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REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS

A Joint Submission to the
Board of Taxation by the
Business Council of Australia and
the Corporate Tax Association

CORPORATE TAX
ASSOCIATION
of Australia Incorporated

BUSINESS
COUNCIL OF
AUSTRALIA

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Table of Contents

1	Executive Summary	3
1.1	The Business Council of Australia Discussion Paper	3
1.2	Treasury Consultation Paper	5
1.3	Comments on the Principal Issues in the Treasury Consultation Paper	6
1.3.1	Attracting equity for offshore expansion	6
1.3.2	Australia as a location for internationally focused companies	7
1.3.3	Controlled foreign company rules	8
1.3.4	Tax treaties	8
1.3.5	Conduit Income	9
1.3.6	Residency	9
1.3.7	Australia as a global financial services centre	10
1.3.8	Improving Australia's tax treatment of expatriates	10
2	Introduction	11
2.1	Why Australia's international tax arrangements need modernising	11
3	Attracting Equity Capital for Offshore Expansion	17
3.1	Imputation bias at the shareholder level	17
3.2	Taxing income and capital – a policy framework	18
3.3	Shareholder credit	19
3.4	Partial dividend exemption	20
3.5	Dividend streaming	21
3.6	Imputation credits for foreign dividend withholding tax	21
3.7	Trans-Tasman arrangements	22
3.8	Recommendation	22
4	Promoting Australia as a Location for Internationally Focused Companies	23
4.1	The Controlled Foreign Company (CFC) Rules	23
4.2	Overview of Recommendations	23
4.2.1	Immediate recommendations	23
4.2.2	Medium term reforms – 12-18 months	25
4.2.3	Longer term – 2-4 years	25
4.3	The CFC Rules – Immediate Reform Recommendations	26
4.3.1	Broad exemption listed countries and the CFC rules	26
4.3.2	Foreign non-portfolio dividends and foreign branch profits	28
4.3.3	Non-portfolio interests in foreign companies	33
4.3.4	The tainted services income rules	34
4.3.5	Outstanding technical issues	40
4.4	Medium term reforms	40
4.4.1	Expand CFC rollover relief	40
4.4.2	The number of broad exemption listed countries	44
4.4.3	"Safe harbour" measures to improve the operation of the CFC rules	47
4.4.4	Investing in strategic international joint ventures	50
4.4.5	Transfer pricing rules for CFC attribution purposes	51
4.4.6	The quarantining of losses incurred by CFC's	52
4.4.7	Repeal section 47A	54
4.4.8	Attribution of income derived by a CFC	55
4.4.9	Attribution of capital gains made by CFCs	55
4.4,10	The sale of non-residents of non-resident interposed entities	56
4.5	Tax Treaties	58
4.5.1	Future treaty negotiations	58
4.5.2	Priority for tax treaty negotiations	60
4.5.3	Negotiating tax treaties	62

4.6	Promoting Regional and International Headquarter Conduit Companies	63
4.6.1	Recommendations	64
4.6.2	General Exemption	64
4.6.3	Disposing of an interest in a foreign company	66
4.6.4	A conduit holding company regime	68
4.6.5	Conduit restructure relief	68
4.6.6	Disposal of a foreign investor of an interest in an Australian company which has foreign assets	69
4.7	The Company Residence Test	69
4.7.1	Recommendation	69
4.7.2	A simple residency test	74
4.7.3	Treatment of a company that is a non-resident for tax treaty purposes	75
5	Promoting Australia as a Global Financial Services Centre	77
5.1	The Foreign Investment Fund (FIF) rules	77
5.2	Broad exemption listed countries and the FIF rules	77
5.3	Non-residents investing in unit trusts	78
5.4	Withholding taxes on distributions to non-residents	79
5.5	Other exemptions from the FIF rules	79
5.6	Fund management services as an eligible activity	80
5.7	Branches	80
6	Improving Australia's tax treatment of foreign expatriates	81
6.1	Temporary Resident Measures	82
6.1.1	The problem is not about "wealthy" foreign executives	82
6.1.2	Additional costs for Australian business	83
6.1.3	Taxation treatment in overseas countries	85
6.2	CGT treatment of departing residents	86
6.3	CGT security deposit measures	86
6.4	Reform of expatriate CGT in general	87
6.5	The double taxation of employee share options	89
6.6	Division 13A cessation event	91
6.7	An ATO cell for expatriates	91
6.8	Other issues for consideration	91
6.8.1	Non-Australian workdays	92
6.8.2	An objective residency test for inbound residents	92
6.8.3	Superannuation	92
7	Glossary	95
8	Appendix A: CFC National Issue Register	97

1. Executive Summary

This review of Australia's international taxation arrangements by the Board of Taxation is an important opportunity to ensure our tax system is keeping pace with a rapidly changing global market for investment and talent, and is promoting Australia's future prosperity.

International taxation arrangements directly affect:

- the attractiveness of Australia to inbound investment;
- our appeal as a location for regional headquarters of international businesses;
- the ability of Australians to take advantage of business and investment opportunities abroad; and
- our ability to compete for internationally mobile, highly-skilled personnel.

The rapid and ongoing globalisation of the international economy presents Australia with both threats and opportunities. Constantly positioning ourselves to capture those opportunities and to overcome the threat of becoming marginalised is our central, long-term national economic challenge. Our international taxation arrangements are a key element in meeting that challenge.

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

Against this background the Review of International Taxation Arrangements is welcomed. This Review provides a timely opportunity to remove the obstacles, strip out the complexity and enhance the competitiveness of our approach to international taxation.

The Business Council of Australia and the Corporate Tax Association welcome the opportunity to provide a submission to the Board of Taxation on the Review of International Taxation Arrangements.

We look forward to continuing the consultation process with the Board, Department of Treasury and other stakeholders with the view to ensuring that reforms to our international tax system maximise the growth opportunities for Australian and international businesses.

1.1 The Business Council of Australia Discussion Paper

In December 2001, the Business Council of Australia released the discussion paper *Removing Tax Barriers to International Growth*. The Business Council paper, commissioned from Andersen, made a major contribution to the debate about how Australia can best design and administer a tax system that maximises the potential growth opportunities for its businesses.

The paper's principal recommendations covered:

- **Internationally-competitive holding company regime**
  - encourage Australian holding companies for Australian-owned businesses and foreign-owned international groups
  - allow flow-through of foreign income and certain gains to non-residents
- **Dividends**
  - review and modernise dividend imputation
  - allow streaming of imputation credits
  - renegotiate double tax agreements to reduce withholding taxes
- **Capital Gains Tax**
  - reforms for conduit holding companies to enhance Australian holding companies in global groups
  - review positions on capital gains and pre-CGT double tax agreements
- **Controlled foreign company (CFC) rules**
  - modernise to allow appropriate use of foreign subsidiaries
- **Corporate residency**
  - modernise rules to enhance Australian management of foreign companies
- **Thin Capitalisation**
  - remedy black holes to ensure that disallowed funding costs can be recoverable in later years
- **Intangibles**
  - allow amortisation of intangible assets
  - reduce withholding tax under double tax agreements
- **Foreign Investment fund**
  - streamline rules to remove impediments to offshore investments by Australian businesses
- **Expatriates**
  - introduce temporary resident status for some expatriates
  - adjust superannuation treatment

- adjust treatment of pre-residence assets and income from those assets
- adjust treatment of pre-residence employees shares

We are pleased to see that the Business Council of Australia's discussion paper has formed the basis of the Treasury consultation paper on International Taxation Arrangements and has helped to set the agenda for the removal of tax-related obstacles to the continuing development of Australia as a base from which to conduct international business.

1.2 Treasury Consultation Paper

The consultation paper on the Review of International Taxation Arrangements (Treasury consultation paper) was prepared and released by the Department of Treasury in August 2002.

The paper explores a range of international tax issues that may affect the attractiveness of Australia as a place for business and investment, and identifies reform options as a basis for consultation.

The principal objectives of the options outlined in the paper are to:

- attract equity capital for offshore expansion;
- promote Australia as a location for internationally focussed companies;
- promote Australia as a global financial services centre; and
- improve Australia's tax treatment of foreign expatriates.

