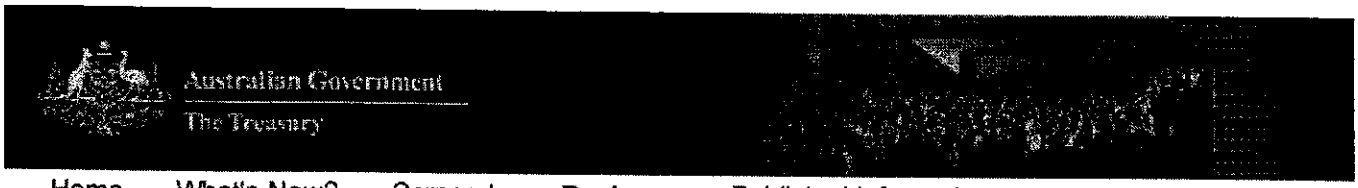

Review of International Taxation Arrangements Measures and Issues — State Of Play

Date: Friday, 26 May 2006

Content ID: 940

Abstract: This document shows the state of play for measures announced by the Treasurer's Press Release No. 32 of 13 May 2003. Also included are issues on which the Government deferred a decision pending further consultation. Measures and issues are ordered by reference to the tranches identified in Attachment A of the Treasurer's press release.

The table identifies the relevant recommendation number from the Board of Taxation's February 2003 report to the Government on international taxation. Note that the measure or issue as described is the Government's response, which in some cases differed from the Board's recommendations.

Documents Available:

Acrobat (PDF)

State of Play 77.96kb

HTML

State of Play 25.58kb

Related Items: **Treasurer's Press Release No. 32 of 2003 - Review of International Tax Arrangements** - 13/05/2003

This press release announces the outcome of the Government's review of Australia's international taxation arrangements, following an extensive consultation process conducted by the Board of Taxation.

Australian Government
Australian Taxation Office

New International Tax Arrangements Act 2004

The *New International Tax Arrangements Act 2004* was introduced into Parliament on 4 December 2003 and received Royal Assent on 23 June 2004.

The *New International Tax Arrangements Act 2004* saw Parliament legislate five Board of Taxation recommendations. The measures:

- Largely eliminate attribution of most of the income (apart from certain limited types of income) of a controlled foreign company (CFC) in listed countries, Board of Taxation recommendation 3(a). This is done through the *Income Tax Assessment Act 1936* (ITAA 1936) and new regulations contained in the Income Tax Amendment Regulations 2004 (No 115).

  (The New International Tax Arrangements Act 2004 refers to Broad Exemption Listed Countries (BELCs), but this classification was changed to Listed Countries by The New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004. Until a list of listed countries is declared, a transitional provision in section 141 of the New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004 specifies that the existing list of BELC countries (ie. US, UK, New Zealand, France, Canada, Japan and Germany) are taken to be listed countries.)

- Increase the balanced portfolio foreign investment fund (FIF) exemption for all taxpayers from 5% to 10%, Board of Taxation recommendation 4.2;
- Exempt complying superannuation funds and similar entities from the FIF rules, Board of Taxation recommendation 4.4;
- Remove 'management of funds' from the FIF rules, Board of Taxation recommendation 4.5; and
- Exempt Australian public unit trusts from interest withholding tax on interest paid on publicly offered debentures issued to non-residents, Board of Taxation recommendation 4.8C.

The five measures in the *New International Tax Arrangements Act 2004* are explained in more detail below.

Overview of Controlled Foreign Company rules

In general terms, Australia's controlled foreign company (CFC) rules (Part X of the *Income Tax Assessment Act 1936* (ITAA 1936)) tax certain Australian shareholders on their share of a CFC's "tainted income" unless that income is comparably taxed offshore or almost all the CFC's income is from active business activities.

A company will be treated as a CFC where it is controlled by Australians. Control is defined in terms of a percentage shareholding or through a *de facto* control test. A CFC has a share of its taxable income, called *attributable income*, included in the assessable income of its Australian resident controllers.

The CFC rules broadly address the deferral of tax that occurs when highly mobile income, passive income, capital gains or profits are accumulated in an entity outside Australia and not repatriated to the Australian controllers by way of dividends.

Largely eliminate attribution of most of the income of a controlled foreign company in a Broad Exemption Listed Country: Board of Taxation recommendation 3(a)

Where Australian residents control an offshore company, the income of that company may be attributed back to those Australian residents under the CFC rules.

Special attribution rules apply if the offshore company is in a listed country. A listed country is a country listed in the regulations as such. As already noted, until a list of listed countries is declared, a transitional provision in section 141 of the *International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* provides that the existing list of BELC countries (ie. the US, the UK, New Zealand, France, Canada, Japan and Germany) are taken to be listed countries. Listed countries have tax systems broadly similar to Australia's. Only certain types of passive income that are concessionally treated and capital gains that are exempt in the listed country (called designated concession income in the *ITAA 1936* and the *ITAA*

36 regulations) are normally attributed.

The Income Tax Amendment Regulations 2004 (No 115), operating through the *ITAA 1936*, replace the broad classes of income which were previously attributed with a list of specific types of concessionally taxed income or untaxed capital gains. (However, note that other income such as foreign investment fund, transferor trust and certain trust income may also be attributed.)

The specific types of concessionally taxed income (called designated concession income) are set out in the income tax regulations and are listed below.

Item	***Summary of the concessional tax treatment that has resulted in an item being identified as Designated Concessional Income***
201	**Canada: international banking centres** *International banking centres were listed in the previous Schedule 9 as specific DCI.* *Interest income derived in respect of an international banking centre from loans to non-residents is exempt from tax in Canada in certain circumstances.*
202	**Canada: investment corporations and mutual fund corporations** *Investment corporations can deduct from their Canadian tax otherwise payable 20 per cent of the amount by which their taxable income exceeds their taxed capital gains.* *Mutual fund corporations (which may also qualify as an investment corporation) receive a refund of Canadian tax for dividends paid out of realised capital gains.*
203	**France: société d'investissement à capital variable (SICAVs)** *SICAVs were listed in the previous Schedule 9 as specific DCI.* *SICAVs are exempt from French tax on their portfolio income.*
204	**France: tonnage taxed income** *Tonnage tax is a tax based upon shipping tonnage, rather than income or profits related to the shipping. Tonnage tax rates are generally set to provide a significantly concessional tax outcome.*
205	**Germany: passive income of a permanent establishment** *Several of Germany's tax treaties provide an exemption from German tax for the income, including in some cases passive income, of German companies from their permanent establishments outside of Germany.*
206	**Germany: capital gains on shares** *Germany generally exempts from tax capital gains on the disposal of shares by a company, but with five per cent of the gain added to the tax base as a non-deductible business expense.*
207	**Germany: tonnage taxed income** *Tonnage tax is a tax based upon shipping tonnage, rather than income or profits related to the shipping. Tonnage tax rates are generally set to provide a significantly concessional tax outcome.*
208	**Japan: governmental bonds** *Interest on Japanese government bonds received by qualified non-residents (including in respect of such a non-resident carrying on a business in Japan through a permanent establishment) is tax exempt in Japan.*
209	**New Zealand: capital gains**

	New Zealand has no general capital gains tax.
210	**United Kingdom: substantial shareholding exemption** *Companies resident in the United Kingdom are exempt from United Kingdom capital gains tax on the disposal of a non-portfolio interest in another company where certain conditions are satisfied.* *This item only applies in certain conditions to capital gains that benefit from the exemption.*
211	**United Kingdom: tonnage taxed income** *Tonnage tax is a tax based upon shipping tonnage, rather than income or profits related to the shipping. Tonnage tax rates are generally set to provide a significantly concessional tax outcome.*
212	**United Kingdom: open-ended investment companies** *Open-ended investment companies are exempt from tax in the UK on capital gains, and taxed at 20 per cent on other income. In addition, open-ended investment companies that hold mostly debt securities can distribute this taxable income as deductible distributions, meaning that they are effectively exempt from tax in the United Kingdom. Such distributed amounts may not be subject to Australian tax (for example, because of the availability of an exemption under section 23AJ of the Act).*
213	**United States of America: tax-exempt governmental bonds** *Interest paid by a state or municipality of the United States of America is generally tax exempt in the US.*
214	**United States of America: regulated investment companies** *Regulated investment companies receive a US tax deduction for dividends paid, and accordingly do not usually pay tax themselves. Such distributed amounts may not be subject to Australian tax (for example, because of the availability of an exemption under section 23AJ of the Act).*

These CFC changes apply in relation to statutory accounting periods beginning on or after **1 July 2004**.

Question: how will this affect the 2004 tax returns?

Answer: *This measure will not generally affect 2004 tax returns as the measure applies to income years or statutory accounting periods beginning on or after 1 July 2004.*

Overview of Foreign Investment Fund rules

Australia's Foreign Investment Fund (FIF) rules (Part XI of the *Income Tax Assessment Act 1936* (ITAA 1936)) apply to Australian taxpayers who, at the end of an income year, have an interest in a foreign company that is not a controlled foreign company or a foreign trust that is not subject to the attribution rules under Division 6AAA (Transferor Trust provisions) of the *ITAA 1936*. An interest includes shares. Taxpayers with a foreign life assurance policy in an income year may also be subject to the FIF rules.

