares to address the current deficiencies in this area of the tax regime.

5.53 Ernst & Young proposed the following solutions:

- removing the taxing point on the termination of a temporary resident's temporary residence status;
- allowing the complete exemption from Australian tax of gains from the holding of pre-arrival stock options;
- undertaking a complete review of Australia's stock option provisions having regard to;
  - the interaction between Division 13A and the long term CGT concessions; and

- removing the requirement for options and shares to be taxed at cessation where there is no possibility of the employee obtaining an economic benefit for an extended period after termination.

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

Problem in the current law

5.54 PricewaterhouseCoopers noted that Australia's tax treatment of ESOs differs from a number of other countries that tax on the basis of source and residency and adds to complications in this area.

Solution

5.55 PricewaterhouseCoopers considered that this option ignores the fact that employee share scheme rewards may not relate to Australian service. The submission noted that an employee may simply be continuing to participate while on overseas assignment. The tax liability that arises under the scheme may not arise in the same year in the foreign country as it does in Australian with the result that it may not be possible to obtain a tax credit. In the case of an Australian resident departing Australia, PricewaterhouseCoopers noted that the proposal may impose unreasonable financial restraints because when the option is eventually exercised it may have little value.

5.56 PricewaterhouseCoopers suggested that many companies operate a tax equalisation scheme to prevent adverse impacts. Accordingly, changes in this area would be met by employers.

5.57 PricewaterhouseCoopers proposed that Australian residents departing Australia could make an election reporting the discount arising at cessation time with the total benefit being apportioned. Further, it suggested that temporary residents should be exempt from tax provided the individual is participating in a foreign employee share plan of their home country employer. The submission noted that all recommendations should be considered in light of the operation of DTAs, the submission noted. PricewaterhouseCoopers did not support the inclusion of a cessation time rule to deal with the problem.

5.58 Deloitte Touche Tohmatsu indicated that the RBT recommendation should not be proceeded with given the range of difficulties that it causes.

5.59 The BCTR and the IFSA considered that the RBT recommendation should not be proceeded with.

5.60 The BCTR noted that this option would result in double taxation without relief where the employee does not exercise options at the time of departure. Alternatively, the employee may be forced to exercise the options to pay Australian income tax liability.

5.61 According to the ICAA, it is a low priority, especially pending a review of the taxation of share and option plans. It noted that this option could lead to an unrealised gain being taxed when no gain is ever realised.

5.62 The TIA does not support this proposal as it would give rise to cash flow difficulties and could significantly disadvantage departing individuals due to fluctuations in share prices that may occur after departure.

5.63 Deloitte Touche Tohmatsu suggested waiting to evaluate the success of similar provisions implemented by Singapore.

5.64 Rio Tinto proposed not proceeding with this option because it considered that it is a disincentive for expatriates coming to Australia and it is likely that Australian employers would have to meet the cost.

5.65 Ernst & Young strongly considered that the RBT recommendation should not be proceeded with.

5.66 The BCA/CTA strongly supported abandoning this measure.

5.67 KPMG recommended that the RBT recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A should not be proceeded with.

5.68 BHP Billiton considered that the RBT recommendation should not be implemented.

5.69 The IFSA stated that creating another taxation event in Australia would only add to the many existing unresolved double taxation issues particularly if the departing expatriate continued to work for the same employer. The IFSA considered that the holder of such ESOs would face similar cash flow and currency valuation issues to the deemed disposal rules in the CGT provisions.

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

Problem with the current approach

5.70 The IFSA noted that there is no specialist area within the ATO that deals with taxation issues that arise for either expatriates or Australians working overseas.

5.71 The TIA stated that dealing in foreign tax systems increases compliance costs.

5.72 Deloitte Touche Tohmatsu noted that foreign expatriates and their employers face complicated tax issues.

5.73 The BCA/CTA said that the current ATO administration of expatriate issues is disjointed.

5.74 Ernst & Young considered that the ATO administration of expatriate issues is disjointed due to the number of different areas dealing with the problem.

Evidence of existing problem

5.75 The IFSA stated that the requirement to be familiar with a second and very complex tax system, increases compliance costs, many of which fall on the employers of expatriates.

5.76 The BCA/CTA said that a placement of an employee on an expatriate assignment changes many aspects of an individual's tax treatment (for example, fringe benefits tax (FBT), superannuation, stock options and CGT), and the ATO has units dedicated to each of these areas. However, there is no central unit in the ATO with authority to deal with expatriate issues that cross over the ATO's different service lines.

Solution

5.77 The BCTR supported this option, as it considered that it would provide integrated administrative support for foreign expatriates and employers.

5.78 The IFSA supported the establishment of such a unit. It considered that the unit should also be proactive in identifying and addressing emerging problems.