Recommendations

The Business Council of Australia/Corporate Tax Association submission addresses the principal issues contained in the Treasury consultation paper.

We have not sought to extend our submission by including all issues contained in the Business Council's discussion paper. Our submission does, however, recommend options not necessarily canvassed in the Treasury consultation paper. In addressing the issues identified, we have sought to recommend the option that we believe provides the most practical and effective outcome for Australian business.

We do note however, that the Board has previously proposed a process for systemic ongoing review and consultation in relation to taxation law in general. We support this proposal, and our recommendations in relation to international taxation arrangements should be considered within the framework of this process. We would be keen to participate in any consultative committee associated with this ongoing review.

Our recommendations are as follows:

- The introduction of a 3/7th shareholder credit or a partial exemption approach, in tandem with dividend streaming, to address the bias against Australian businesses undertaking direct investments offshore.

- Reform of the controlled foreign company (CFC) rules by:
    - excluding from the attribution rules CFCs resident in countries on the broad exemption list;
    - exempting non-portfolio dividends;
    - exempting the sale of non-portfolio interests in foreign companies from capital gains tax;
    - abolishing, or at the very least modifying, the tainted services income rules;
    - establishing a process for addressing the outstanding technical issues already brought to the attention of the Australian Taxation Office; and
    - implementing CFC reforms in the medium and longer term to achieve a better balance between integrity of the system and its operational simplicity.
- the adoption by Australia of its own published model tax treaty, building on our experiences with the recently negotiated Australia-US protocol.
- the introduction of a general exemption for non-portfolio dividends received from foreign companies and for capital gains derived from the sale of non-portfolio interests in foreign companies.
- the adoption of a residency test based on country of incorporation.
- the fundamental redesign of the foreign investment fund (FIF) rules, at the earliest opportunity.
- reform of the tax treatment of executives working temporarily in Australia and Australians working overseas.

1.3 Comments on the Principal Issues in the Treasury Consultation Paper

1.3.1 Attracting equity for offshore expansion

Our current international taxation arrangements create an inherent bias against investment in Australian companies that derive most of their profits offshore. A major focus of this review should be to eliminate this bias.

Under the current dividend imputation system, Australian resident shareholders only receive franking credits on dividends paid by resident Australian companies where Australian company tax has been paid. Australian resident shareholders do not receive credits for foreign company tax paid by a branch or offshore subsidiary of an Australian company.

As resident investors judge investment choices on an after-tax basis, 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.

To expand offshore, Australian businesses need to access both domestic and foreign sources of equity capital. By effectively double taxing the foreign income of Australian companies, the dividend imputation system favours investment in companies which derive their income domestically, thereby increasing the cost of capital for Australian businesses undertaking direct investments offshore.

It is claimed in the Treasury consultation paper that this bias should not affect a resident company's cost of capital. We strongly disagree with this and believe that domestic investors will always have an important bearing on new equity raisings, and hence the cost of funds, for Australian companies.

While we firmly support reform to address the bias, we do not believe this should be achieved through changes to the dividend imputation system. Rather, measures should be adopted that operate in conjunction with the imputation system.

We recommend therefore that either a 3/7th shareholder credit or a partial exemption approach be introduced, in tandem with dividend streaming. Additional work should be carried out to weigh up the respective advantages and disadvantages of the two approaches. Such further work should have regard to factors including the impact on the cost of capital, integrity issues, compliance concerns and the likely impact on profit repatriation.

The Treasury consultation paper suggests addressing the bias through a 1/9th non-refundable shareholder credit. While we believe that this would be an important step in the right direction, we do not consider it goes far enough in terms of mitigating the high effective tax rates faced by shareholders receiving unfranked distributions out of taxed foreign earnings.

For the shareholder credit proposal to have an impact on behaviour, we consider it would need to be increased significantly. A credit of 3/7th of the unfranked dividend paid out of a designated foreign income account would provide relief for foreign sourced dividends on the same basis as dividend imputation does now in respect of domestic earnings.

An alternative option would be to adopt a partial exemption model for foreign source income, which allows exempt dividend income to flow through a chain of entities to the ultimate shareholder (either resident or non-resident). The ultimate shareholder would then be subject to tax under a partial exemption approach if they were a resident, and full exemption if they were a non-resident.

We support the option in the Treasury consultation paper to provide dividend streaming. It directly addresses the bias at the resident shareholder level by allowing Australian companies to provide access to foreign profits directly to foreign shareholders. The current law prevents dividend streaming and consequently creates legislative complexity and increases administrative and compliance costs.

1.3.2 Australia as a location for internationally focused companies

International tax arrangements can affect the attractiveness of Australia as a location for Australian-based businesses and regional holding companies.

The issues that are relevant to promoting Australia as a location for internationally focussed companies are:

- controlled foreign company rules;

- Australia's tax treaty network;
- treatment of income repatriated from direct investment offshore;
- conduit income arrangements; and
- determination of the place of residency of a company.

1.3.3 Controlled foreign company rules

Australia's controlled foreign company (CFC) rules aim to prevent residents accumulating "tainted income" taxed at low or zero rates in foreign entities. Tainted income comprises passive income, such as dividends, interest and capital gains on certain assets and tainted sales and services income.

The international business and tax environments have changed markedly since the introduction of the CFC rules in the late 1980s. This has resulted in a significant misalignment between the CFC rules and international business practice, so that the rules are now creating a number of unwarranted taxation impediments for Australian businesses.

As a very effective initial step, we recommend that CFCs resident in countries on the broad exemption list be entirely excluded from the attribution rules. This would result in a substantial and immediate reduction in compliance costs for Australian business, and could be achieved without any significant adverse revenue impact.

We recommend the provision of a general exemption for non-portfolio dividends and exempting the sale of non-portfolio interests in foreign companies from capital gains tax. We also recommend the abolition, or at the very least modification, of the tainted services income rules.

There are specific technical issues brought to the attention of the Australian Taxation Office that we recommend also be addressed immediately.

In the medium to longer term we recommend the implementation of reforms that will achieve a better balance between integrity of the system and its operational simplicity.

1.3.4 Tax treaties

Tax treaties govern the division of resident and source taxing rights between two countries. They aim to facilitate cross-border trade, investment and movement of people by preventing double taxation of income arising from those activities.

Australia has tended to emphasise its source taxing rights in its treaties, and this has resulted in higher than normal withholding tax rate limits. These higher levels of withholding tax disadvantage Australian companies operating offshore. The current treaty system is also extremely unresponsive to rapid change.

We recommend that Australia should adopt its own published model tax treaty, building on experience with the recently negotiated Australia-US protocol.

1.3.5 Conduit Income

Generally, residents of Australia are taxed on their worldwide income, whereas non-residents are only taxed on income considered to have an Australian source. However, under current Australian law, a non-resident investing in foreign assets through an Australian company can often be subject to Australian tax on income that is generated from those foreign assets. Any gain on the disposal of those foreign assets is also generally subject to Australian tax.

Conduit income is foreign source income non-residents earn through an Australian entity. The Treasury consultation paper acknowledges that the general policy should be to avoid taxing conduit income.

We support this policy and recommend that a general exemption should be provided for non-portfolio dividends received from foreign companies and for capital gains derived from the sale of non-portfolio interests in foreign companies.

Australia has never taxed the foreign source income of non-residents, and we firmly believe that the same policy principles should apply to foreign non-portfolio dividends and capital gains of Australian companies owned by foreign investors.

There should be no incidence of Australian tax simply because a non-resident has chosen to own assets through an Australian company. To do so would perpetuate the disincentive that currently exists to use Australia as a holding country for regional investments.

We believe that this measure should be revenue positive, as it would encourage greater Australian employment and involvement in the management of international activities.

We consider that the exemption of foreign non-portfolio dividend income and capital gains on disposal of foreign assets should also apply to Australian based companies which are not foreign owned. We see this extension as an important element in neutralising potential OECD resistance to conduit companies, and is an important element of neutrality for Australian companies.