The operative provision (section 529 of ITAA 1936) includes an amount in a taxpayer's assessable income that represents the taxpayer's share of income that is taken to have accrued to the taxpayer from their interest in the FIF.

Any assessable income under the FIF rules is included in the Australian taxpayer's assessable income for the income year in which the notional accounting period of the FIF or the Foreign Life assurance Policy ends.

The following three measures in the *New International Tax Arrangements Act 2004* changed Australia's FIF rules.

Increase the balanced portfolio foreign investment fund exemption for all taxpayers

Australian Government
Australian Taxation Office

House of Representatives New International Tax Arrangements Bill 2003 New International Tax Arrangements Act 2004

Explanatory Memorandum

(Circulated by authority of the Treasurer, the Hon Peter Costello, MP)

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	Definition
ADF	approved deposit fund
A Tax System Redesigned	Review of Business Taxation: *A Tax System Redesigned*
ATO	Australian Taxation Office
CFC	controlled foreign company
CGT	capital gains tax
Commissioner	Commissioner of Taxation
FIF	foreign investment fund
ITAA 1936	*Income Tax Assessment Act 1936*
IWT	interest withholding tax
PST	pooled superannuation trust

General outline and financial impact

Introduction

In the 2003 Federal Budget, following extensive consultation and a report by the Board of Taxation, the Government announced a package of reforms to international taxation. The measures contained in this bill, along with legislation enacting a new tax treaty with the United Kingdom, are part of the first instalment of these reforms.

Foreign investment funds

Schedule 1 to this bill will:

- exempt from the FIF rules qualifying superannuation entities and fixed trusts where all of the beneficiaries are complying superannuation entities;
- increase the FIF balanced portfolio exemption threshold from 5% to 10%; and
- remove management of funds from the FIF 'blacklist' of non-eligible business activities.

Date of effect: The superannuation exemption and the increase in the balanced portfolio exemption will apply to income years beginning on or after 1 July 2003. The removal of 'management of funds' will apply to notional

accounting periods of FIFs beginning on or after 1 July 2003.

Proposal announced: These proposals were announced in Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The FIF exemption and the increase in the balanced portfolio exemption have a total cost to revenue of $15 million for 2004-2005, $20 million for 2005-2006 and $20 million for 2006-2007. The removal of management of funds will have a negligible impact on revenue over these years.

Compliance cost impact: These measures are expected to substantially lower compliance costs for affected taxpayers.

Interest withholding tax exemption for certain unit trusts

Schedule 2 to this bill will:

- remove the need for certain unit trusts to withhold tax on interest payments to non-residents in relation to widely offered debentures; and
- extend this exemption to foreign eligible unit trusts carrying on business in Australia where the interest would otherwise be subject to IWT.

Date of effect: The exemption from IWT will apply to all qualifying debentures issued on or after the day of Royal Assent.

Proposal announced: This proposal was announced in Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The financial impact of this measure is estimated to be up to $3 million per annum over the forward estimates period.

Compliance cost impact: The amendments are expected to decrease compliance costs by reducing the need for eligible unit trusts to withhold a portion of interest payments made to foreigners. Furthermore, special purpose companies will not need to be created to enable eligible unit trusts to receive the exemption.

Attributable income of controlled foreign companies

Schedule 3 to this bill amends Part X of the ITAA 1936 to better target certain amounts that are included in the notional assessable income of a CFC resident in a broad-exemption listed country. Certain foreign source amounts will no longer be included in a CFC's notional assessable income, unless the amounts are also of a kind specified in regulations.

Date of effect: The amendments apply in relation to the statutory accounting periods of CFCs beginning on or after 1 July 2004.

Proposal announced: This is part of a proposal announced in Treasurer's Press Release No. 32 of 13 May 2003, as one component of several reforms to the CFC rules.

Financial impact: The financial impact of the amendments is expected to be negligible.

Compliance cost impact: The compliance cost of applying the CFC rules will be reduced.

Preventing double taxation of royalties subject to withholding tax

Schedule 4 to this bill amends the ITAA 1936 to ensure that double taxation does not occur where deductions

for royalty payments have been denied as a result of the operation of the transfer pricing provisions.

The amendment enables the Commissioner to determine that royalty withholding tax is not payable by a taxpayer to the extent that the transfer pricing rules have been used to disallow a deduction to the payer of the royalty.

Date of effect: The amendment made by this Schedule applies to applications of section 136AD of the ITAA 1936 that occur on or after the day of Royal Assent.

Proposal announced: Federal Budget Measures 2003-2004, Budget Paper No. 2.

Financial impact: The revenue impact of this amendment is $1 million per annum.

Compliance cost impact: Nil.

Summary of regulation impact statement

Regulation impact on business

Impact: Changes to the FIF rules are designed to better target the FIF rules and reduce compliance costs for affected taxpayers (principally the superannuation and managed fund sectors).

The IWT change will reduce the cost of obtaining offshore finance for certain unit trusts operating in Australia. The change will have greatest impact on the managed funds sector, which typically operates through unit trust structures. This change will ensure the same tax treatment is given to debentures issued by these trusts as is currently given to companies.

The change to the CFC rules is designed to reduce the cost of complying with these rules.

Note, this bill also contains an amendment that was not part of the review of international taxation arrangements. This amendment ensures royalty payments are not subject to double taxation to the extent that the transfer pricing rules have disallowed a deduction to the payer of the royalty. Due to its minor nature no regulation impact statement is required for this amendment.

Main points:

- Complying superannuation entities are unlikely to bias investments toward the kind of offshore investments that the FIF rules target. A new FIF exemption for qualifying superannuation entities and certain fixed trusts will mean that these taxpayers will no longer be subject to the FIF rules with associated savings in compliance costs. For example, these taxpayers will no longer classify their investments as 'exempt' or 'non-exempt', determine accrual income or maintain attribution accounts.

- The increase in the balanced portfolio exemption will lower compliance costs for fund managers and other taxpayers by reducing the practice of 'selling down' non-exempt FIF assets at the end of the income year in order to meet the balanced portfolio exemption threshold.

- The removal of 'management of funds' from the FIF 'blacklist' will reduce the compliance costs of the FIF rules for those taxpayers that hold investments in offshore funds management companies.

- The IWT measure will make it easier and less expensive for certain unit trusts, typically in the managed funds industry, to borrow offshore. It will remove a distortion in favour of companies over trusts in relation to offshore borrowing.

Consequential amendments

2.17 The consequential amendments to the ITAA 1936 ensure that the operation of the withholding tax provisions is not compromised. These consequential amendments ensure like treatment is provided to debentures issued by companies and eligible unit trusts. ***[Schedule 2, items 1 to 4, subsection 25(2), paragraph 128AAA(2)(b), subparagraph 128B(3)(h)(iv) and section 128D]***

Chapter 3 - Attributable income of controlled foreign companies

Outline of chapter

3.1 Schedule 3 to this bill amends Part X of the ITAA 1936 to better target those amounts that are included in the notional assessable income of a CFC resident in a broad-exemption listed country. Certain amounts will no longer be included in a CFC's notional assessable income, unless the amounts are also of a kind specified in the regulations. This chapter explains the amendments. Context of amendments

3.2 The CFC rules include in the taxable income of an Australian taxpayer, the taxpayer's share of specified income of non-resident companies in which they have a controlling interest. The income that is targeted for attribution to taxpayers is income that can readily be shifted by taxpayers to non-resident companies to take advantage of any lower overseas taxation.

3.3 For CFCs resident in broad-exemption listed countries (currently Canada, France, Germany, Japan, New Zealand, the United Kingdom, and the United States of America) a narrower range of income is attributable. These countries have comparable income tax regimes to Australia, which significantly reduces the scope to avoid tax.

3.4 While a narrower range of income is attributable for CFCs in broad-exemption listed countries, various general categories of income (e.g. royalties and certain foreign source amounts) remain attributable subject to the application of various tests. These categories and tests were introduced in 1991, when the number of countries treated like broad-exemption listed countries was over 60. The large number of countries made precise identification of attributable income difficult.

3.5 As part of the Government's response to the Board of Taxation's report to the Treasurer, the Government will amend the ITAA 1936 and the Income Tax Regulations 1936 to further reduce the categories of income attributable in respect of CFCs resident in broad-exemption listed countries. This will be done by more precisely identifying the types of income that give rise to significant revenue risk. While this will primarily be achieved by future changes to the regulations (not covered in this bill), the amendments in Schedule 3 complement those intended changes. The changes will reduce compliance costs and improve the commercial flexibility of CFCs resident in broad-exemption listed countries. Summary of new law

3.6 The amendments in this Schedule reduce the scope of income attributable in respect of CFCs resident in broad-exemption listed countries, subject to a safeguard that allows amounts to remain attributable if identified in the regulations.

3.7 The amendments apply to statutory accounting periods of CFCs beginning on or after 1 July 2004.

Comparison of key features of new law and current law

New law	Current law
The notional assessable income of a CFC resident in a broad-exemption listed country is calculated taking into account certain foreign source amounts only if those amounts *are of a kind specified in regulations.*	The notional assessable income of a CFC resident in a broad-exemption listed country is calculated taking into account certain foreign source amounts.

Detailed explanation of new law

3.8 A CFC's attributable income is calculated on a notional basis using the rules for calculating the taxable income of an Australian resident company, subject to some modifications and exemptions. The notional assessable income of a CFC depends on whether the CFC is resident in a broad-exemption listed country or elsewhere.

3.9 If a CFC is resident in a broad-exemption listed country, a greater range of otherwise notional assessable income is exempt from attribution. One category of notional assessable income that remains subject to attribution relates to foreign source amounts that are not eligible designated concession income and pass certain tests, whether derived directly or through a partnership (subparagraphs 385(2)(a)(ii) and (d)(ii)).

Limiting the inclusion of foreign source amounts in attributable income

3.10 While these foreign source amounts can potentially give rise to attributable income in a wide range of circumstances, in practice this is unlikely to occur. For example, even where a CFC resident in a broad-exemption listed country derives a relevant foreign source amount, it is not attributable if subject to certain foreign taxes. However, taxpayers can still incur compliance costs to confirm that there is no such attributable income. The amendments remove the need for taxpayers to consider such amounts, except those, if any, specified in regulations. ***[Schedule 3, item 1, subparagraphs 385(2)(a)(ii) and (d)(ii)]***

3.11 The ability to identify in regulations income amounts that should still be attributable is a revenue safeguard (e.g. in the case where a broad-exemption listed country changes its tax system in a way that opens up tax avoidance opportunities for Australian taxpayers). In most cases, though, income of concern is likely to be attributable under other provisions (e.g. as eligible designated concession income under subparagraphs 385(2)(a)(i) and (d)(i)).

Application and transitional provisions

3.12 The amendments apply to statutory accounting periods of CFCs beginning on or after 1 July 2004. ***[Schedule 3, item 2]***

3.13 The statutory accounting period of a CFC is, in general, each 12-month period ending 30 June. However, a CFC can elect for its statutory accounting period to end on a different date. The attributable income of a CFC, in respect of a particular statutory accounting period, is included in the assessable income of relevant Australian taxpayers in the year of income in which the statutory accounting period ends.

Chapter 4 - Preventing double taxation of royalties subject to withholding tax

Outline of chapter

4.1 Schedule 4 to this bill amends the ITAA 1936 to ensure that double taxation does not occur where deductions for royalty payments have been denied as a result of the operation of the transfer pricing provisions.

4.2 The amendment enables the Commissioner to determine that royalty withholding tax is not payable to the extent that the transfer pricing rules have disallowed a deduction to the payer of the royalty.

Context of amendments

4.3 Australia's domestic transfer pricing provisions and the *Associated Enterprises* Article of Australia's tax treaties authorise the adjustment of profits between related parties to reflect an arm's length profit for taxation purposes.

Bills Digest No. 133 2003-04

New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004

WARNING:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments. This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.

CONTENTS

The following abbreviations and acronyms are used throughout this Bills Digest.

Abbreviation	***Definition***
AFBAP	active foreign business asset percentage
ATO	Australian Taxation Office
CGT	capital gains tax
Consultation Paper	Treasury's consultation paper, *Review of International Taxation Arrangements*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
RITA	Review of International Tax Arrangements
the Board	Board of Taxation
the Board's Report	Board of Taxation's Report, *International Taxation – A Report to the Treasurer*

Passage History

New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004

Date Introduced: 1 April 2004

House: House of Representatives

Portfolio: Treasury

Commencement: Formal provisions of the bill commence on Royal Assent. The various measures contained in the bill have various application dates, which are indicated in the Main Provisions section of this Bills Digest.

Purpose

There are 3 Schedules to the bill and the main purpose of each Schedule is set out below.

- Schedule 1 to this bill amends the income tax law to ignore capital gains and losses arising from capital gains tax (CGT) events happening to shares in foreign companies which are held either by Australian companies or by controlled foreign companies in certain, specified circumstances. Broadly, the gains or losses will be disregarded to the extent that the foreign company has an underlying active business.

- Schedule 2 to this bill extends the existing exemptions for branch profits earned in, and non-portfolio dividends paid from, certain listed countries to all countries. It also changes the existing classification of countries as broad-exemption listed countries, limited-exemption listed countries or unlisted countries to either listed or unlisted countries.

- Schedule 3 to this bill amends sections 448 and 450 of the *Income Tax Assessment Act 1936* to reduce the scope of tainted services income. Tainted services income will, in general, no longer include income from services provided by a company to a non-resident associate, or the overseas permanent establishment of an Australian resident.

Generally, the purpose of the measures in the bill is to improve the international competitiveness of Australian companies.

Background

1. On 2 May 2002 the Treasurer announced details of a review of international tax arrangements (RITA) concentrating on at least four principal areas:

- the dividend imputation system's treatment of foreign source income,
- the foreign source income rules,
- the overall treatment of 'conduit income' , and
- high level aspects of Double Tax Agreement (DTA) policy and processes[1].

2. The consultation paper titled – *Review of International Tax Arrangements – Consultation Paper* was released by Treasury on 19 September 2002[2]. This paper explored a range of international tax issues that may affect the attractiveness of Australia as a place for business and investment and identified options for consultation to be conducted by the Board of Taxation.
3. After extensive public consultation the Board of Taxation reported to the Treasurer on 28 February 2003[3]. This report was titled – *Review of International Tax Arrangements: A Report to the Treasurer*.
4. On 13 May 2003, the Treasurer released the report of the Board of Taxation and announced the Government's response.[4] To enable public consultation to be undertaken on the design of legislation, including addressing integrity issues, the Treasurer announced that the majority of reforms will not commence until 1 July 2004 or later. It was also announced that the package will be introduced in tranches. The Explanatory Memorandum to the bill states that following on from a new tax treaty with the United Kingdom and the New International Tax Arrangements Bill 2003, the measures contained in this bill are a further substantial instalment of those reforms.[5]
5. The New International Taxation Arrangements Bill 2003 was introduced into the House of Representatives on 4 December 2003. The Bill passed the House of Representatives on 4 March 2004 and was introduced into the Senate on 10 March 2004. The Bill has been referred to the Senate Economics Legislation Committee for inquiry and report by 12 May 2004.[6]

Main Provisions

Schedule 1- CGT concession for shares held by Australian holding companies or controlled foreign companies in active foreign companies

Item 3 of **Schedule 1** of the Bill which will insert **proposed Subdivision 768-G** provides a reduction in capital gains and losses from CGT events in relation to non-portfolio interests of an Australian holding company or a controlled foreign company in active foreign companies. The gain or loss is reduced by a percentage called the ***active foreign business asset percentage*** (AFBAP) under **proposed subsection 768-505(2)** that reflects the degree to which the assets of the foreign company are used in an active business. In the case of a controlled foreign company, the rules will apply in the calculation of the controlled foreign company's attributable income under Part X of the ITAA 1936.

Who and what shares will this measure apply to?

Proposed section 768-505 provides that the Australian holding company of a share in a foreign resident company must satisfy the following tests to be eligible for the CGT reduction in **proposed Subdivision 768-G**:

(a) the holding company must hold a direct voting percentage of 10% or more in the foreign resident company when the CGT event happens; and

(b) the requisite share interest was held by the holding company for a continuous period of at least 12 months in the two years before the CGT event; and

(c) the share in the foreign resident company must not be an eligible finance share or a widely distributed finance share as defined in Part X of the ITAA 1936.

The Explanatory Memorandum states in paragraphs 1.37 and 1.38 that the requirement in relation to minimum shareholding and minimum period of holding are included to ensure that the relief is limited to structural holdings of the Australian company and not to mere temporary investments in a foreign resident company. Further, it adds that the intention of this measure is to allow companies to restructure their foreign structural holdings without being overburdened by Australian tax considerations.

The Explanatory Memorandum in paragraph 1.22 states that an eligible finance share or a widely distributed finance share are excluded as such shares are in substance the equivalent of debt and the relief measure is intended for equity interests.

Meaning of voting percentages that an entity has in a foreign company?

Proposed section 768-550 and **proposed section 768-555** provide definitions of direct voting percentage and indirect voting percentage respectively that an entity may have in a foreign company. There is also a definition of total voting percentage in **proposed section 768-560** as being the sum of the direct voting percentage and indirect voting percentage.

What is the meaning of direct voting percentage?

The direct voting percentage that an entity has in a foreign company follows section 160AFB of the ITAA 1936 under **proposed paragraph 768-550(1)(a)**. It is equal to the voting interest it holds in that foreign company as a percentage of the voting power of that company. However, **proposed subsection 768-550(2)** modifies the application of section 160AFB by providing that an entity is not the beneficial owner of a share in a foreign company if a trust or a partnership is interposed between the entity and the trust. In

consequence, where a trust or a partnership is so interposed, **proposed paragraph 768-550(1)(b)** provides that the direct voting percentage is zero.

What is the meaning of indirect voting percentage?

An entity's indirect voting percentage in a subsidiary company as defined in **proposed subsection 768-555(1)** provides for a situation when there is one or more interposed intermediate companies or a chain of intermediate companies between the entity and the subsidiary.

The indirect voting percentage is worked out by multiplying:

(a) the entity's direct voting percentage in an intermediate company:

by:

(b) the sum of:

(i) the intermediate company's direct voting percentage in the subsidiary; and

(ii) the intermediate company's indirect voting percentage in the subsidiary

Proposed subparagraph 768-555(1)(b)(ii) states that in determining the intermediate company's indirect voting percentage it should be worked out under one or more other applications of **proposed section 768-555** in an attempt to avoid the circularity of this definition.

Reduction in Capital Gains and Losses from Certain CGT Events based on active foreign business asset percentage (AFBAP) to total assets

Proposed Subdivision 768-G sets out the manner in which the AFBAP is to be worked out. It offers the holding company the option of two methods to work out the AFBAP under **proposed section 768-515**. The options available are the market value method provided in **proposed subsection 768-510(2)** or the book value method provided in **proposed section 768-510(3)**. Failure to qualify for these options will result in the application of a default method set out in **proposed subsection 768-510(4)**.

Market value method for working out AFBAP

The market value method can be chosen if there is sufficient evidence of the market value at that time of the CGT event of:

(i) all assets included in the total assets of the foreign company at that time; and

(ii) all active foreign business assets of the foreign company at that time.

This requirement is set out in **proposed paragraph 768-510(2)(b)**.

The method statement to work out the AFBAP for the market value method is set out in **proposed section 768-520**. The reader should refer to paragraphs 1.70 to 1.78 of the Explanatory Memorandum to the bill for further explanations and examples of the application of the market value method to determine the AFBAP.

Book value method for working out AFBAP

The book value method can only be adopted if there are recognised company accounts of the foreign company as provided in **proposed subsection 768-510(3)**. A definition of the expression 'recognised company accounts' will be inserted into section 995-1(1) by **item 17** of **Schedule 1**. Under this definition the recognised company accounts of a foreign company are accounts that are prepared in accordance with:

- the accounting standards prepared by the responsible body in Canada, France, Germany, Japan, New Zealand, United Kingdom (UK) or United States of America (USA), or the international accounting standards; or

- commercially accepted accounting principles that give a true and fair view of the financial position of the foreign company.

The reader should refer to paragraphs 1.79 to 1.98 of the Explanatory Memorandum to the bill for further explanations and examples of the application of the book value method to determine the AFBAP.

Default method for working out AFBAP

The default method prescribes the value of the AFBAP in **proposed subsection 768-510 (4)** and varies depending on whether it is to be applied to a capital gain or capital loss. In the case of a gain, the AFBAP will be 0% and the amount of the gain will be fully taxable. In the case of a loss, it will be 100% and the full amount of the capital loss will be disregarded.

The Explanatory Memorandum in paragraph 1.102 states that the default rule is an integrity measure that aims to prevent a company that has made a capital loss from gaining a benefit just because it has chosen not to calculate the AFBAP under the market value method or the book value method.

What are active foreign business assets of a foreign company?

Proposed sections 768-540 and **768-545** provide a definition of active foreign business assets of a foreign company and which is broadly based on existing definitions in the income tax law of 'tainted asset' in section 317 of the ITAA 1936 and 'active asset' in section 152-40 of the ITAA 1997.

The following conditions must be satisfied for an asset to be classified as an active foreign business asset of a foreign company.

(a) The asset must be included in the total assets of the company. (**proposed paragraph 768-540(1)(a)**)

(b) The asset must be one of three kinds of assets.

(i) the asset must be used or ready for use in the course of carrying on a business;

(ii) the asset is goodwill;

(iii) the asset is a share.

(**proposed paragraph 768-540(1)(b)**)

(c) The asset is not a CGT asset which has the necessary connection with Australia. (**proposed paragraph 768-540((1)c)**)

(d) The asset must not be an excluded asset as defined in **proposed subsection 768-540 (2)**. (**proposed paragraph 768-540(1)(d)**)

(e) The asset is not covered by **proposed subsection 768-540(4)** where the foreign company is an Australian financial institution (AFI) subsidiary. (**proposed paragraph 768-540(1)(e)**.

Assets excluded in working out AFBAP under proposed subsection 768-540(2)

The assets specifically excluded from the definition of active foreign business asset under **proposed subsection 768-540(2)** include financial instruments, certain types of shares, interests in a trust or partnership, life insurance policies, rights or options to certain assets, cash or cash equivalent and assets deriving passive income.

These exclusions are generally based on provisions in tax law dealing with the distinction between active and not active assets or income. Assets whose main use in the course of carrying on business is the derivation of passive investment income such as interest, an annuity, rent, royalties or foreign exchange gains are specifically excluded from the definition of active assets under **proposed paragraph 768-540(2)(g)** except where:

(i) the asset is an intangible asset and its market value has been substantially enhanced through development, alteration or improvement to the asset; or

(ii) the main use for deriving rent was temporary.

Modifications of measures for working out total assets and active foreign business assets for Australian Financial Institutions (AFI)

The measures in the Bill provide for the modification of the rules for working total assets and active foreign business assets of AFI subsidiaries in recognition of the fact that financial institutions hold, trade in and dispose of certain financial instruments as part of their active rather than mere passive investment activities. The modifications provide for derivative assets to be included in total assets under **proposed section 768-545** and certain financial instruments to be included in active business assets under **proposed paragraphs 786-540 (1)(e)** and **proposed subsection 768-540(3)**. **Proposed paragraphs 768-540(1)(e)** and **768-545(1)(c)** and **subsection 768-540(3)** provide that the modified rules for working out total assets and active foreign business assets will apply to AFI subsidiaries whose sole or principal business is financial intermediary business. The meaning of both AFI subsidiary and financial intermediary business is the same as the meaning in Part X of the ITAA 1936.

Modifications of measures for working out the active foreign business asset percentage for insurance companies

The calculation of the active foreign business asset percentage for foreign life and foreign general insurance companies is modified taking into account the special regulatory and solvency requirements for insurance companies. The calculation of the active foreign business asset percentage for both life insurance and general insurance companies is modified in **proposed section 768-530**.

In the case of life insurance companies, the value of active foreign business assets is modified to include the value of non-active assets held to meet untainted insurance policy liabilities (**proposed subsections 768-530(3)** and **(4)**). Untainted insurance policies are insurance policies that do not give rise to tainted services income. The insurance policies that do give rise to tainted services income are those where the owner of the policy is an Australian resident.

For general insurance companies, the value of active foreign business assets is modified to include the value of non-active assets that relate to untainted outstanding claims of the company (**proposed subsections 768-530(3) and (4)**). Untainted outstanding claims are so much of the outstanding claims of the company at the end of the statutory accounting period that are referable to general insurance policies that do not give rise to tainted services income of the company of any statutory accounting period.

The reader is referred to paragraphs 1.178 to 1.213 of the Explanatory Memorandum for further details of the modifications for insurance companies.

Modifications for foreign wholly owned groups to determine the foreign business asset percentage on a consolidated basis

Where the determination of the active foreign business asset percentage involves a tier of foreign companies the calculation may be done on a consolidated basis for wholly-owned companies comprising or within that tier of companies. One calculation is performed for the top foreign company in the wholly-owned group that also covers all its 100% owned foreign subsidiary companies. **Proposed subsection 768-535(2)** gives the holding a choice to calculate the active foreign business asset percentage of the top foreign company on a consolidated basis. However, **proposed paragraph 768-535(1)(b)** provides that this choice cannot be made if the top foreign company of the wholly-owned group is:

an AFI subsidiary

a foreign life company; or

- a foreign general insurance company.

The use of consolidated accounts reflects the principle that within a wholly-owned group, internal transactions, and particularly internal debt and equity funding, should not affect the extent to which the foreign company being disposed of is considered to have an underlying active business.

Application

The measures relating to the reduction in capital gains and losses arising of non-portfolio interests in active foreign companies apply to CGT events happening on or after 1 April 2004 (**Schedule 1, item 1**), the date of introduction of the bill.

Schedule 2 – Foreign branch income, non-portfolio dividends and listed countries

The measures in **Schedule 2** expand the current exemptions for foreign branch profits and foreign non-portfolio dividends received by Australian companies. It also effects changes to the definition of 'listed country'.

Foreign branch income exemption

Currently, resident companies do not include in assessable income certain foreign branch income and certain capital gains derived from a business carried on through a permanent establishment in a listed country. The amounts are not assessable and are not exempt income under section 23AH of the ITAA 1936. Non-assessable non-exempt income as defined in section 6-23 of the ITAA 1997 is not assessable income and is not taken into account in working out a taxpayer's taxable income for an income year. As the amount is also not exempt income, it is not taken into account in working out a taxpayer's tax loss for an

income year or in working out how much of a prior year tax loss is deductible in an income year.

Further, a resident company may be a partner in a partnership or beneficiary of a trust that has a permanent establishment in a foreign country (there may also be several interposed partnerships and trusts between the resident company and the partnership or trust). In such circumstances, similar amounts of foreign branch income and capital gains, derived from a business carried on through the permanent establishment, are also not included in assessable income to the extent of the company's indirect interest in that income or those gains.

Item 1 of **Schedule 2** will repeal section 23AH and substitute **proposed new section 23AH**. The new section provides an exemption to a resident company for most foreign income and gains derived through a foreign permanent establishment in either a listed or unlisted country. The exemption will also continue to be available to resident companies that are partners in a partnership or beneficiaries of a trust (or where there are several interposed partnerships and trusts). The exemption applies to the extent of the company's indirect interest in the amounts derived through the permanent establishment.

Foreign non-portfolio dividends

Non-portfolio dividends paid from a company resident in a listed country are currently not included in the assessable income of resident company recipients under section 23AJ of the ITAA 1936. Some dividends paid by a company resident in an unlisted country may also not be included where the dividend is paid out of profits that were taxed in a listed country. Division 6 of Part X of the ITAA 1936 (about exempting receipts, profits and profits percentage) provides a mechanism for this, particularly for dividends paid by companies resident in unlisted countries. Non-portfolio dividend as defined in section 317 of the ITAA 1936 means a dividend paid to a company where that company has a voting interest amounting to at least 10% of the voting power. It does not include a finance share dividend or a widely distributed finance share dividend.

The policy underlying section 23AJ and Division 6 of Part X was to exempt comparably taxed profits upon distribution to a resident company. The Treasurer's announcement in Press Release No. 32 of 13 May 2003 removed the comparable tax requirement, thus allowing an exclusion from assessable income for all non-portfolio dividends. To give effect to this policy change **Item 4** of **Schedule 2** repeals section 23AJ and substitutes **proposed new section 23AJ. Item 57** of **Schedule 2** repeals Division 6 of Part X.

Foreign tax credits

A foreign tax credit is generally available under Division 18 of Part 111 of the ITAA 1936 where a resident entity includes foreign income in its assessable income and foreign tax was paid on its foreign income. The foreign tax credit was intended to avoid double taxation. As all non-portfolio dividends will be excluded from assessable income under the proposed measures there will be no double taxation of such income and foreign tax credits for underlying foreign company tax now available under section 160AFC of the ITAA 1936 will no longer be required. **Item 37** of **Schedule 2** repeals section 160AFC.

The repeal of section 160AFC will have impacts on several other provisions which are discussed together with the consequential amendments in paragraphs 2.72 to 2.93 of the Explanatory Memorandum to the bill.

Listed countries

The current provisions relating to the exemption of foreign branch income require that it must be subject to tax in a listed country. Income taxed in a listed country generally means that the foreign income is considered to have been comparably taxed to income derived in Australia. Currently, listed countries as defined in subsection 320 of the ITAA 1936 fall into two classes: broad-exemption listed countries and limited-exemption listed countries. Broad-

exemption listed countries are countries with very similar income tax systems to Australia while limited-exemption listed countries are countries with broadly comparable income tax systems to Australia. **Items 85** and **86 of Schedule 2** repeal the definitions of broad-exemption listed country and limited-emption listed country in subsection 320(1) of the ITAA 1936. **Item 87** repeals the definition of listed country and substitutes a new definition in subsection 320(1) of the ITAA 1936. Under the proposed definition a listed country means a foreign country, or a part of a foreign country, that is declared by the regulations to be a listed country for the purposes of Part X of the ITAA 1936 dealing with controlled foreign countries.

Comparison of key features of new law proposed by Schedule 2 and current law

Current law	New law
A foreign non-portfolio dividend paid to a resident company out of comparably taxed profits is not assessable income.	All foreign non-portfolio dividends paid to Australian companies are not assessable income.
Some non-portfolio dividends paid to a controlled foreign company may be attributed to an Australian shareholder.	Non-portfolio dividends paid to a controlled foreign company are no longer attributed to Australian shareholders.
Foreign branch profits derived by a resident company from a comparably taxing country are generally exempt from Australian tax. There is no active income test for branches in broad-exemption listed countries and no income earned in branches in unlisted countries is exempt.	Active foreign branch income derived by a resident company in any foreign country will be non-assessable income. Only tainted income will ever be assessable and that will depend on the branch failing an active income test in all cases.
Foreign tax credits are available for foreign underlying company tax deemed to be paid by a resident company that receives an assessable foreign dividend from a related foreign company.	There will be no foreign tax credit for underlying tax paid on profits from which dividends are paid.
Section 458 directly includes in the assessable income of an attributable taxpayer a non-portfolio dividend paid from a controlled foreign company in an unlisted country to another controlled foreign company in a listed country which doesn't tax the dividend. It also applies to certain other dividends.	Section 458 is repealed.
Section 459 directly attributes deemed dividends paid directly or indirectly between some controlled foreign companies to their Australian shareholders.	Section 459 is repealed but in some cases the deemed dividend may be counted as part of the attributable income of a controlled foreign company.
An attributable taxpayer's assessable income includes: • unrealised gains accumulated on all assets; and • all distributable profits, where a controlled foreign company changes residence from an unlisted to a listed country.	An attributable taxpayer's assessable income will include only: • unrealised gains accumulated on tainted assets; and • adjusted tainted income other than non-portfolio dividends, where a controlled foreign company changes residence from an unlisted to a listed country.
The controlled foreign companies rules,	Countries are either listed or unlisted. The

dividend rules and branch profits rules apply differently depending on the country concerned. Countries are classified as either broad-exemption listed countries, limited-exemption listed countries or unlisted countries.	unlisted category includes countries previously classed as limited-exemption listed countries. The listed class consists of those previously called broad-exemption listed countries. The previous limited-exemption listed country list is used for one provision only.

Source: Explanatory Memorandum at the end of paragraph 2.12

Application

- The expanded exemption for foreign branch profits applies to income years commencing on or after 1 July 2004 (**Schedule 2, item 140(1)**).
- The expanded exemption for non-portfolio dividends apply to dividends paid after 30 June 2004 (**Schedule 2, item 140(2)**).
- The changes to the classification of countries and the definition of a listed country apply to income years and statutory accounting periods commencing on or after 1 July 2004 (**Schedule 2, item 140(3)**).

Schedule 3 – Tainted services income

The controlled foreign companies rules include in the taxable income of an Australian taxpayer, the taxpayer's share of the specified income (known as attributable income) of a non-resident company in which they have a controlling interest. The income targeted for attribution is income that can readily be shifted offshore by taxpayers to non-resident companies that they own or control, to take advantage of any lower tax rates offshore

One category of attributable income is called tainted services income. Tainted services income is, in general, income from services provided by a company to an Australian resident or to an associate of the company (including non-resident associates). It also includes income from services provided to a non-resident in connection with a business carried on by the non-resident through a permanent establishment in Australia.

The measures in **Schedule 3** reduce the scope of tainted services income without altering the tainted services concept. The amendments in **item 1** of **Schedule 3** repeal existing paragraph 448(1)(a) and substitutes **proposed new paragraph 448(1)(a)** which generally removes from the scope of tainted services income, the income a company derives from providing services to non-resident associates.

The removal of services provided to non-resident associates from tainted services income is applied consistently to the treatment of insurance premium income and relevant Australian financial institution subsidiary income by amendments proposed by **items 3, 4, 7, 8** and **9** of **Schedule** 3.

Application

The amendments apply to statutory accounting periods of companies beginning on or after 1 July 2004 (**Schedule 3, item 10**).

Concluding Comments

Economic benefits of the measures in the Bill

The economic benefits resulting from implementing the measures in the Bill are set out in paragraphs 4.22 to 4.26 of the Regulation Impact Statement which is Chapter 4 of the Explanatory Memorandum to the Bill. These are set out below for ease of reference.

CGT relief for disposal of a non-portfolio interest in a foreign company with an active business – Schedule 1 amendments

This measure will align more closely the tax treatment of selling an interest in a foreign company (that has an active business) with the tax outcome that would result if the foreign company disposed of its active foreign business assets and distributed those profits to its shareholders. In other words, there will be no liability to Australian tax if an Australian company (or its controlled foreign company) sells a non-portfolio interest in a foreign company *or* if the Australian company (or its controlled foreign company) procures the foreign company to sell its active assets and distribute those profits as a dividend.

This will increase flexibility in corporate restructuring decisions, and will provide an exemption to Australian companies similar to what is currently available in many European countries. This will ensure that Australian companies are not at a competitive disadvantage when they seek to invest offshore, and will encourage foreign groups to establish a regional headquarters in Australia.

Extension of the exemption for non-portfolio dividends and certain foreign branch profits to all countries – Schedule 2 amendments

The measure will assist Australian companies investing in foreign countries to be more competitive with foreign counterparts, as they will not be required to pay additional Australian tax on foreign active business income. It will also remove income tax impediments for companies who distribute profits from countries not currently eligible for an exemption, but who will benefit from the extended exemption.

The substantial compliance cost savings for companies will also provide economic benefits.

Modified application of the tainted services income rules – Schedule 3 amendments

The measure will allow Australian multinationals to better compete internationally, with negligible risk to the tax base. It will also provide a more neutral treatment of services provided to group companies by offshore group service centres. Achieving these outcomes will increase Australia's ability to retain and attract multinationals and regional headquarter operations

Financial impact of the measures in the Bill

The costs to revenue of the measures contained in the Bill are summarised from information provided in the Explanatory Memorandum, as follows:

Measure	2003-2004	2004-2005	2005-2006	2006-2007
1. CGT relief for disposal of a non-portfolio interest in a foreign company with an active business – Schedule 1	The financial impact of this measure is not quantifiable	The financial impact of this measure is not quantifiable	The financial impact of this measure is not quantifiable	The financial impact of this measure is not quantifiable

amendments				
2. Extend exemption for non-portfolio dividends and certain branch profits to all countries – Schedule 2 amendments	Nil (a)	Nil (a)	-$30 million (a)	-$55 million (a)
3. Modified application of the tainted services income rules Schedule 3 amendments	Nil (b)	Nil (b)	-$10 million (b)	-$10 million (b)

However, the Regulation Impact Statement (RIS) in Table 4.3 titled - Taxpayers affected by measures in the bill - refers to the lack of complete data relating to taxpayers affected by measures in the bill. This would appear to cast doubts on the accuracy of the estimates in rows 2 and 3 of the above table. The reservations in the RIS are set out in paragraphs (a) and (b) below:

(a) Extending the exemptions for non-portfolio dividends and certain foreign branch profits to all countries will potentially impact on all companies considering substantial investments offshore. It is not known how many companies will be affected.

(b) The modified application of the tainted service income rules will primarily benefit Australian resident taxpayers with controlled foreign companies or overseas branches that provide services to non-resident associates. A reliable estimate of the number of overseas permanent establishments of Australian companies is not available given current data holdings.

Endnotes

1. Treasurer's Press Release No 021 of 2 May 2002, http://www.treasurer.gov.au/tsr/content/pressreleases/2002/021.asp

2. *Review of International Tax Arrangement – Consultation Paper* of 19 September 2002, Commonwealth Treasury, http://www.taxboard.gov.au/content/int_tax/int_tax.asp

3. Review of International Tax Arrangements: A Report to the Treasurer, http://www.taxboard.gov.au/content/rita_report/index.asp

4. Treasurer's Press Release No 032 of 13 May 2003, http://www.treasurer.gov.au/tsr/content/pressreleases/2003/032.asp

5. Explanatory Memorandum to the New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004, p. 3.

6. Explanatory Memorandum, to the New International Tax Arrangements Bill 2003 and the, Bills Digest No 79 2003-04.

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International Taxation

A Report to the Treasurer

Volume 1
The Board of Taxation's Recommendations

The Board of Taxation

28 February 2003

CHAPTER 1: INTERNATIONAL TAX ARRANGEMENTS PROMOTING AUSTRALIA'S COMPETITIVENESS

Introduction

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- *The efficiency principle*: in raising revenue, the business tax system should interfere as little as possible with the best use of existing national resources, with the efficient allocation of risk, and with long term economic growth. An internationally competitive economy requires, and is sustained by, the efficient use of its economic resources. To this end, a vital precondition for Australia's international competitiveness is that business decisions are not unduly constrained by the business tax system.

- *The neutrality principle:* (which complements the efficiency principle) a tax system should reflect the goals of (1) capital export neutrality (CEN), whereby all residents' income is taxed at the same rate, regardless of whether it is earned domestically or overseas; and (2) capital import neutrality (CIN), whereby the

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

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

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

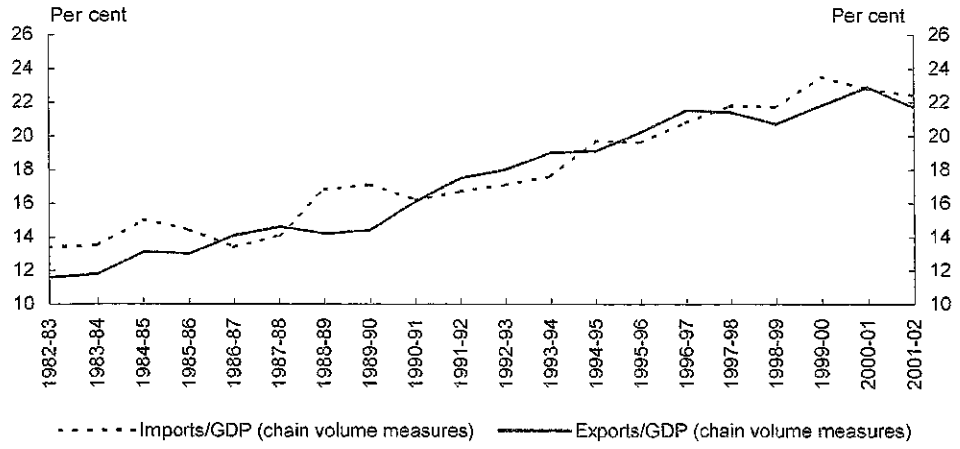
1.13 This chapter outlines what is at stake for Australia's international competitiveness and its international taxation arrangements. It summarises each group of the Board's recommendations, and discusses the benefits to be derived from implementing them.

How Australia benefits from integrating into the global economy

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

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

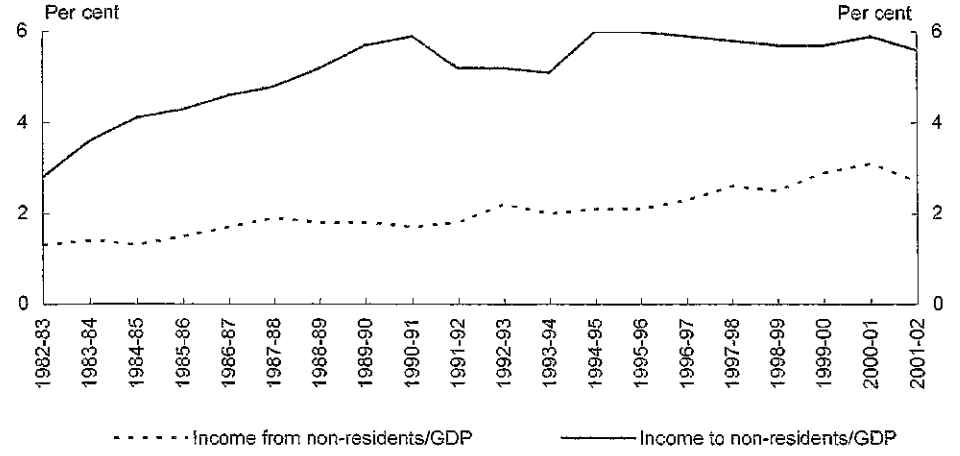
Figure 1.1: Exports and Imports as a proportion of GDP, chain volume measures, 1982-83 to 2001-02



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

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

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



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

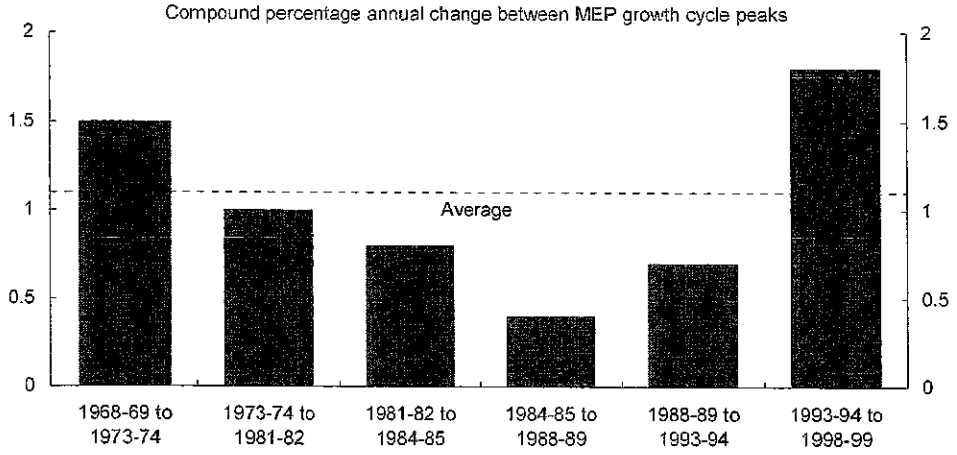
1.17 Australia's increased integration into the global economy has coincided with a surge in productivity growth, underpinning Australia's strong economic performance over the last decade. The Productivity Commission has shown that most of the key

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

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

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

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



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

Why impediments to continuing integration need to be removed

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Removing impediments to Australian investment abroad

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

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

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

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

Summary of recommendations

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

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

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

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

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

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

Rationale of recommendations

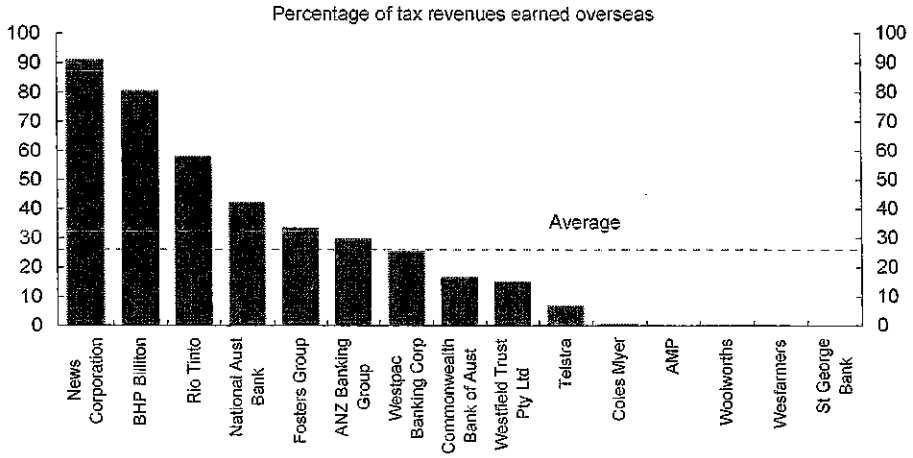
1.36 Australia's tax system must respond to globalisation, given the increasing importance to Australian companies of FSI. In 2000–01, Australia's top 15 listed companies earned approximately 26 per cent of their total revenues from overseas (Figure 1.4).[13] A Productivity Commission survey found that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

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

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

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

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



Source: Compiled by The Allen Consulting Group.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Competing for key investments, particularly headquarters

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

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

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

1.49 The role that tax plays in inhibiting businesses from retaining their headquarters in Australia is highlighted by the Productivity Commission's recent survey of Australia's 201 largest firms. The survey found that foreign and domestic

taxation regimes were among the most important *government* factors influencing investment decisions.[19]

Summary of recommendations

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

1.51 The Board recommends (see Chapter 3):

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

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

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

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

Rationale of recommendations

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

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

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

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

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

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

economy' risks). The Board is confident that the benefits will clearly outweigh the revenue cost of the recommendations.

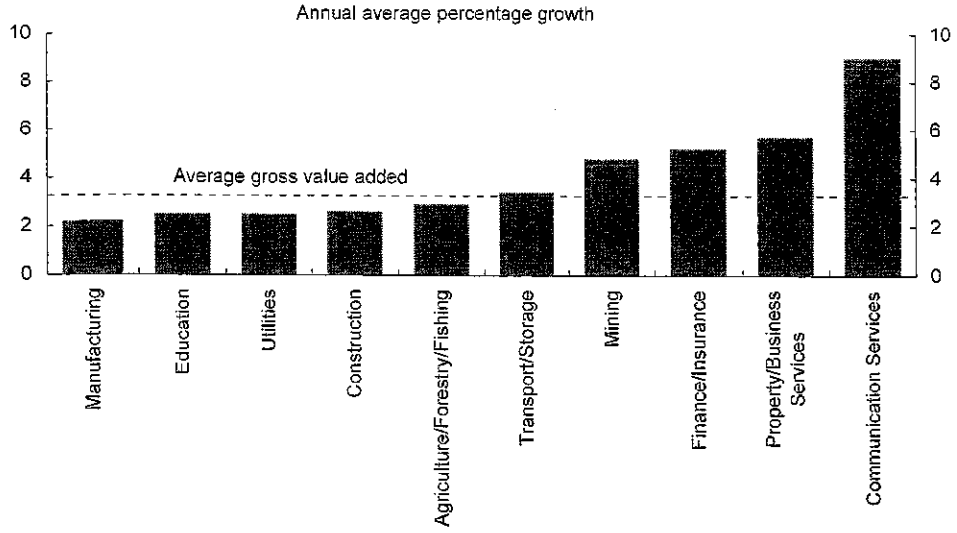
Competing in the financial sector

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

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

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

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



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

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

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

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

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

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

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

- the application of foreign investment fund (FIF) provisions to funds management activity. This discourages possible efficiencies that could be generated by the use of offshore pools;

- the capital gains treatment of foreign investment in Australian funds. This discourages overseas investment into Australia; and

- various other provisions relating to trusts, branch structures, and the like.

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

- that the FIF rules are too complex and impose very high compliance costs, including the requirement to keep an attribution account for each investment at the investor level; and

- that more onerous tax consequences arise for investments made by overseas investors in Australian-managed funds compared to direct Australian investments by overseas investors.

Summary of recommendations

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

- funds registered under the managed investment provisions of the *Corporations Act 2001* and companies registered under the *Life Insurance Act 1995* (in certain circumstances);

- funds applying widely-recognised indexes; and

- complying superannuation entities.

1.62 The Board also recommends:

- a general review of the FIF rules;

- increasing the 5 per cent balanced portfolio exemption threshold in the FIF rules to 10 per cent of the overall cost of the assets;

- amending the FIF rules to allow fund management services to be an eligible activity for the purposes of the rules;

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

Rationale of recommendations

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

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

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

Removing impediments to mobility of key personnel

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

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

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

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

1.68 Concerns about the unresponsiveness of the current tax system to the continuing integration of national economies and the increasing mobility of capital and

skilled labour were reflected in a national survey of Australian business executives by PricewaterhouseCoopers in May 2002. This survey found that tax reform was the most important factor in boosting Australia's ability to attract overseas talent — see Box 1.2.

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

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

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

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

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

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

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

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

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

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

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

Summary of recommendations

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

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

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

Rationale of recommendations

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

1.73 The benefits from increased personnel mobility include:

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

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

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

Summing up: benefits and budgetary cost

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

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

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

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

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

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

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

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

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

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

ADDENDUM TO CHAPTER 1

Short and longer-term impacts of providing limited dividend relief

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

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

Recommendation

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

Short-term impacts

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

against overseas investment and towards domestic investment within Australia. The bias is illustrated by the numerical examples set out in Table 1 below.[23]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

25 Dollar figures rounded to whole numbers.

26 Not shown as a specific example in the table.

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

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

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

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

Consequent and longer-term impacts

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

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

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

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

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

- reduced cost of capital for Australian companies wishing to expand overseas, only partly offset by an increased cost of capital for those remaining focused on domestic opportunities;

- reduced cost of capital for internationally-oriented companies wishing more readily to combat overseas competitors, to gain scale, to speed up the adoption of new technology and business systems and generally to operate more efficiently, including at home;

- benefits to Australian shareholders from the growth of Australian companies which otherwise would have been unable to grow at comparable rates domestically (again, these positive shareholder gains being only partly offset by *relatively* negative effects on the share prices of domestically-focused companies);

- increased repatriation of profits to Australia, thereby increasing the wealth of Australians and taxes paid;

- increased foreign investment, as the bias which makes Australian domestic investments relatively expensive to foreign investors and relatively cheap to Australians is reduced; and

- reduced levels of borrowing by Australian companies to finance foreign investment, thereby reducing risks and potential credit rating downgrades.

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

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

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

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

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

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

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

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

Controlled Foreign Company (CFC) Rules

Policy objectives

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

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

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

Current law

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

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

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

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

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

Problem

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

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

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

3.6 Specific problems include:

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

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

- under the tainted services income rules, Australian-owned businesses providing services into Australia from overseas pay Australian levels of tax on that income. Foreign-owned competitors providing the same services do not. Further, foreign subsidiaries of Australian companies are discouraged from providing services

among themselves, as the income produced is usually attributed to the Australian parent; and

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

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

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

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

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

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

Option 1 — Malaysia as a hub

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

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

Option 2 — Australia as a hub

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

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

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

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

Conclusion

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

Box 3.2: Case Study — Observation of a multinational

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

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

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

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

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

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

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

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

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

Evidence of the problem

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

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

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

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

Policy issues arising from the problem

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

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

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

- to passive sales and services income which is subject to transfer pricing.

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

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

- many Australian firms have reached the limits of possible growth in Australia. Expansion overseas is driven by business considerations, not merely to find a more favourable tax regime;

- the Organisation for Economic Cooperation and Development (OECD) Tax Competition project is identifying harmful tax practices in some countries and taking steps to remove their harmful features. This facilitates making judgments based on countries' systems overall rather than dissecting all the features of their tax regimes;

- international trade has increased between related parties compared to unrelated parties. This has led to coordinated international action against, and a much higher profile for, transfer pricing. (The OECD produced its Guidelines on Transfer Pricing in 1995 and has updated them several times.) The CFC regime

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

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

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

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

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

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

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

Potential solutions

Exemption for BELCs

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

example, NZ does not have a CGT regime; untaxed capital gains of defined types arising in NZ could be a listed feature. These situations would be specific and much narrower than the current listing.

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

- limiting the BELC exclusion to income sourced in the BELC or otherwise included in its tax base (or sourced in or otherwise included in the tax base of any other BELC); and

- limiting the BELC exemption to CFCs deriving income mainly from a BELC. For example, a de minimis rule could allow a small percentage of income sourced outside the BELC.

Advantages and disadvantages

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

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

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

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

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

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

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

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

Recommendation 3:

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

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

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

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

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

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

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

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

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

Advantages and disadvantages

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

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

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

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

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

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

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

Option 3.1: Extending CGT rollover relief

Recommendation 3.1(1):

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

Recommendation 3.1(2):

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

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

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

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

Advantages and disadvantages

3.36 The Board accepts the need to reform the tainted-income rules. A number of submissions suggested handling the problem by distinguishing between active and passive businesses of providing services. However, rapid developments in the high-value services area make enduring definitions difficult. Further tinkering with the

definitions of tainted sales and tainted services income is likely to add to complexity and compliance costs without fully solving the problems. Where the concern is transfer pricing out of Australia, the Board considers that Australia's transfer pricing regime is sufficient and reliance could be placed solely on the transfer pricing rules, not the CFC regime. Where the concern is the movement of service capacity from Australia, the issue for taxation of income from services under the CFC rules is in essence no different to that for sales income. Different treatment would disadvantage companies deriving services income internationally compared to others.

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

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

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

Option 3.2: Reforming the tainted services income rules

Recommendation 3.2:

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

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

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

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

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

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

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

Recommendation 3.3:

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

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

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

3.43 The FSI Subcommittee of the National Tax Liaison Group has maintained a list of CFC issues (CFC issues register) for a decade. A large number of submissions referred to this list, and called for immediate action. The submissions pointed out that

the issues have remained unresolved for many years, even though CFC issues had been raised in two major reviews (the 1997 CFC review[4] and the RBT).

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

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

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

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

3.47 Conversely, there is concern that marginal tinkering:

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

Advantages and disadvantages

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

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

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

Recommendation 3.4:

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

(a) currency exchange fluctuations;

(b) limited liability companies and limited partnerships;

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

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

Tax Treaties

Policy objectives

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

Current position

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

- a wide definition of permanent establishment (PE), which increases Australia's taxing rights over non-residents' business operations in Australia; and
- relatively high withholding tax rate ceilings for dividends, interest and royalties derived by non-residents from Australia.

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

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

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

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

Problems

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

3.56 Further, the treatment of capital gains has been a vexed issue under pre-CGT treaties for over a decade. The overwhelming private sector view is that pre-CGT treaties override the domestic CGT rules. However, the ATO view is that they do not. This standoff has detrimental effects on investment decisions by non-residents in

relation to Australia, as the CGT treatment of the investment is uncertain. While the position under more recent DTAs is clear, the broad CGT jurisdiction claimed by Australia is out of line with international norms and also affects investment decisions by non-residents under these treaties.

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

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

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

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

Evidence of the problems

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

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

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

Policy issues arising from the problems

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

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

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

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

3.66 The UN Model Double Tax Convention between Developed and Developing Countries was designed for situations where investment and trade flows are not in balance. This is the typical situation between a developed and a developing country. It

gives greater emphasis to source basis taxation to ensure that revenue from trade and investment is shared fairly between the two countries.

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

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

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

Potential solutions

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

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

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

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

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

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

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

Option 3.5: Australia's future treaty practice

Recommendation 3.5:

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

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

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

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

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

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

Recommendation 3.6:

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

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

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

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

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

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

Option 3.7: Priorities in negotiation

Recommendation 3.7:

The Board recommends that the Government set the following priorities:

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

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

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

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

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

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

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

Option 3.8: Improving consultation arrangements

Recommendation 3.8:

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

Conduit income

Policy objectives

3.84 Conduit income raises two related policy issues:

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

Current law

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

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

3.86 Depending on these factors, the dividends may be exempt, partially exempt, subject to a foreign tax credit in whole or part (and relating to underlying corporate tax, or dividend withholding tax, or both), or simply taxable. Most dividends paid to Australia are received by Australian companies from non-portfolio interests in foreign companies. They are generally exempt from tax if they are paid by companies resident

in either BELCs or LELCs. The exemption does not generally apply to dividends received directly (or in some cases indirectly) from unlisted countries.

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

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

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

Problems

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

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

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

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

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

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

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

Evidence of the problems

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

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

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

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

Policy issues arising from the problems

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

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

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

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

3.104 The combination of these policies also produces a conduit situation — that is, foreign income passes through a country to non-resident owners without tax in a direct investment situation. Unless appropriate policies are adopted, it becomes necessary to create special rules to deal with conduit situations. The FDA serves this purpose in current law for outgoing dividends (there is no relief for capital gains). But the FDA

covers only incoming dividends; it does not cover other FSI. The RBT recommended that other income be covered by the account, so that conduit treatment is also possible for other types of foreign income such as foreign branches.

Potential solutions

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

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

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

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

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

Option 3.9: General exemption for non-portfolio dividends

Recommendation 3.9:

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

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

3.109 Constructing a targeted conduit regime is fraught with difficulties:

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

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

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

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

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

- CGT exemption for sale by an Australian resident of a non-portfolio interest in a foreign company that has an underlying active business — see Recommendation 3.10(2);

- simplifying the CFC regime (exemption for CFCs in relation to income from BELC) — see Recommendation 3; and

- exempting non-portfolio gains on shares in Australian companies — see Recommendation 3.11(2).

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

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

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

Recommendation 3.10(1):

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

Recommendation 3.10(2):

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

Recommendation 3.10(3):

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

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

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

3.116 The FDA currently is part of limited conduit arrangements. In the form of an FIA, it will still be used for conduit type treatment of dividends under the streaming proposal in Chapter 2 (see paragraph 2.45). However, Australia is moving to a treaty policy of exempting non-portfolio dividends from Australian withholding tax, as in the recent US Protocol. This treatment goes beyond conduit relief (as it also covers dividends out of Australian source profits). But the adoption of the previous two recommendations will effectively provide conduit relief for non-portfolio dividends

from foreign companies (Recommendation 3.9) and capital gains on non-portfolio interests in foreign companies conducting an active business (Recommendations 3.10(2) and 3.10(3)). Again, the Board considers that broader systemic measures of this kind are more effective than a specific regime to achieve conduit relief. Therefore, it was not considered necessary to include any other form of foreign income in this recommendation. With respect to allowing the tax free flow through of foreign income amounts along a chain of Australian companies, the Board has had insufficient evidence put to it on whether the benefits outweigh the revenue cost and other integrity issues for it to determine whether it should make a recommendation. The Board believes that further work should be undertaken to establish the viability of such a proposal.

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

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

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

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

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

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

Recommendation 3.11(1):

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

Recommendation 3.11(2):

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

Company residence

Policy objectives

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

Current law

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

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

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

Problems

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

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

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

Evidence of the problems

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

Policy issues arising from the problems

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

Potential solutions

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

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

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

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

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

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

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

Option 3.12: Residence of companies

Recommendation 3.12:

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

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

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

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

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

Option 3.13: Dual residents

Recommendation 3.13:

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

Administration and integrity issues

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

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

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

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

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

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

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

The Hon Peter Costello MP
Treasurer
of the Commonwealth of Australia

NO.109

BOARD OF TAXATION REVIEWS

As part of the Government's commitment to ensuring that the tax system is operating effectively, I have asked the Board of Taxation to undertake reviews of two different aspects of the tax system.

First, I have asked the Board to undertake a review of the foreign source income anti-tax-deferral regimes. This review builds on the significant inroads that the Government has achieved to simplify and reduce the complexity of the tax laws through the Government's responses to the Review of International Taxation Arrangements (RITA).

Australia has several anti-tax-deferral regimes which are designed to prevent resident taxpayers from using foreign entities to defer or avoid Australian tax — the controlled foreign company, foreign investment fund, transferor trust and deemed present entitlement regimes.

Business has raised a number of concerns with Government about the anti-tax-deferral regimes, including that they are complex and involve substantial compliance and administration costs. Additionally, in some cases they are poorly targeted, potentially impacting on offshore investment decisions that are not motivated by tax deferral reasons.

Against this background, I have asked the Board to review the operation of the anti-tax-deferral regimes. The objectives of the review are:

- to reduce the complexity and compliance costs associated with the anti-tax-deferral regimes including whether the current regimes can be collapsed into a single regime; and
- to examine whether the anti-tax-deferral regimes strike an appropriate balance between effectively countering tax deferral and unnecessarily inhibiting Australians from competing in the global economy.

The review will involve extensive consultation with stakeholders. Following this broad consultation, the Board will report to Government in mid-2007 on the outcome of the review.

Second, I have asked the Board to undertake a review of the taxation treatment of off-market share buy-backs. This review will help the Government to determine whether the taxation treatment of off-market share buy-backs should be changed with a view to increasing certainty for businesses and reducing compliance costs.

In conducting the review, the Board will take into account:

- the factors influencing the increasing trend towards the use of off-market share buy-backs;
- the implications of the current taxation treatment of off-market share buy-backs for different types of shareholders;
- the compliance cost impacts of off-market share buy-backs;
- the administrative practices of the Australian Taxation Office relating to off-market share buy-backs;
- the basis for splitting the proceeds of off-market share buy-backs into a dividend component and a capital component;

- the application of the dividend streaming rules to off-market share buy-backs;
- the capital gains tax implications of off-market share buy-backs; and
- any other matters the Board considers to be appropriate.

The Board will conduct consultations with stakeholders and make recommendations on the appropriate taxation treatment of off-market share buy-backs. It will report to Government in the second half of 2007.

The Board of Taxation's charter includes providing advice to the Government on the quality and effectiveness of tax legislation along with the general integrity and functioning of the tax system. Details about the Board of Taxation can be found at http://www.taxboard.gov.au.

CANBERRA
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