5.79 The ICAA suggested that this cell should be able deal with all issues that arise for expatriates.

5.80 The TIA supported this proposal and recommending increased funding for this task if necessary.

5.81 Deloitte Touche Tohmatsu supported the establishment of a specialist cell within the ATO primarily to deal with the issue of tax residency status, taxation of foreign income, superannuation requirements and exemptions, DTAs, ESOs and CGT.

5.82 Rio Tinto strongly supported the proposal.

5.83 The BCA/CTA supported establishing a specialist cell as a reference point for all expatriate tax issues.

5.84 Ernst & Young supported the proposal.

5.85 Axiss Australia supported the proposal. However, it argued that for many highly mobile skilled expatriates the issues raised in Chapter 5 of the Treasury Paper are not the main problem. The submission noted that the availability of expert advisers familiar with the concerns and requirements of expatriates entering the Australian tax jurisdiction would be a highly valued service, not only by expatriates, but also by employers seeking to attract highly skilled, globally mobile employees to Australia, usually under tight time constraints.

CHAPTER 6: ADDITIONAL ISSUES RAISED IN THE SUBMISSIONS

Summary of additional issues raised

A number of submissions raised issues that were not directly connected to the options canvassed in the Consultation Paper: *Review of International Taxation Arrangements*, August 2002 (Treasury Paper). Some of these issues directly related to Chapters 2 to 5 of the Treasury Paper, while others concerned other international tax issues.

A number of the additional issues related to a range of controlled foreign company (CFC) issues in Chapter 3 of the report, whilst others related to Chapter 5 and sought changes to Australia's taxation law to reduce the impact of and complexity of tax laws that apply to foreign expatriates. Finally, a range of general issues were raised with a number that related to Australia's managed fund industry.

6.1 A number of submissions raised a range of additional issues not directly connected to the options canvassed in the Treasury Paper. Some of these issues directly related to particular chapters of the Treasury Paper, while others concerned other unrelated international tax issues. Several issues raised had little direct link to international tax matters. The issues summarised in this chapter are those that reasonably stated the nature of the problem and broadly either offered some evidence of the problem and/or proposed particular solutions.

6.2 This report has grouped the issues raised into two categories:

- issues that related to each of Chapters 2 to 5 of the Treasury Paper; and
- issues concerning other unrelated international tax issues.

Issues relating to attracting equity capital for offshore expansion (Chapter 2)

Triangulation case with New Zealand needs resolution (BCA/CTA; AICD)

Problem with current law

6.3 The Business Council of Australia and the Corporate Tax Association (BCA/CTA) and the Australian Institute of Company Directors (AICD) stated that Australia and New Zealand have similar tax systems but Australian companies are not able to provide franking credits to Australian shareholders for income tax paid in New Zealand, and vice versa.

Solution

6.4 The submissions proposed that the triangulation case with New Zealand needs to be resolved to remove the impediment to the flow of investments between Australia and New Zealand.

Allowing foreign-owned entities to frank distributions to residents who hold equity interests in entities where the interests are issued in Australia (IBSA)

Problem with current law

6.5 The International Banks & Securities Association of Australia (IBSA) noted that franking credits are available to domestic entities but not to foreign entities that are wholly-owned by non-residents. This means, the IBSA stated, 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.

Solution

6.6 The IBSA submission recommended that 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 to both foreign-owned subsidiaries and to permanent establishments (PEs) that issue equity interests to Australian shareholders.

Issues relating to promoting Australia as a location for internationally focused companies (Chapter 3)

Capital gains tax (CGT) potentially applies to the sale of revenue assets by a foreign branch or CFC (Australian Bankers' Association (ABA))

Problem with current law

6.7 In the case of the disposal of a revenue or trading asset by a foreign branch or a CFC, the BCA/CTA noted that the gain in foreign currency terms may be fully subject to foreign tax (and thus exempt from additional Australian tax under section 23AH or Part X of the 1936 Act). However, the application of section 103-20 of the 1997 Act would mean that it would also be necessary to consider whether or not a capital gain in Australian dollar terms was derived on the disposal of the asset. The CGT reconciliation provision in section 118-20 of the 1997 Act would not apply to reduce the capital gain. Consequently, CGT could potentially apply in relation to a comparably taxed gain derived on the disposal of a revenue asset by a foreign branch or a CFC.

Solution

6.8 The ABA proposed that CGT should not apply on the disposal of revenue assets by foreign branches of Australian entities and by CFCs where the gain is exempt from additional Australian tax under section 23AH or Part X of the 1936 Act. The ABA also considered that section 103-20 of the 1997 Act should be amended such that it does not apply to gains derived on revenue assets disposed of by a foreign branch or a CFC.

Extend foreign investment fund (FIF) treatment of bare trusts and nominee arrangements to CFC rules (Westfield Holdings)

Problem with current law

6.9 Westfield Holdings considered that for FIF purposes, section 484 of the 1936 Act disregards the existence of nominee or bare trust arrangements. There is no such comparable provision in the CFC regime it noted.