1.3.6 Residency

Under current law, a company incorporated outside of Australia is taken to be resident in Australia for tax purposes if it carries on business here and has its central management and control in Australia or has its voting power controlled by Australian resident shareholders.

The current test raises a number of practical uncertainties, particularly where directors are located in more than one country and where board meetings are held by phone or video conference. A further uncertainty is the extent to which commercial activity can constitute the carrying on of business in Australia, and thus residence, where central management and control or voting power is located here.

We support, as a first step, the clarification of the residence test to ensure that merely exercising central management and control in Australia does not constitute the carrying on of a business. This could be done by way of a simple amendment to the legislative definition of residence to provide that a company shall not be deemed to carry on a business in Australia as a consequence of exercising its central management and control here.

However, we believe that reform should go further and re-examine the continuing appropriateness of a central management and control test. We recommend a residency test based on country of incorporation. Such a test would be simple to apply in practice and would eliminate the administrative burden and the negative policy implications associated with the current test.

1.3.7 Australia as a global financial services centre

As acknowledged in the Treasury consultation paper, the current foreign investment fund (FIF) rules are overly and unnecessarily complex and result in high compliance costs for affected taxpayers and managed funds. The rules also catch investments beyond those at which they are targeted.

While the Treasury consultation paper acknowledges the problems, the options proposed are inadequate and are not sufficient substitutes for a fundamental redesign of the FIF rules.

We recommend that the Government commit to a fundamental redesign of the FIF rules at the earliest opportunity.

We further believe that a consultative process needs to be established with business to examine how the numerous technical problems within the existing FIF rules can be addressed.

1.3.8 Improving Australia's tax treatment of expatriates

The growing international focus of business means it is now common for middle level and senior executives to be employed internationally. The current international taxation arrangements penalise Australian executives posted overseas and foreign executives posted to Australia by their global companies. The arrangements also make it more difficult for Australian companies to attract people with specific skills needed to allow those companies to compete successfully at a global level.

These issues affect people on middle to higher level incomes. They affect talented young people with families and children as much as they affect senior CEO-level people.

The Government has previously announced 'temporary resident' tax exemptions for foreign nationals working in Australia. The measures, however, were rejected by the Senate and have recently been re-introduced into Parliament[1].

We fully support these measures as an important first step in removing the disincentives to the employment of foreign expatriates. We also support measures to address the double taxation of employee share options.

We do not, however, support the Review of Business Taxation[2] recommendation that residents departing Australia provide security for deferred capital gains tax liability. This would be both costly and contrary to current Government policy.

[1] Taxation Laws Amendment Bill (No. 7) 2002.
[2] "A Tax System Redesigned", *The Review of Business Taxation,* Report, July 1999, Recommendation 22.20.

2. Introduction

While ours is a growing and vibrant economy, Australia accounts only for around one and a half percent of global market capitalisation and we are half a world away from major markets and financial centres.

Sustaining our current rates of growth over the next ten years will deliver a level of national income in 2012 that is around 50 per cent higher in real terms than its 2002 level.[3] If we can do this we will have taken a giant stride towards meeting our broader social objectives.

This will require searching for new sources of economic growth, with the modernisation of Australia's international taxation arrangements being a key priority.

A key element impacting on our ability to at least sustain current levels of growth is the increasing global competition for economic opportunities.

International taxation arrangements occupy a critical place as gateways for our economic links with the rest of the world. They exert their influence:

- on the attractiveness of Australia to inbound investment;
- on our success in promoting ourselves as a location for regional headquarters of international businesses;
- on the ability of Australians to take advantage of business and investment opportunities abroad; and
- on the degree to which we can compete for internationally mobile, highly-skilled personnel.

We need to ensure these gateways are open and clear of unnecessary obstacles. This is vital if are to compete for higher levels of inbound investment and business activity, and if we are to improve our ability to participate in the international economy. This is also vital if we are to ensure we can attract and retain highly-skilled personnel.

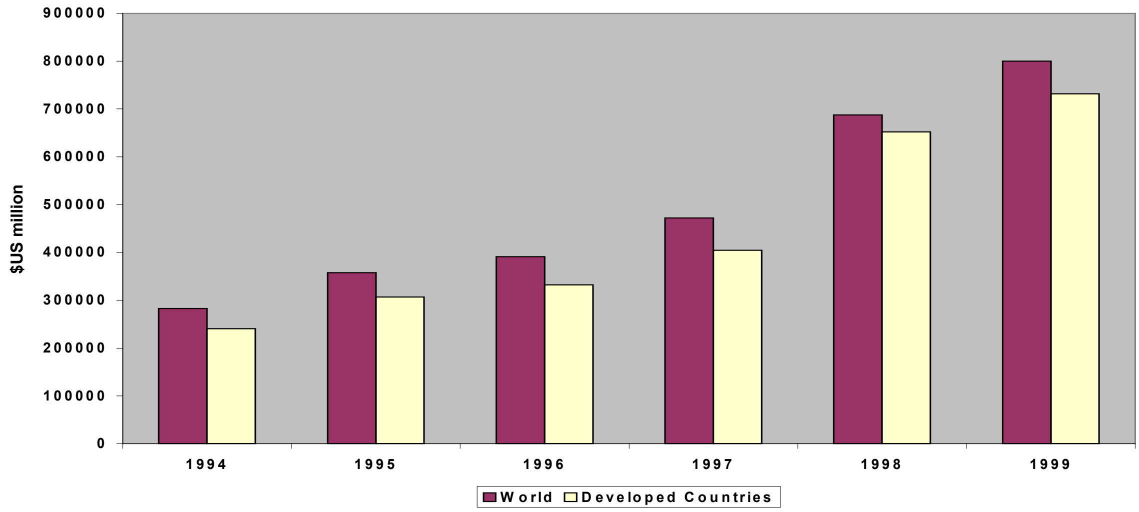
These are core components in our ability to at least sustain current rates of economic growth.

2.1 Why Australia's international tax arrangements need modernising

The world and Australia's place in it are changing rapidly. Across the world, international investment and business activity are escalating and distinct segments of labour markets are becoming more internationally mobile (see Figure 1).

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

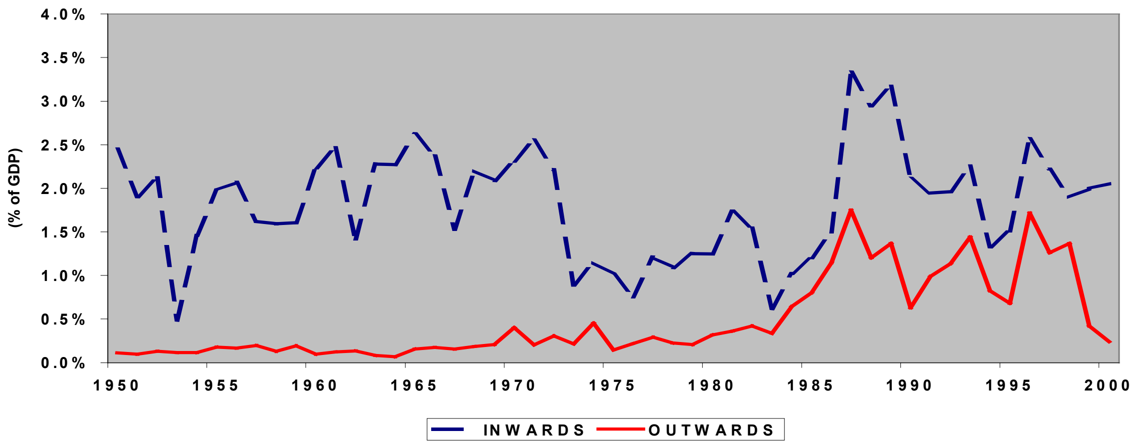
Figure 1: Direct Foreign Investment Outflows 1994-1999[4]



Australia has participated in this growth, and the pace of foreign investment into and from Australia has accelerated, in trend terms, at a rate faster than GDP.

Particularly over the past twenty years, foreign investment from Australia has grown faster than inward investment and, in 2000-01, the value of outwards foreign direct investment exceeded the value of inwards direct foreign investment.[5] (see Figure 2).

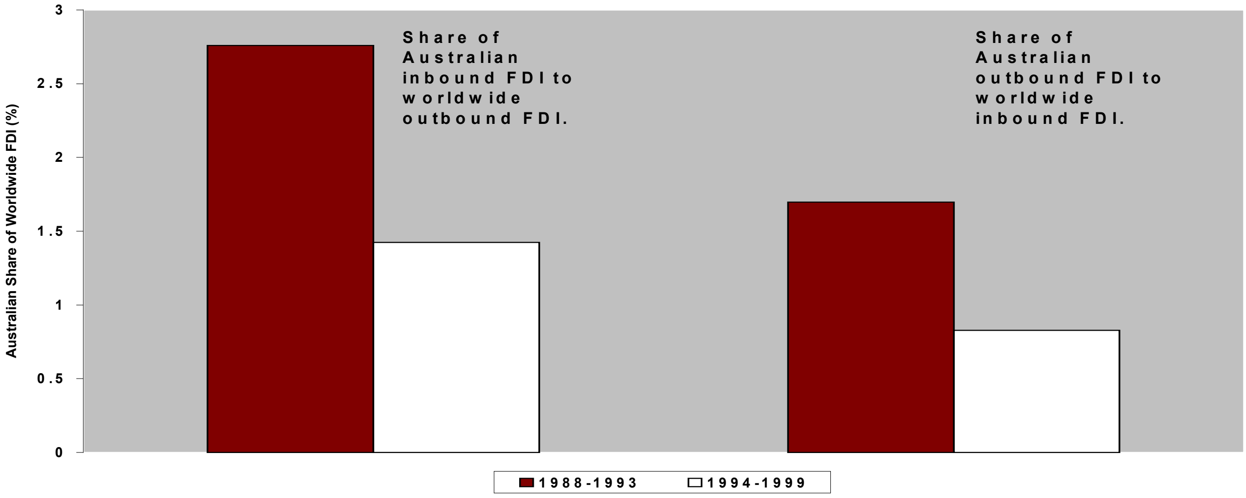
Figure 2: Australian Direct Foreign Investment Inwards and Outwards 1950-2000 Percentage of GDP[6]



While these movements have added to Australia's growth potential, there are strong signs that Australia's competitiveness as both a destination and source of international investment is falling behind the rest of the world (see Figure 3).

[4] United Nations, 2000, *World Investment Report 2000*, p.289.
[5] Productivity Commission, 2002, *Offshore Investment by Australian Firms: Survey Evidence,* p.9.
[6] Australian Bureau of Statistics (ABS), Balance of Payments and International Investment Position, (5363.0).

Figure 3: Australia's Share of Worldwide Foreign Direct Investment (FDI) Annual Averages 1988-93 and 1994-99[7]



At the same time, while Australia continues to be a net beneficiary of (temporary and permanent) skilled migration, there is faster growth of participation in these markets from Australia than of participation in Australia.

A central factor in these worrying developments is the lagging state of our international taxation arrangements. While other countries have made, or are actively considering, major improvements to the competitiveness of their international taxation arrangements,[8] no one familiar with Australia's international tax regime could deny that it presents as a barrier to inbound and outbound investment and that it inhibits our ability to attract and to retain skilled personnel.

Australia's size and our geographical remoteness place us at risk of becoming marginalised in the global economy. We need to ensure we can compensate for the "tyranny of distance" and its associated diseconomies, by developing our commercial links with other countries in our region and further afield.

From a business perspective the importance of reform is compounded by a number of features of the contemporary business environment:

- as the internationalisation of business proceeds apace, more foreign companies are considering Australia as a base from which to direct their growth in the region. Many of these decisions are once-in-a-lifetime opportunities;
- a rising proportion of new Australian businesses are currently seeking early growth opportunities in other countries;
- a large number of well-established, Australian-based companies have become world leaders in their industry sectors with successful operations abroad; and

[7] United Nations, 2000, *World Investment Report 2000*, pp.283&289.

[8] This includes the UK – a very large investor in Australia and a significant (from Australia's point of view) recipient of Australian investment. Other countries that have made major changes recently include Germany, Sweden, Ireland, Singapore and Israel. International taxation features strongly in New Zealand's recent Tax Review 2001 and taxation has been isolated as a critical factor in the increased incidence of US companies reincorporating abroad.

- the combination of increased global opportunities and the relatively uncompetitive status of our taxation of personal income is making it more difficult for Australia to attract and retain highly-skilled personnel.

Many of the most profitable growth paths currently open to international businesses, whether based in Australia or abroad, are littered with obstacles arising from Australia's existing international tax arrangements. These tax distortions can have perverse effects – both for business and for the future growth of the overall economy (and, therefore, the domestic tax base). These inhibiting distortions include the impact Australia's international tax arrangements have on:

- deterring the inflow of investment into Australia – particularly investment related to establishing an Australian base for regional operations;

- creating incentives to shift control centres of Australian businesses offshore and, in the extreme, to encourage a change of corporate residency;

- restraining the rate of growth of Australian investment abroad;

- the imposition of significant compliance and uncertainty barriers to potential business opportunities;

- encouraging Australians to consider alternative countries in which to work; and,

- imposing prohibitive costs on local companies looking to attract skilled employees from abroad and making it unattractive for skilled employees to relocate to Australia.

These are barriers that actively inhibit business's contribution to income creation, productivity enhancement and economic growth.

At the same time, the improvement in our international tax arrangements presents an important opportunity to add to our growth potential.

The international tax debate has evolved from the positive position of how Australia can attract regional headquarters, to the current defensive stance of how Australia will be reduced to becoming a branch office economy. The fundamental issue remains how to sustain Australia's growth path by attracting and retaining high growth dynamic companies. That growth is needed to create employment and economic development.

Many younger, emerging companies have a greater international focus than some of our larger, domestically focussed companies, and emerging companies are often more mobile than larger companies. Tax issues are just as important for dynamic young companies as for large successful companies in Australia. International tax is no longer a big business issue.

Business headquarters not only provide significant direct employment for Australians, they also provide many indirect benefits for Australia. Head offices support a significant services sector, lead to a more internationally attuned debt and equity market and potentially attract further investment in Australia.

In short, to encourage international businesses to locate in Australia, and to ensure that the international and regional headquarters of businesses are retained in Australia, we need to remove the uncompetitive barriers imposed by our international tax rules.

A number of factors influence the decision of an Australian parent company to move offshore or the decision of a foreign multinational company to locate its regional headquarters in Australia. The geographic location of suppliers and customers, capital markets, competition policy, the taxation of both parent company group and executives, as well as the profile of shareholders will all be important factors.

Recognising that taxation may be a significant factor when international investment decisions are considered, many countries have specifically tailored their tax systems to attract new investment. Countries such as the United Kingdom, Germany and Sweden (as well as emerging countries like Singapore, Ireland and Israel) are fine-tuning their tax systems to retain and attract business:

- The UK Government recently stated publicly that it wishes to make Britain "the best place in the world for multinationals to locate"[9].

- Sweden, often proposed as a successful peer of Australia, introduced in its annual Budget for 2001 a series of measures designed to make it a more attractive headquarters location.

- Germany has recently announced tax reform measures for similar purposes.

Businesses, both large and small, and in all industries, are facing increasing challenges to retain their top talent. Competition for the best people is fierce as today's employees have become increasingly mobile and are presented with more options than ever before.

The issue and the challenge is to achieve a truly competitive tax system for all international businesses operating in and through Australia. Only in this way will Australia's natural advantages of our resource base, our talented people and skills, be maximised in a highly competitive international business environment.

[9] UK Pre-Budget Report dated 8 November 2000

3. Attracting Equity Capital for Offshore Expansion

3.1 Imputation bias at the shareholder level

Dividend imputation creates distortions in investment choices at the shareholder level.

By imputing domestic tax paid at the company level to shareholders, Australia's dividend imputation system has, since 1987, provided a strong incentive to invest in domestic companies. Dividend imputation has undoubtedly been an important factor in lifting the level of share ownership by Australian investors to one of the highest in the world.

Imputation works well in a closed economy, where all firms competing for equity capital have their returns to shareholders taxed, by imputing tax paid at the corporate level to individual shareholders on a gross-up and credit basis. Where firms operate globally, however, and pay foreign tax on their foreign earnings, the investment dynamics are altered.

Because competing investment choices are judged by resident investors on an after-tax basis, dividend imputation means that the pre-tax rate of return for Australian based multi-national enterprises with significant overseas operations has to be higher than those of their domestic competitors. When looked at in this way, imputation indirectly creates a bias against investing in Australian based companies that derive most of their profits offshore.

The Treasury consultation paper acknowledges there may be a bias against some Australian companies at the shareholder level, and goes on to ask whether this translates into a structural disincentive against foreign investment, and hence impacts negatively on the cost of capital for such companies. We agree that the rationale for any policy decisions in this area should rest on there being a positive impact on the cost of funds for Australian companies with foreign operations.

The Treasury consultation paper suggests that larger well-established Australian companies typically have access to global capital markets. Therefore, because non-resident investors attach little or no value to imputation credits (which we broadly agree with), addressing the imputation bias at the shareholder level may have little impact on the cost of capital for those companies.

We disagree with that conclusion. The experience of our members is that even companies with significant foreign earnings continue to have a disproportionate domestic shareholder base. This mismatch is the product of the relatively small size of Australian companies, as well as the information costs associated with foreign investors assessing the prospects of such companies in what to them is a distant and unfamiliar market. With very few exceptions, Australian companies simply do not register in foreign equity markets.

While large Australian corporates will make every effort to tap into foreign equity markets, they cannot afford to neglect the domestic market, where they can leverage off their existing shareholder base and where they enjoy a much higher level of recognition.

Other factors which tend to support the active involvement of domestic investors in equity raisings include the widespread use of dividend reinvestment schemes, rights issues, the needs of domestic index investors and imputation funds, as well as the continuing growth of domestic superannuation savings. Domestic investors will always represent a major source of funds in new equity raisings, and franking credits are clearly valued by this important segment of the Australian equities market.

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

Recently published research suggests that imputation credits have significant value in the context of the capital asset pricing model, see for example, Officer (1994)[10] and JB Were (1996)[11]. More recent work by Lally (June 2002)[12] and the ACCC (September 2002)[13] suggest that national equity markets should be seen as segmented rather than integrated, so that foreign investors may be disregarded for the purposes of valuing franking credits. While these studies do not appear to have focused solely on Australian companies that are expanding offshore, neither were they confined to purely domestic companies. Their conclusions are inconsistent with the marginal foreign equity investor approach suggested in the Treasury consultation paper.

Accordingly, we believe the cost of capital impact is significant, and should be addressed as one of the outcomes of this review. Additional economic modelling work in this area has been commissioned by the BCA and the Australian Bankers Association. We would be happy to make the results of this work available to the Board once it is completed.

3.2 Taxing income and capital – a policy framework

The consultation paper briefly considers, but quickly discards, the option of returning to the classical system of dividends that operated before 1987. We support the principles reflected in the imputation system, and would not support addressing the bias against foreign dividends by taxing domestic dividends more heavily. There is no support for such an approach in the business community nor, we believe, among investors.

Nevertheless, we consider that recent European reforms in this area may point in the direction that Australia should head in the future. Many mistakenly believe that the Europeans have abolished dividend imputation, but they have in fact modified their systems with none of the countries involved having returned to the classical system of the double taxation of dividend income.

Rather, the European countries have moved to systems that involve taxing income from capital at a lower rate than income from labour. This difference in tax treatment reflects the much higher mobility of capital, and hence the higher dead-weight loss that arises from taxing income from capital at higher rates. This approach represents a useful policy framework against which to assess the various policy options that might be considered for Australia.

The European approach has much to commend it for a country like Australia, with its high marginal rates for individuals that apply at relatively low thresholds. In fact, Australia has already taken an important step in this direction by introducing preferential treatment for the taxation of capital gains in the hands of individuals and super funds.

The European reforms have generally involved partial integration systems through the mechanism of providing notional credits to shareholders for all dividends received,

[10] "The Cost of Capital of a Company under an Imputation Tax System", *Accounting and Finance*, vol. 34. Pp. 1-17
[11] *Australian Equity Market Profile,* JB Were & Son, March 1996.
[12] "The Cost of Capital under Dividend Imputation", Martin Lally, Victoria University of Wellington, June 2002.
[13] "Victorian Transmission Network Revenue Caps 2003-2008: Draft Decision, 24 September 2002.

irrespective of the source of the profits, or whether tax has been paid at the corporate level. The effect of these systems is to at least partially address the double taxation of dividend income, while at the same time removing any bias against foreign source income.

We recognise there would be sensitivities associated with abolition of dividend imputation, which is well understood by investors and generally has had a positive overall impact on Australia's investment climate. There would also be transitional issues, such as needing to deal with existing franking accounts, and legitimate concerns could be raised about the potential impact of such a major change on the share price of domestically based Australian companies, particularly in the current investment climate.

Accordingly, we believe the dividend imputation system should be left undisturbed, and that any measures that might be adopted to address the imputation bias should operate in conjunction with the imputation system.

The Treasury consultation paper canvasses a number of options, some of which have previously been considered in the *Review of Business Taxation*[14]. This submission comments on the options set out in the Paper, as well as others.

3.3 Shareholder credit

While the 1/9th non-refundable shareholder credit canvassed in the Treasury consultation paper would represent an important step in the right direction, we do not consider it goes nearly far enough in terms of mitigating the high effective tax rates faced by shareholders receiving unfranked distributions out of taxed foreign earnings.

By way of example, for resident shareholders on the top marginal rate of 48.5 per cent, the proposed shareholder credit of 1/9th would reduce their effective tax rate in respect of taxed foreign earnings distributed as an unfranked dividend from 64 per cent to 61.6 per cent[15]. It is considered unlikely that such a modest level of relief would have the desired impact on shareholder behaviour, pricing, and the cost of capital.

For the shareholder credit proposal to have an impact on behaviour, we consider it would need to be increased significantly. A credit of 3/7th of the unfranked dividend paid out of a designated foreign income account would provide relief for foreign sourced dividends on the same basis as dividend imputation does now in respect of domestic earnings. From an equity perspective, this approach might be preferable to a full exemption, since it would retain a "top-up" tax for resident individuals on higher marginal rates.

Concerns could be raised about the potential revenue impact of a shareholder credit as high as 3/7th. We believe that second round revenue effects, in the form of increased profit repatriation, combined with top-up tax for some resident individuals, would go some way towards offsetting the revenue impact. Beyond that, there are a variety of mechanisms for containing those costs, including, but not limited to:

- making the shareholder credits non-refundable;
- making the shareholder credit non-offsettable against other income;

[14] "A Tax System Redesigned", *Review of Business Taxation*, Report July 1999
[15] Assume 30% underlying tax; zero withholding tax

- restricting the 3/7th credit to comparable tax countries (broad exemption listed countries), and granting lower credits in respect of other countries, depending on their headline corporate rate; or

- considering some alternative level of credit.

We would be pleased to consult further with the Board on these options, and also share the results of the economic modelling commissioned in this area.

3.4 Partial dividend exemption

Australia, like most developed jurisdictions, uses an exemption model to alleviate double taxation of foreign source dividends received from listed countries at the corporate level. The use of a partial exemption model at the shareholder level could be considered as an alternative to the tax and credit approach canvassed above. Such an approach would involve a similar mechanism as the Foreign Dividend Account (FDA) system, which allows foreign source dividends to be paid to non-residents exempt from any further Australian tax (including withholding tax).

A full exemption is not regarded as appropriate, since individuals on higher marginal rates would receive a much greater benefit under a full exemption than under a shareholder credit system (under a full exemption there would be no "top-up" tax). This would raise cost to revenue and equity issues.

A partial exemption model for foreign source dividends would allow foreign dividend income to flow through a chain of entities to the ultimate shareholders (either resident or non-resident). Resident shareholders would then be subject to tax under a partial exemption approach, while a flow-through exemption would apply to non-residents (as is presently the case under the FDA mechanism). Given the low tax rate facing complying superannuation funds, we would propose that they and tax-exempt entities be eligible for a full exemption.

Under this proposal, resident individual shareholders would be assessed on a deemed Australian taxable component of, say, 20% of the amount of the unfranked foreign sourced dividends received. Lower or higher proportions could also be considered, and some modelling is being done in this area. We acknowledge that this proportion will depend on the trade-off between revenue from the assessable component and the credit and would be happy to consult further with the Board of Taxation on this proposal.

The partial exemption approach would maintain the progressiveness of the tax system, albeit in respect of the deemed taxable amount only. While individuals on the top marginal rate would receive a larger absolute benefit, individuals across all tax brackets would experience relief of 80% of the "top-up" tax they currently face in respect of foreign sourced unfranked dividends.

This approach would significantly reduce the additional layer of domestic tax imposed on foreign sourced dividends distributed as unfranked dividends to resident investors. Because of the likely impact on the repatriation of accumulated foreign earnings, this proposal may actually be slightly revenue positive because tax would be collected on distributions of foreign earnings which are presently not being made.

We regard the partial exemption model as achieving broadly the same outcome as the shareholder credit option in terms of relieving the tax imposts on resident investors. Both options should, in our view, be further examined.

3.5 Dividend streaming

Dividend streaming would address the bias issue by providing foreign dividends directly to foreign shareholders. This is the variation of streaming we recommend, through some kind of stapled share arrangement where that is permitted under domestic law. Streaming is theoretically available under the current law, but only by debiting the franking account, which generally makes it an unattractive proposition.

Streaming would, in some jurisdictions, also provide non-resident shareholders with the benefits of their own domestic imputation system (in the UK, for example), thereby further improving their after-tax return at no cost to the Australian revenue.

As stapled stock arrangements are not legally or commercially feasible in all countries where Australian companies might carry out operations, direct steaming of foreign dividends to foreign shareholders should be supplemented by a mechanism that permits the flow-through of Foreign Dividend Account amounts to foreign shareholders through a chain of Australian companies.

Companies potentially affected by such a measure would benefit significantly in terms of the expected impact on their cost of funds – certainly to a far greater extent than the 1/9th shareholder credit proposal put forward in the consultation paper.

The cost to the revenue of dividend streaming would not be significant if it were to operate in conjunction with either a 3/7th shareholder credit or an 80% partial exemption. This is because the shareholder returns and cost of capital impact of adopting either of the first two options as the primary mechanism for addressing the imputation bias would mean that fewer Australian companies would need to consider streaming as a way of reducing the high effective tax rates resident shareholders face on foreign dividends.

Streaming was claimed in the *Review of Business Taxation*[16] to have its limitations because it requires the right combination of foreign earnings and foreign shareholders. Accordingly, it was likely to be of immediate benefit to only a small number of Australian companies. However, this review is designed to bring benefits in the medium to long term, based on the structure of Australian companies in the future rather than as they are today.

Over the longer term, many emerging companies would hope to get much closer to matching the proportion of their foreign shareholders with their foreign earnings. We therefore expect that over time this option would have much wider application.

3.6 Imputation credits for foreign dividend withholding tax

We agree with the Treasury analysis that providing imputation credits in respect of foreign dividend withholding tax is unlikely to significantly address the bias against Australian companies investing in foreign operations. The major impediment to repatriating accumulated foreign profits is the charge to earnings at the company level when those profits are repatriated. In the US in particular, we understand this has significantly inhibited the repatriation of the accumulated US earnings of Australian companies. Providing credits at the shareholder level does nothing to address this problem.

The recent developments in relation to the Australia-US Protocol will have a significant impact on profit repatriation out of the US. Most Favoured Nation clauses in other treaties to

[16] "A Tax System Redesigned", *Review of Business Taxation*, Report July 1999

which Australia is a party should also result in reductions in dividend withholding taxes between Australia and other countries in the foreseeable future. While efforts to reduce withholding taxes should continue, the bias in the future will arise almost exclusively from underlying foreign taxes.

We note, however, that this option was one of the Review of Business Taxation[17] recommendations taken up by the Government, and has already been factored into the overall revenue neutral business tax reform package which has been implemented progressively over the last few years. This means that a potential revenue cost of some $200 million per annum has already been factored into the forward budget estimates. If the effect of the imputation bias is to be addressed, this amount (but not necessarily only this amount) should be earmarked for that purpose.

3.7 Trans-Tasman arrangements

We believe that attention needs to be given to the triangulation case with New Zealand. This matter needs to be resolved to remove the impediment to the flow of investments between Australia and New Zealand, and should be taken up as part of this Review.

3.8 Recommendation

We recommend that additional work be carried to analyse the advantages and disadvantages of the 3/7th shareholder credit approach versus a partial exemption. We consider that one of these approaches would work well in tandem with dividend streaming. The analysis should cover the impact on the cost of capital, integrity issues, compliance concerns and the likely impact on profit repatriation.

[17] "A Tax System Redesigned", *Review of Business Taxation*, Report July 1999

4. Promoting Australia as a Location for Internationally Focused Companies

4.1 The Controlled Foreign Company (CFC) Rules

Background

The CFC rules were designed in the late 1980s with two objectives in mind: to preserve the integrity of the Australian tax system by preventing the accumulation of what can broadly be described as 'passive' income outside Australia, while at the same time not creating unwarranted taxation impediments for Australian businesses that operate internationally.

The design of the rules, and the balance struck between integrity and operational simplicity, was naturally coloured by the international business and tax environment of the time. Both of these environments have changed markedly in the ten or so years since the introduction of the rules. As will be shown below, the changes in both environments have created a significant misalignment between the CFC rules and international business practice, with the rules now creating a number of unwarranted taxation impediments for Australian businesses.

Notwithstanding this, in the decade since their introduction, the rules have been subject to only one major change, and that change moved the balance even further towards the maintenance of integrity. It is therefore a fitting time for a review of these rules.

4.2 Overview of Recommendations

We recommend immediate reforms to the CFC rules that can be implemented on 1 July 2003. In addition we recommend implementation of further reforms in the medium to longer term that will achieve a better balance between integrity of the system and its operational simplicity.

4.2.1 Immediate recommendations

We recommend that as a priority:

- CFCs resident in countries on the broad exemption list be entirely excluded from the attribution rules;
- a general exemption for non-portfolio dividends be introduced;
- an exemption for the sale of non-portfolio interests in foreign companies from capital gains tax be introduced;
- the tainted services income rules be abolished or, at the very least, modified ; and
- outstanding technical issues already brought to the attention of the Australian Taxation Office be addressed.

These reforms can be undertaken now and we recommend their immediate announcement with the view to implementation on 1 July 2003.

We believe that the exclusion of CFCs resident in broad exemption listed countries from the attribution rules altogether would represent an enormous and immediate compliance saving for Australian business. We believe that this is achievable without having any adverse revenue impact.

The exemption in section 23AJ of the *Income Tax Assessment Act 1936,* (the 1936 Act), should be expanded to cover all foreign non-portfolio dividends received by Australian companies. Non-portfolio dividends received from both listed and unlisted countries should be exempt from tax. Most of the legislative provisions dealing with the treatment of dividends paid by foreign companies to Australian companies could then be repealed.

The present anomaly regarding share sales of CFCs engaged in active business activities should be removed. We believe that the disposal of non-portfolio interests in a CFC should not give rise to attribution where the relevant CFC passes any of the following tests:

- the active income test;
- the active-business test; or
- the purpose test.

The same exemption should apply where a CFC sells a non-portfolio interest in another foreign company.

Such an exemption, combined with an expansion of section 23AJ, will mean that Australian multinationals would be able to decide whether to sell shares in foreign companies or assets of those foreign companies without being influenced by Australian tax considerations.

We believe the simplest approach to dealing with the problem of tainted services would be to abolish the tainted services income rules entirely as integrity concerns associated with the rule may, on closer examination, prove to be largely immaterial.

However, if the tainted services income rules are not abolished entirely, we believe that the problems caused by the existing tainted services income rules can be alleviated by amending the definition of tainted services income in two ways:

- confining its operation to services provided by CFCs to Australian resident associates; and
- adding an exemption that excludes from attribution all services provided by a CFC (including those provided to Australian resident associates) where the CFC is undertaking an active business of providing those services to, or directly for the benefit of, non-associates.

Over the past decade, numerous technical issues have been brought to the attention of the Australian Taxation Office, resulting in the development of a list of outstanding issues that are yet to be addressed. This list is at Appendix A.

We believe a process should be put in place to address these outstanding technical issues. However, this process should not detract from implementing our other priority recommendations.

4.2.2 Medium term reforms – 12-18 months

In the medium term, we believe that the following reforms can be implemented:

- expand CFC rollover relief;
- increase the number of broad exemption listed countries;
- introduce two additional “safe harbour” measures to improve the operation of the CFC rules: an active business test and a purpose test;
- allow Australian companies to invest in strategic international joint ventures without unnecessary CFC constraints;
- narrow the application of the transfer pricing rules for CFC attribution purposes;
- eliminate the quarantining – by class of income and by CFC – of losses incurred by CFCs;
- repeal section 47A of the 1936 Act;
- attribute income derived by a CFC only to taxpayers who own shares in the CFC at the time the income is derived; and
- attribute capital gains made by CFCs as capital gains rather than as income.

These recommended reforms have not been listed in any particular order of priority. We believe that each of these reforms is important and should be given careful consideration

4.2.3 Longer term – 2-4 years

Our preferred framework for the building of a fully revitalised CFC regime is to focus in the short and medium term on dealing with the major problems in the current rules and to undertake the wider review with the benefit of the knowledge obtained from that work. This staged process is to be preferred for two reasons:

- it will ensure that material improvements are made to the system, in the event that the comprehensive review fails to identify a new and clearly better system; and
- it will improve the likelihood of the comprehensive review producing a successful outcome, by removing unnecessary distractions (problems that have been solved through the earlier work), and focussing attention on a conceptual “re-think” that provide the best chance for the rules to be reformed in a comprehensive manner.

If the recommendations for immediate and medium-term reforms of the rules are adopted, we will have a CFC regime that operates with wide-ranging attribution rules constrained by relatively flexible exemptions. Although the regime would still not be optimal, it would represent a substantial improvement over the existing system.

However, with this more flexible regime in place, it would enable the comprehensive review to consider whether, for instance, it is possible to create a set of rules that reverses the current approach – that is, provide wide-ranging exemptions with limited but targeted attribution rules. A focused approach such as this provides the best framework within which a comprehensive review would occur.

Finally, we submit that a review that focused on re-writing the rules in order to produce, in essence, a "simplified" version would be unproductive. A meaningful review should focus on the key conceptual issues, rather than on "word-smithing" the current flawed rules.

4.3 The CFC Rules - Immediate Reform Recommendations

The proposals set out below are, in combination, recommendations for immediate reforms of the CFC rules that:

- enable the Australian business community to compete in the global economy on a more even footing with its main international competitors;
- materially reduce the complexity of the tax compliance burden for Australians carrying on active businesses outside Australia;
- should not result in any material cost to the revenue;
- can be implemented in the context of the existing legislative regime; and
- do not compromise the integrity of the CFC rules.

There is a limited degree of overlap between some of the proposals. Accordingly, the adoption of some key measures, for example, the introduction of a full exemption for broad exemption listed countries, may reduce the scope of changes needed with respect to some of the other proposals. However, each proposal contributes to an overall solution that will significantly improve the existing CFC rules.

4.3.1 Broad exemption listed countries and the CFC rules

Current Law

Under the current law, there are a number of circumstances in which income derived by a CFC resident in a broad exemption listed country may be attributable under the CFC rules.

For example, where a CFC is resident in a broad exemption listed country, it is necessary to consider whether the CFC derives any capital gains, offshore income (that is, income from carrying on an offshore banking, financial, reinsurance, insurance or investment business), interest income, royalties or shipping income. If the CFC does derive any of those types of income or gains, it is necessary to consider whether the following conditions are satisfied:

- in the case of a capital gain, whether the gain is exempt from tax in the broad exemption listed country;
- in other cases, whether the income is subject to a "reduction of tax", as defined.

Ascertaining whether these conditions are satisfied requires a detailed understanding of the law of the relevant foreign country.

If these conditions are satisfied, it is necessary to consider whether the capital gain, offshore income, interest income, royalty or shipping income is tainted income. If it is, it will generally be attributable.

In addition, it is necessary to consider whether the CFC derives any income or gains that satisfy the following conditions:

- the income or gains are, according to the tax laws of the relevant broad exemption listed country, not derived from sources in that country;

- the income or gains do not consist of capital gains that are exempt from tax in the foreign country or of offshore income, interest income, royalty or shipping income that is subject to a reduction of tax, as defined; and

- the income or gains are not "subject to tax" as defined in the relevant broad exemption listed country.

If the item of income or the gain satisfies these conditions, it may be attributable.

Finally, it is necessary to consider whether any income is attributable under paragraphs (b), (c), (ca), (d) or (e) of subsection 385(2) of the 1936 Act.

Problems with the current law

Although almost all the income and gains derived by CFCs resident in a broad exemption listed country will be exempt from attribution, confirming that they are exempt is a difficult, time-consuming and expensive process. It invariably calls for a detailed examination of the tax treatment in the relevant foreign country of each type of income and each type of gain derived by a CFC, as well as a detailed examination of the deductions, rebates and credits that may be granted in the foreign country. The work involved in confirming that the income and gains derived by a CFC resident in a broad exemption listed country are not attributable can be enormous.

In addition, income or gains derived by a CFC may be regarded as being subject to a reduction of tax, and therefore may be attributable, if the income or gain is taxed in the broad exemption listed country in a period that is later than the period prescribed by the CFC rules. For example, a foreign country may grant rollover relief for a gain made by a CFC in a particular year. If the CFC rules do not grant rollover relief, that gain may be taxed in Australia, even though it may also be taxed in a subsequent year in a broad exemption listed country when the relevant asset is disposed of to a third party.

Evidence of the problem

The complexities involved in confirming that income and gains derived by a CFC resident in a broad exemption listed country are not attributable is evident from a brief examination of section 385 of the 1936 Act and Part 8A of the regulations to that Act. Invariably, Australian multinationals are obliged to design detailed compliance manuals and questionnaires for their CFCs to confirm that they are not subject to attribution even if those CFCs are resident in broad exemption listed countries. Because of the complexity of the CFC rules and their interaction with foreign tax laws, in many instances Australian tax managers are obliged to travel to foreign countries and to meet with accountants and lawyers in those countries to confirm that the relevant CFC's income and gains are not attributable.

Scrip-for-scrip transactions are prime examples of transactions that may qualify for rollover relief in a broad exemption listed country but may lead to attribution under the CFC rules. If, in a subsequent year the CFC disposes of the new scrip and is therefore taxed in the broad exemption listed country, the group suffers double taxation.

Solution

The broad exemption listed countries are countries whose tax systems are broadly comparable to Australia's. It is likely that a relatively small amount of income is, or will be attributed from these countries. Investment by Australians in those countries is almost exclusively non-tax motivated and they are not an attractive repository for passive or mobile income. Companies resident in those countries should therefore be entirely exempt from the CFC rules.

It will be necessary to consider whether the extended exemption would enable CFCs in broad exemption listed countries to be used as conduits for entry into non-broad exemption listed countries so as to take advantage of the exemption. If additional countries are classified as broad exemption listed countries and those countries do not have CFC rules, it may be necessary to build integrity measures into this extended exemption.

However, if the broad exemption listed countries all have CFC rules, the use of companies resident in those countries as conduits should not be a concern.

This change would require the elimination of the active income test for CFCs resident in broad exemption listed countries, as it would become redundant.

4.3.2 Foreign non-portfolio dividends and foreign branch profits

Current Law

Non-portfolio dividends received by Australian companies from foreign companies may be wholly or partly exempt from tax under sections 23AI or 23AJ of the 1936 Act. The manner in which the two sections apply depends on whether the foreign company paying the dividend is a resident of a listed or an unlisted country.

Where the foreign company is a resident of a listed country, the treatment of the dividend is as follows:

- if any of the foreign company's profit has previously been attributed to the Australian company under the CFC rules, the portion of the dividend deemed to have been paid from the attributed profit is exempt under section 23AI; and
- the remaining portion of the dividend is exempt under section 23AJ.

On the other hand, where the foreign company is a resident of an unlisted country, the foreign company's profits are divided into three baskets:

- exempting profits (see below);
- attributed profits (i.e. profits that have been attributed under the CFC rules); and
- other profits.

To the extent that the dividend is deemed to have been paid out of exempting profits, it is exempt from tax under section 23AJ. To the extent that it is deemed to have been paid out of attributed profits, it is exempt under section 23AI. Finally, to the extent that it is deemed to have been paid out of other profits, it is taxable. The legislation contains ordering rules for determining whether dividends are deemed to have been paid out of exempting profits, attributed profits or other profits.

Exempting profits generally include profits that fall into any of the following categories:

- profit earned by the foreign company from carrying on business through a branch in a listed country;
- a non-portfolio dividend received by the foreign company from a company resident in a listed country; or
- a non-portfolio dividend received by the foreign company from a company resident in an unlisted country where that dividend was in turn paid from profits that fall within either of the first two categories.

Because of the third category, where an Australian company owns a chain of foreign companies resident in unlisted countries and receives a dividend from the top company in the chain, the Australian company will generally need to determine the ultimate source of the profits from which the dividend has been paid. It will therefore need to keep a record of the profit earned by each company in the chain, allocate that profit to each of the three baskets and then track dividends, within each basket, as they are paid up the chain.

Similarly, where an Australian company owns a chain of foreign companies and income from one or more of the foreign companies has been attributed to the Australian company under the CFC rules, the Australian company will need to keep a record of the amount of profit attributed from each foreign company. The Australian company will then need to track the distribution of that profit up the chain, to ascertain whether dividends received by it have been paid from previously attributed profits.

Where an Australian company receives a non-portfolio dividend from a company resident in an unlisted country and the dividend is not exempt under section 23AJ, the Australian company is generally entitled to foreign tax credits for foreign taxes paid on the dividend or on the profit from which the dividend was paid. If any of the profit from which the dividend is paid has been attributed under the CFC rules and a foreign tax credit was allowed for foreign tax paid on the attributed profits, the foreign tax credit allowed on receipt of the dividend is reduced to ensure that foreign tax credits are not granted more than once for a single payment of foreign tax.

Consequently, where an Australian company obtains foreign tax credits at the time of attribution, the Australian company must keep a record of the amount of the credits claimed. If the foreign company whose income has been attributed pays a dividend to the Australian company, the Australian company must determine what portion of the foreign tax credit previously claimed relates to the dividend (and therefore reduces the foreign tax credit that may be claimed on the dividend) and what portion relates to the foreign company's undistributed profit (if any). If there are CFCs interposed between the Australian company and the foreign company and dividends paid by the foreign company are distributed up the chain, it is necessary to ascertain how much of the foreign tax credit relates to the dividend paid by the foreign company and then how much relates to each of the dividends paid up the chain.

Because non-portfolio dividends paid by companies resident in listed countries to Australian companies are exempt from tax under 23AJ but dividends paid by companies resident in unlisted countries may be taxable, the 1936 Act contains a number of anti-avoidance rules to ensure that profits are not shifted from companies resident in unlisted countries to companies resident in listed countries without those profits being taxed in Australia or in a listed country.

The anti-avoidance rules include the following:

- section 47A – a CFC resident in an unlisted country may be deemed to have paid a dividend if it forgives a debt, makes a loan, acquires shares (or rights or options to acquire shares) in another company, acquires units (or rights or options to acquire units) in a trust, or transfers property or provides services for less than market value;

- section 457 – a CFC resident in an unlisted country becomes a resident of a listed country or of Australia; and

- sections 458 and 459 – a CFC resident in an unlisted country pays, or under section 47A is deemed to have paid, a dividend to another CFC or to a partnership or trust, and certain conditions are satisfied.

Where an Australian company carries on business through a branch in a listed country, income derived from carrying on business through the branch may be exempt from tax under section 23AH of the 1936 Act. The conditions that must be satisfied to obtain the exemption are, broadly speaking, similar to the conditions that must be satisfied to prevent attribution of income derived by a CFC resident in the particular listed country. Section 23AH is intended to ensure that an Australian company operating through a branch in a listed country is not disadvantaged in comparison to an Australian company operating through a subsidiary resident in the listed country.

Under current law, income derived by an Australian company from carrying on business through a branch in an unlisted country is taxable in Australia. The Australian company will usually be entitled to foreign tax credits for taxes paid on that income in the unlisted country.

Problems with the current law

There are two problems with the existing law – complexity of the legislation leading to high compliance costs and the discouragement of the repatriation and subsequent investment of profits to Australia.

It will be evident from the foregoing discussion that the provisions dealing with dividends paid by companies resident in unlisted countries are complicated and that complying with them will often entail considerable costs. An Australian company that owns foreign companies resident in unlisted countries must determine, for each of those companies, how much of its profit consists of exempting profits, attributed profits and other profits. That process involves not only determining how much income falls within each basket, but also apportioning expenses and foreign income taxes among the three baskets. Once the amount of each of the three baskets of profits has been determined, the Australian company must track the distributions made from each basket. The Australian company must also track, within each basket, the amount of foreign taxes relating, on the one hand, to profits retained within the foreign company or received as dividends by the foreign company and, on the other hand, to profits distributed by the foreign company.

Such tracking requires an Australian company to maintain at least three notional accounts for each of the foreign companies:

- an attribution account (to record the profit that has been attributed under the CFC rules);

- an attributed tax account (to record the tax paid on the attributed profit); and

- an account for exempting profits.

Section 47A is a particularly complicated provision that may entail significant compliance costs. It applies in a wide range of circumstances and sometimes limits unreasonably the transactions a CFC may enter into. Two examples are outlined below.

Example 1 – Joint Venture Transactions

> Assume a CFC resident in an unlisted country wishes to enter into a 50/50 joint venture with an unrelated party. If a joint venture company is formed and the CFC subscribes for 50% of the shares in that company, the joint venture company is potentially an "associated entity" in relation to the CFC for the purposes of section 47A, and section 47A may deem the subscription of shares to be a dividend paid by the CFC.

Example 2 – Intercompany accounts and deemed dividends

> Assume a CFC resident in an unlisted country provides services to, and receives services from, other members of the group. Arm's length fees are charged for the services and booked to an intercompany account, which is settled, say, every 30 days. If the intercompany account fluctuates daily, it may be impractical to charge interest on the daily balance. On the other hand, if interest is not charged by the CFC on the intercompany account when it is in debit, the intercompany account arguably constitutes an interest free loan and therefore may be deemed to be a dividend under section 47A.

The second problem is that the existing legislation discourages the repatriation to Australia of profits earned by companies resident in unlisted countries and the investment of those profits in Australia. Where a foreign company carries on an active business in an unlisted country, such as Hong Kong, and does not derive exempting receipts, non-portfolio dividends paid by the foreign company to an Australian company would be taxable in Australia. In those circumstances, the distribution of profits by the foreign company is clearly disadvantageous to the Australian company, and the Australian company can be expected to encourage the foreign company not to repatriate its profits and instead to invest its profits outside Australia.

It is worth noting that the US tax system does not discourage foreign subsidiaries of US multinationals from repatriating profits to the US, at least not to the same extent as the Australian tax system does. This is because in the US income is taxed on a worldwide basis and, within each type of basket, foreign tax credits may be claimed on a worldwide basis. Consequently, where the effective tax rates on income earned in foreign countries exceeds the effective US tax rate, foreign tax credits for the excess tax may be claimed against income earned in low-tax countries. