MONASH UNIVERSITY

Faculty of Business and Economics

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The International Taxation Project
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
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Dear Sir,

SUBMISSION ON THE REVIEW OF INTERNATIONAL TAX ARRANGEMENTS CONSULTATION PAPER

We welcome the Board of Taxation's release of the Review of International Taxation Arrangements Consultation Paper ("**Consultation Paper**") for public comment. We have addressed a number of issues raised in the Consultation Paper and our comments on these issues are provided below.

SUBMISSION ON CHAPTER 2

Chapter 2 of the Consultation Paper recognises concerns expressed by the business community that the imputation system favours domestic investment as it only provides franking credits for the payment of Australian income tax. Accordingly, while an Australian company obtains franking credits for the tax it pays on its Australian operations, it does not obtain franking credits for the following:

- payments of foreign tax on its direct investments offshore through a branch;
- withholding tax paid on foreign dividends received from foreign companies that it has invested in; or
- foreign underlying tax paid by foreign companies that it has invested in.

The broad policy of the imputation system is to ensure that the underlying profits of an Australian company are ultimately subject to tax at its resident shareholders' marginal tax rates when distributed to them. This is achieved by the gross up and (generally refundable) credit mechanism.

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When an Australian company pays its resident shareholders dividends, the company's underlying foreign profits can be subject to tax at a rate that is greater than the shareholders' marginal tax rates since foreign profits are paid to them as unfranked distributions and can therefore be subject to double taxation. For instance, by virtue of the operation of section 23AJ or 23AH of the *Income Tax Assessment Act 1936* (Cth), non-portfolio dividends and certain branch profits are exempt from tax in Australia in the hands of resident companies. However, on distribution of these exempt foreign amounts, resident shareholders will need to still pay Australian tax. This is the case even though foreign taxes (including withholding tax) may have already been paid on these amounts.

Given this situation, the international tax system creates a disincentive for Australian companies to invest offshore. Expressed in another way, the imputation system creates an incentive to pay Australian tax as opposed to foreign tax because of the availability of franking credits. There is therefore a conflict between the operation of the imputation system and the need for Australian companies to become globally competitive and expand offshore.

The difficulty in trying to rectify the above problem is that any solution will come at a potential cost to the Australian Government. Therefore, ultimately the appropriate solution will depend on the Government's ability to, in effect, fund the recommendations.

The Consultation Paper examines three options to encourage foreign investment by Australian companies. These options are explained in the Consultation Paper and our views on them are outlined below.

Option A - domestic shareholder relief for unfranked dividends out of foreign source income

Option A suggests possibly introducing a non-refundable tax credit of, for example, one-ninth of unfranked dividends paid out of designated foreign source income. This option adopts an arbitrary credit which is not tied to any actual payments of foreign tax. Therefore while it provides relief, it may not provide full relief against foreign taxes. Nevertheless, it goes a step towards addressing the conflict.

Option B - allowing dividend streaming of foreign source income

Option B proposes to allow resident companies to stream unfranked dividends to non-resident shareholders, so that franked dividends can be paid to those shareholders that can most use the credits. The problem with this option is that for it to be of benefit it requires an Australian company to have both resident and non-resident shareholders. It will therefore not benefit a company with only resident shareholders. Also the benefit of streaming will vary depending on the ratio between resident and non-resident shareholdings. In addition, allowing streaming for payments to non-residents, while retaining streaming for payments to residents, creates imbalances in the system which, as a matter of general policy, should be avoided. We therefore do not recommend this as an appropriate option.

Option C - providing franking credits for foreign dividend withholding taxes

Option C only provides a benefit where withholding tax has been paid. Obviously, it will therefore be of no value where no withholding tax is payable - such as will be the case with dividends paid from companies resident in certain jurisdictions (eg the United States).

Recommendation

We recommend that a combination of Option A and Option C be adopted.

Option A would apply to all unfranked dividends paid out of designated foreign source income and would therefore not generally discriminate between dividends. While it might not necessarily alleviate the effect of all foreign tax paid, it will go some way to addressing the problem. As a fixed credit, it also offers the benefits of simplicity. We have not considered whether a one-ninth credit is the appropriate amount as ultimately this depends on the extent to which the government is prepared to fund this kind of tax expenditure. Obviously the greater the credit, the greater the incentive to operate offshore.

By also allowing franking credits for withholding tax, Option C prevents discrimination against Australians that invest in companies that operate in countries that impose withholding tax as opposed to Australians that invest in companies that operate in countries that do not impose withholding tax.

SUBMISSION ON CHAPTERS 3 AND 4

The CFC, FIF and transferor trust rules are all targeted at essentially the same "abuse" namely sheltering specific kinds of income in tax havens so as to defer a liability to Australian tax. The present regimes are incredibly complex and scattered throughout the legislation. While we do not have specific information about the compliance costs associated with these regimes, we anticipate that they would be quite high.

Recommendation

We submit that the provisions should be redrafted as one entire discrete regime rather than three separate regimes. We also recommend that the provisions should not be drafted in such a way that they operate as a "catch all" regime, but rather as a specifically targeted anti-avoidance regime which only applies to special categories of deferred income subject to a generous *de minimis* rule and other appropriate exemptions.

Once a review of the existing broad exemption listed countries has been completed, as a measure to simplify the international tax regime, it would be worthwhile considering totally removing both CFCs and FIFs in broad exemption listed countries from the accruals regimes given that, in any case, many of these countries would have their own accruals regimes.

It would also be worthwhile considering totally abandoning the FIF regime and only focusing accruals taxation measures on controlled arrangements, such as is the case with the CFC regime. It is understood that there is only a relatively small amount of revenue collected under the FIF regime and that there are high compliance costs associated with it. It is therefore an inherently inefficient taxing regime which only serves to further complicate the tax law.

Alternatively, it would be appropriate to limit the operation of the FIF regime by substantially increasing the FIF exemptions. In this respect, it would be worthwhile considering increasing the *de minimis* exemption from $50,000 to say $1m so that only large investors would fall within the regime. Likewise, the 5% balanced portfolio exemption should be increased to a more realistic figure of around the 20% mark.

Furthermore, for the reasons outlined in the Consultation Paper and to further encourage superannuation investment, it would be appropriate to completely exempt complying superannuation funds from the FIF rules. Given the onerous burdens of the FIF regime, it would also be worthwhile considering exempting interests held in widely-held managed funds from the operation of the regime.

We thank the Board for the opportunity to comment and look forward to being involved in future consultations.

Yours sincerely,

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