Solution

6.10 Westfield Holdings stated that a provision similar to section 484 should be inserted into the CFC regime.

CGT payable for sale of non-portfolio interests in a non-resident company (Rio Tinto; Deloitte Touche Tohmatsu)

Problem with current law

6.11 Rio Tinto and Deloitte Touche Tohmatsu considered that where a CFC sells its assets, the CFC rules do not require attribution of profit until repatriation of the profit, which then is exempt if tax has been paid in a listed country. Where an Australian company realises a gain from the disposal of an interest in a non-resident company, the profit is taxable even if such a profit is not taxable under the CFC or Foreign investment fund (FIF) rules.

6.12 The submissions stated that this disparity/ambiguity has a significant commercial ramification especially for intangible rights over mining assets.

Solution

6.13 Rio Tinto considered that where an Australian company has a non-portfolio interest in a foreign company, a profit made from the sale of that interest should be exempt from Australian CGT. This proposal is relevant it stated if the current exemption system for dividends is expanded to apply to all non-portfolio dividends.

6.14 Deloitte Touche Tohmatsu considered that profits of an Australian company made from the sale of a non-portfolio interest in a CFC should be exempt from Australian CGT where the CFC is carrying on an active business or is a holding company for such company.

Treatment of Limited Partnerships in broad-exemption listed countries (BELCs) (Westfield Holdings)

Problem with current law

6.15 Westfield Holdings stated that limited partnerships are treated as a company for Australian CFC purposes. However, UK or US limited partnerships are treated as a resident of no particular unlisted country unless the limited partnerships are subject to tax in the UK or the US[1], where they are treated as 'look through' entities and do not satisfy the Australian Taxation Office's (ATO) 'subject to tax' requirement.

Solution

6.16 Westfield Holdings sought that consideration be given to amending the law in relation to the treatment of limited partnerships.

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1 TD2001/D14.

Heavy compliance costs for publicly traded trusts (Westfield America Trust)

Problem with current law

6.17 Westfield America Trust noted that the current public trading trust rules impose significant compliance costs on Australian unit trusts. Where the public unit trust owns property in a BELC this does not make sense, as there is no risk to the revenue.

Solution

6.18 Westfield America Trust proposed excluding controlling interests in foreign property owning vehicles in BELCs from the operation of Division 6C of the 1936 Act.

Functional currency rules for CFC attribution calculations (Westfield Holdings)

Problem with current law

6.19 Westfield Holdings stated that where a CGT event occurs in relation to a CFC, the calculation of the capital gain includes the foreign currency conversion gain, which may not represents an economic gain to the CFC. A similar situation arises where there is a time gap between the receipt and payment (for example, loans or other receivables).

Solution

6.20 Westfield Holdings sought that the CFC rules be amended so that all capital gains and losses are determined in the functional currency of the CFC and only the net capital gain is converted to Australian dollars.

Withholding tax on related party loans (BCA/CTA)

Problem with current law

6.21 The BCA/CTA considered that under the current law, the exemption from interest withholding tax only applies to loans between non-associated parties. However, the submission stated that there is no obvious policy basis for confining the exemption to borrowings that are sourced from overseas banks and financial institutions.

Solution

6.22 The BCA/CTA proposed that the interest withholding tax exemption should be extended to related party (inter-company) loans.

Issues relating to promoting Australia as a global financial services centre (Chapter 4)

CGT discount may not be available for Australian investors (Australian Skandia)

Problem with current law

6.23 Australian Skandia stated that the benefit of the CGT discount concession on gains from assets held for more than 12 months is not be available under the present law in some cases under Division 115 of the 1997 Act. The current section 115-215(3)(b) is such that the calculation of discount capital gains of an Australian investor in US trusts is convoluted and could be simplified.

Evidence of existing problem

6.24 Australian Skandia considered that as a result of a technical anomaly 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 the Australian CGT discount available under Division 115.

Solution

6.25 Australian Skandia was of the view that section 99B(1) should be incorporated into section 115-215(2)(b). No suggestion for improving section 115-215(3)(b) was provided. Also, section 513 of the 1936 Act should be expanded to cover other investments such as Dublin based investment funds.

Exemption from FIF rules for widely held funds (IFSA; Westfield Holdings)

Problem with current law

6.26 The Investment and Financial Services Association (IFSA) and Westfield Holdings stated that the FIF rules create unnecessary compliance costs. An exemption for widely held funds could be introduced to alleviate compliance costs, they noted.

Evidence of existing problem

6.27 The submissions cited mirroring of overseas funds if Australian investors sought to invest in that style of fund. Investments are difficult to categorise due to the classification system.

Solution

6.28 The IFSA suggests that a carve out be provided for particular types of Australian investors if:

- the taxpayer is a registered managed investment scheme or a life company regulated by Australian Prudential Regulation Authority (APRA) or a fixed trust;
- the entity and responsible entity are resident in Australia;
- a trust, is not a public trading trust or corporate unit trust; and
- the ATO has not given notice that the fund is not a genuine public offer vehicle.

6.29 Westfield Holdings suggested that the FIF rules should be amended to have no application to Australian listed companies, trusts, managed investment schemes or other collective investment vehicles. If the FIF rules apply, the taxpayers should have a choice of a deemed rate of return based on the 13 week Treasury Note rate.

Issues relating to improving Australia's tax treatment of foreign expatriates (Chapter 5)

High tax costs act as a disincentive for foreign expatriates (IBSA; Ernst & Young; KPMG; ICAA)

Problem with current law

6.30 The IBSA considered that Australia's high top marginal tax rate is a disincentive in bringing skilled workers into Australia, as are other aspects of the taxation of expatriates.

6.31 Ernst & Young considered that when foreign expatriates are brought into Australia the harsh costs arising from Australia's tax regime are borne by the employers of the expatriates. The submission noted that these costs ultimately lead to Australia being less competitive. The submission noted that the problem is not just about wealthy foreign expatriates but also middle income talented expertise Australia needs.

6.32 KPMG considered that Australia's high rates of personal income tax and the level at which the highest marginal tax rate cuts in impact on attracting foreign expatriates.

6.33 The Institute of Chartered Accountants in Australia (ICAA) considered that the high tax costs borne by Australian employers of employing expatriates in Australia, even those on moderate incomes is a significant disincentive.

Evidence of existing problem

6.34 The IBSA noted that reform would make Australia a more attractive career location. 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, it noted.

6.35 Ernst & Young noted that bringing a foreign expatriate to Australia resulted in considerable costs including the payment by the employer of additional income tax that is payable in Australia and also fringe benefits tax in respect of this payment.

Solution

6.36 Expatriate taxation measures in the Taxation Laws Amendment Bill (No 7) 2002 should be passed by Parliament, the IBSA, Ernst & Young and the ICAA stated.

6.37 The Council of Small Business Organisations of Australia Ltd (COSBOA) endorsed improvements to the taxation of foreign expatriates to eliminate double taxation.

Simplifying the proof of identify requirements for tax file number applications (KPMG)

Problem with current law

6.38 KPMG considered that the proof of identity requirements for people seeking a tax file number are too onerous.

Solution

6.39 KPMG sought simplification of the proof of identity requirements.

Simplifying the preparation of tax returns (COSBOA)

Solution

6.40 The COSBOA sought that the preparation of tax returns for foreign expatriates should be simplified.

Superannuation problems for individuals relocating to Australia (Corporate Super Association; PricewaterhouseCoopers)

Problem with current law

6.41 The Corporate Super Association and PricewaterhouseCoopers stated that individuals relocating to Australia must transfer their superannuation to Australia. They must do this within six months of moving here and the growth on their super balances is taxed at the top marginal tax rate even if they cannot access their funds.

Often the funds are not accessible due to preservation requirements and the tax results in significant hardship.

Solution

6.42 The submissions proposed:

- extending the exemption time limit;
- releasing the amount of preserved benefits required to meet the tax liability resulting from the transfer;
- averaging individual tax rates; and
- clarifying the interaction of FIF rules with section 27CAA of the 1936 Act to ensure double taxation does not occur.

Offshore retirement accounts (Ernst & Young)

Problem with current law

6.43 Ernst & Young noted that Australians who have worked in the US or Americans who come to Australia to work, will frequently have funds invested in individual retirement accounts. The submission noted that these are genuine retirement vehicles which are subject to significant US tax penalties if withdrawn prior to retirement.

Solution

6.44 Ernst & Young also sought that foreign personal retirement plans be excluded from the FIF rules given that they are genuine retirement vehicles.

Qualifying period for treatment of expatriates (IBSA; Deloitte Touche Tohmatsu)

Problem of current law

6.45 The requirement under section 23AG of the 1936 Act for a continuous 91 day period offshore is inflexible and inappropriate for foreign expatriates based in Australia with regional responsibilities, the IBSA and Deloitte Touche Tohmatsu stated.

Solution

6.46 The IBSA proposed more flexible taxing arrangement for Australian-based executives who pay tax in other jurisdictions on income earned offshore.

6.47 Deloitte Touche Tohmatsu sought that the foreign earnings exemption for temporary residents apply where the taxpayer has a period of more than 90 days offshore in a tax year without the need for those days to be continuous.

Uncertainties and adverse impact of the tax system on foreign expatriates (Australian Institute of Company Directors (AICD))

Problem of current law

6.48 The AICD stated that the Australian tax system has adverse impacts on visiting executives, and significantly adds to the cost and compliance associated with employing overseas personnel.

Evidence of existing problem

6.49 The submission stated that it is difficult to correctly identify how the incoming executive will be treated for Australian taxation purposes.

Solution

6.50 The following solutions were proposed by the AICD:

- The passage by Parliament of Taxation Laws Amendment Bill (No. 4) and (No. 7) 2002;
- simplification, including treatment of all expatriates as living away from home for assignments of four years or less;
- allowing Australian employers to deduct expenses in respect of payments made to eligible overseas pension or retirement funds operated by the overseas employers;
- exemption for expatriates from the superannuation surcharge and health insurance levy (or make them creditable); and
- a fairer and simpler approach to addressing returning expatriates overseas superannuation entitlements.

Cost of superannuation and foreign expatriates (BCTR; TIA)

Problem with current law

6.51 The Business Coalition for Tax Reform (BCTR) noted that superannuation contributions can significantly increase the cost of employment for both domestic and foreign employers. There are many inequitable features of the current system for foreign expatriates.

6.52 The Taxation Institute of Australia (TIA) considered that unless superannuation concessions are available to foreign expatriates, the requirement to make contributions to a complying superannuation fund could increase the cost to Australian employers of hiring those who wish to remain in their home-country retirement plans.

Solution

6.53 The BCTR proposed accelerating negotiations with Australia's major trading partners to finalise bilateral superannuation agreements. It also supported the passage of amendments currently before the Parliament in Taxation Laws Amendment Bill (No 7) 2002.

6.54 The TIA strongly urged the Government to cease superannuation double coverage agreements separate from DTAs.

Superannuation arrangements and Australian expatriates (Deloitte Touche Tohmatsu)

Problem with current law

6.55 Deloitte Touche Tohmatsu considered that the current SDC agreements do not provide adequate protection for Australians undertaking temporary assignments offshore, because the SDC agreements only provide dual coverage relief where such contributions are mandatory in both jurisdictions.

Solution

6.56 The submission stated that the SDC agreement should be extended to include situations where voluntary Australian superannuation contributions of an equivalent level are maintained during the assignment period. The current 30 per cent withholding tax should not be applied to inter-fund transfers.

Taxation of foreign expatriates, particularly CGT issues (BCA/CTA)

Problem with current law

6.57 The BCA/CTA considered that Australia's current tax laws dealing with foreign expatriates present an unfriendly and unwelcoming tax environment compared with most other developed countries. The problem is not about dealing only with wealthy foreign executives it stated.

Evidence of existing problem

6.58 The submission stated that the problem impacts particularly upon middle level employees.

Solution

6.59 The BCA/CTA proposed introducing domestic legislation, particularly, Taxation Laws Amendment Bill (No.7) 2002 for the Senate to pass the rules.

6.60 The submission stated that Taxation Laws Amendment Bill (No.7) 2002 does not, however, address the issue of date for setting the deemed acquisition value — the date that CGT exposure starts. The deemed acquisition date should be the same date as the date assets move from one tax system to the other.

6.61 Alternatively, following a similar approach to the UK practice, a temporary resident might be exempt from Australian CGT during their temporary resident period, provided the income from the realisation of the property was not brought into Australia, stated the submission.

6.62 A more structured approach to eligibility for the CGT concession may be obtained by abolishing the entire system of deemed disposal for domestic residents departing on temporary assignments as well as temporary residents working in Australia on temporary visas. Also, a tapered concession for residents over a seven-year period (that is, progressively scale back for two more years after five years) could be introduced.

Non-Australian workdays (BCA/CTA; Ernst & Young; ICAA)

Problem with current law

6.63 The BCA/CTA considered that the high rate of marginal tax in Australia reduces its attractiveness as a location for regional head offices.

6.64 Ernst & Young considered that Australian tax rules provide no incentives to increase Australia's attractiveness as a home of regional head offices compared to neighbours such as Hong Kong, Singapore, Thailand and Malaysia.

Evidence of existing problem

6.65 The submissions stated that executives looking at where to locate an office will make their decision based on paying 47 per cent on all their income in Australia or between 17 per cent and 35 per cent on only part of their income in neighbouring countries.

Solution

6.66 The BCA/CTA and Ernst & Young stated that Australia must provide a mechanism for tax relief of non-Australian source employment income received by temporary residents. ICAA also supported tax relief in relation to this issue.

An objective residency test for inbound residents (BCA/CTA, Ernst & Young)

Problem with current law

6.67 The BCA/CTA and Ernst & Young stated that the current definition of a resident of Australia is out of date and step with Australia's need to create a more definitive tax environment. It also provides inconsistent outcomes for people coming to and leaving Australia on a temporary basis they stated. Basing a person's tax residency on where their mail is delivered or where they keep their goods is not relevant to the type of expatriates that Australia tries to encourage to come to Australia, noted the BCA/CTA and Ernst & Young.

Solution

6.68 The BCA/CTA and Ernst & Young considered that an objective test should be developed based on days of physical presence and apply to both arriving and departing international travellers.

Superannuation agreements (BCA/CTA; Ernst & Young)

Problem with current law

6.69 The BCA/CTA and Ernst & Young stated that the Government's moves to allow temporary residents to withdraw their superannuation contributions when they leave Australia will still impose additional non-recoverable costs on employers, being an amount of 30 per cent tax payable on contributions and 30 per cent payable on withdrawing the balance, and administrative costs.

Evidence of existing problem

6.70 According the BCA/CTA and Ernst & Young, the recent Australia/US social security agreement only provides an exemption for an Australian resident in the US from US social security where the Australian superannuation guarantee contributions system covers an employee. This has a limited value stated the submissions.

Solution

6.71 All temporary residents should be excluded from having to make contribution to Australia's compulsory superannuation charges, stated the BCA/CTA and Ernst & Young. Alternatively, the submissions proposed recognising contributions to foreign social security systems as being equivalent to Australian superannuation and allowing Australian employers to claim deductions for contributions to foreign superannuation plans on account of temporary residents.

6.72 The BCA/CTA and Ernst & Young stated that Australia should negotiate its treaties to reflect the commercial reality of superannuation contributions for Australian citizens rather than the minimum recognised under the superannuation guarantee law.

Removal of PAYG withholdings for foreign expatriates (PricewaterhouseCoopers)

Problem with existing law

6.73 PricewaterhouseCoopers stated that pay as you go tax collection provisions place an obligation on foreign employers to meet the tax obligations upon salary and wages of a foreign expatriate employee working in Australia, in default of which punitive rules may apply against the foreign employer.

Solution

6.74 The pay as you go tax rules, according to PricewaterhouseCoopers, should be reviewed to address the issues faced by multi-national companies doing business in Australia. The rules should allow foreign employers to enter into an agreement, consistent with tax equalisation policies, to guarantee payment of the employee's Australian tax liabilities in respect of their remuneration and other benefits in lieu of the pay as you go tax obligations. The submission noted that such an agreement could be entered into, for example, as part of the process for application of a Temporary residency work visa which is ordinarily sponsored by the employer.

CGT and deemed disposals (BHP Billiton; Ernst & Young; Victorian Government Department of Innovation Industry and Regional Development)

Problem

6.75 Ernst & Young noted that Australia and Canada are the only two countries in the world that operate a CGT deemed disposal regime. The submission noted that the regime punishes people who wish or are required to work in Australia for more than 5 years and discourages foreign expatriates from coming to Australia to work or from extending their stays in Australia.

6.76 The Victorian Government Department of Innovation, Industry and Regional Development stated that the current tax treatment discourages foreign expatriates from relocating to Australia for significant periods of time, as they can face Australian tax on income from non-Australian assets acquired prior to their arrival in Australia. This is a serious impediment to attracting the best talent.

Solution

6.77 Ernst & Young considered that:

- the whole system of deemed disposals should be abolished for temporary residents working in Australia on temporary visas;
- the whole system of deemed disposals should be abolished for Australian residents departing on temporary assignments;
- the tax concessions should be adjusted to allow a tapered exemption model as follows;
  - foreign executives in Australia for periods up to 5 years would not be subject to CGT on their foreign assets; and
  - this concession would be progressively scaled back for two further years after the fifth year.

6.78 Ernst & Young considered that if assets are to be subject to Australian tax from a particular date then the assets should be valued at that date. Accordingly, when the temporary resident ceases to be eligible for the temporary resident tax concessions, there should be a deemed acquisition at the same time as the asset transfers from one system to the other.

6.79 BHP Billiton proposed that the current law should be repealed to the extent that it deems the disposal of assets that a taxpayer held just before ceasing to be an Australian resident.

International tax issues not specifically related to the Treasury Paper

High withholding tax for distribution to non-resident investors (BCA/CTA; IFSA)

Problem with existing law

6.80 The BCA/CTA considered that the rate of withholding tax payable by resident trusts in the funds management industry to non-resident investors is set at a minimum of 29 per cent from those taxable components that are not subject to interest, royalty or dividend withholding tax. Most non-resident investors consider this is a punitive rate and consequently seek to invest through other jurisdictions. The problem is particularly acute for funds which utilise foreign exchange hedging for their foreign assets.

6.81 The IFSA also reported that the withholding arrangements that apply to non-resident beneficiaries under sections 98(3) and (4) of the 1936 Act are a problem. The IFSA stated that rates of withholding are punitive and not internationally competitive noting that non-residents seek to invest through other jurisdictions, where they are tax exempt or do not have to chase tax credits.

Solution

6.82 The BCA/CTA stated that consideration should be given to an exemption for unit trusts which satisfy the definition of a fixed trust from the withholding obligations imposed on Australian trusts under sections 98(3) and (4) of the 1936 Act. Alternatively a withholding tax rate of 15 per cent was recommended. An amendment to the tax law to exclude Australian managed funds from withholding obligations would provide employment opportunities for highly skilled workers, strengthen the Australian equity and bond markets and associated infrastructure and provide for economies of scale to drive down costs for Australian investors.

6.83 The IFSA proposed:

- an exemption to specifically exclude unit trusts which satisfy the definition of a fixed trust from the withholding obligations imposed on Australian trusts under section 98(3) and (4) of the 1936 Act; and
- adopting a 15 per cent withholding on the taxable component of property trust distributions where the non-resident investor holds a portfolio investment in the property trust.

Division 6C is a barrier to investing offshore (Westfield Holdings)

Problem with current law

6.84 Westfield Holdings stated that Division 6C of the 1936 Act provides an anti-competitive tax barrier to Australian listed property trusts investing offshore.

Evidence of existing problem

6.85 Where the trust controls a real estate investment trust (REIT) in the US, the REIT must observe its own REIT requirements and also those of Division 6C. This results in unnecessary overlapping, stated Westfield Holdings. Further, if an investor chooses to invest in the REIT directly rather than through Australian listed property trusts, Division 6C does not apply, thereby creating a bias in favour of direct investment.

Solution

6.86 Westfield Holdings sought that Division 6C should not apply to Australian listed property trusts investing offshore.

Compliance cost of determining eligible returns for certain securities (IFSA)

Problem with current law

6.87 The IFSA noted that significant compliance costs are incurred in working out whether securities have an eligible return for the purposes of Division 16E of the 1936 Act.

Solution

6.88 The submission proposed that the ATO should maintain a database of securities to which Division 16E applies.

Consolidations — interaction of Australian and foreign tax rules (IBSA)

Problem with current law

6.89 Due to the interaction of Australian tax rules with that of the home jurisdiction, there may be instances where a foreign owned entity does not want to consolidate fully for tax purposes, IBSA stated.

Evidence of existing problem

6.90 For example, according to the IBSA, the US double dip rules may inhibit an entity from grouping its losses with other members of its tax consolidation group.

Solution

6.91 The submission proposed that a foreign owned entity within a tax consolidation group should be given the option not to group its losses with other entities in the tax consolidated group.

Blackhole expenditure (ICAA)

Problem with current law

6.92 The ICAA considered that 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.

Solution

6.93 The ICAA proposed that systematic treatment of rights and blackhole expenditures should be implemented.

Treatment of intangibles (ICAA; Ernst & Young; Victorian Government Department of Innovation Industry and Regional Development)

Problem with current law

6.94 The ICAA and Ernst & Young considered that the treatment of intangibles is not internationally competitive.

6.95 The Victorian Government Department of Innovation Industry and Regional Development stated that the current law allows the amortisation of the development costs on only certain types of intellectual property interests. The Government recently announced the capital allowance provisions with effect from 1 July 2001, the submission noted, but it stated that there remains a considerable amount of non-deductible expenditure on the creation of intangible property that falls outside of the capital allowance provisions.

Solution

6.96 The ICAA proposed that existing limited categories of intangible property eligible for write-off under the uniform capital allowances (UCA) rules should be expanded.

6.97 Ernst & Young sought that in the medium term Australia should consider an enhanced process for the amortisation of business intangibles particularly in the context of acquisitions.

6.98 The Victorian Government Department of Innovation Industry and Regional Development considered that 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.

Royalty withholding tax (ICAA; Ernst & Young; Victorian Government Department of Innovation Industry and Regional Development)

Problem with current law

6.99 The ICAA and Ernst & Young considered that Australia's double-tax agreements do not strive for any advantageous treatment in relation to royalty withholding taxes. Australia is not seen as an attractive location for the holding of global intellectual property.

6.100 The ICAA and Victorian Government Department of Innovation Industry and Regional Development stated that Australia has in the past been a net importer of intellectual property, and has focused on source taxation to protect its revenue. Many countries the submissions noted have recently reduced their royalty withholding tax rates and Australia has been slow to follow this trend especially when it is becoming an exporter of technology. This overall is impeding Australia's competitive edge.

Solution

6.101 The ICAA and Ernst & Young proposed that royalty withholding tax rates should be reduced to zero.

6.102 The Victorian Government Department of Innovation Industry and Regional Development supported the renegotiation of DTAs to reduce royalty withholding tax as in the recent US Protocol where the rate was negotiated at 5 per cent.

Venture capital (ICAA; Ernst & Young; Victorian Government Department of Innovation Industry and Regional Development)

Problem with current law

6.103 ICAA and Ernst & Young considered that one of the unattractive features of the Australian tax environment is the lack of truly viable venture capital concessions, notwithstanding the measures proposed in the RBT report and introduced in 1999.

6.104 The Victorian Government Department of Innovation Industry and Regional Development Australia supported the need for a strong and active venture capital industry to raise the equity required to fund innovation, economic growth and employment creation. It noted that venture capital investment provides significant sources of funding for early stage investments (for example in biotechnology, computer technology, engineering and other innovative production processes).

Solution

6.105 The ICAA and Ernst & Young considered that effective venture capital concessions should be developed and introduced.

6.106 The Victorian Government Department of Innovation Industry and Regional Development welcomed the recent venture capital reforms proposed, but considered that the criteria to qualify for these venture capital concessions may be limited.

Investment in resource exploration (Government of Western Australian)

Solution

6.107 The Western Australian Department of Industry and Technology stated that the recently introduced venture capital concessions for innovation should equally apply to resource development projects including those projects where exploration is unsuccessful.

Depreciation regime (Government of Western Australian)

Problem with current law

6.108 The Western Australian Department of Industry and Technology noted the arbitrary (and non-transparent) nature of concessions given to the treatment of depreciation of some assets and not others. It considered that this may have a negative impact on investment in general.

6.109 The Western Australian Department of Industry and Technology stated that companies in Western Australia cannot utilise accelerated depreciation provisions as they did in the past. The recent reforms, it noted, may be good for the established 'service sector', but are detrimental to businesses requiring new capital intensive investment on which the Western Australian economy relies heavily on for its economic growth. The new measures also favour large businesses rather than medium sized emerging businesses.

Uncertainty about tax treatment of foreign exchange gains and losses (Westfield America Trust, Property Council)

Problem with current law

6.110 Westfield America Trust and the Property Council stated that there is significant uncertainty about the treatment of foreign exchange gains and losses arising after the High Court decision concerning ERA in 1996.

Solution

6.111 The submissions considered that foreign currency gains and losses should be matched with the character of the underlying transaction. Any foreign currency gain or loss arising in respect of capital transactions should be treated as part of the cost base of the capital asset or part of capital proceeds on disposal of the asset as applicable. This is a high priority according to the submissions.

Separate entity taxation for authorised deposit taking institutions (ADI) branches are complex (BCA/CTA)

Problem with current law

6.112 BCA/CTA stated that the separate entity approach to taxing ADI represents a significant step in the right direction, however, improvements are still required in some areas. Importantly, the tax regime for non-ADI branches is far too complex, uncertain and highly disadvantageous.

Solution

6.113 The above issues need to be addressed, the BCA/CTA stated.

Residency of trustees (Property Council)

Problem with current law

6.114 The Property Council noted that Australian fund managers and property trust managers are highly sought after overseas. However a significant barrier occurs because trust estates are treated as resident in Australia if the trustee or manager is resident in Australia.

Solution

6.115 The Property Council sought an amendment to the residence rules in the tax law to ensure a trust estate or similar entity is not resident in Australia if the trustee or manager is resident in Australia.

Hybrid Tier 1 capital not deductible (ABA)

Problem with current law

6.116 The ABA stated that under the debt/equity rules, treatment of hybrid tier 1 capital is not deductible thus affecting international competitiveness. It stated that the issue relates to the interplay of tax and regulatory rules.

Evidence of existing problem

6.117 Following the US Protocol access by US banks to Australian markets on a tax free basis from 1 July 2003, will mean that 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, the ABA stated. It is understood similar terms are to be included in new UK and German DTAs.

Solution

6.118 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 ABA stated. The Panel should include representatives of the ABA, Treasury and the APRA.

Restructuring for Non-Operating Holding Companies (ABA)

Problem with current law

6.119 The ABA stated that the Wallis Report recommended banks should be able to establish non-operating holding companies. 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

6.120 The ABA noted that various detailed industry submissions over a number of years have addressed this issue.

Solution

6.121 The submission sought specific enabling legislation to provide appropriate tax relief to allow non-operating holding companies to be established in a tax neutral manner.

Ability to transfer losses incurred in countries outside Australia (Clough Engineering)

Problem with current law

6.122 Clough Ltd noted that the construction services industry overseas is competitive and can often result in losses in some countries and profits in others. The losses are currently quarantined which results in a higher rate of tax being paid.

Solution

6.123 The submission proposed allowing offsets of both exempt country and non-exempt country losses. Alternatively, the submission proposed as a minimum that grouping of non-exempt income from all sources be allowed.

Exemption from Australian withholding tax under section 128F(8) of the 1936 Act

Solution

6.124 A confidential submission sought an amendment to the tax law to extend the exemption from Australian withholding tax under section 128F(8) of the 1936 Act. Specifically the submission sought that the section apply to situations where a non-resident parent borrows money through the issue of debentures solely for the purpose of funding the financing activities of its wholly owned Australian operations.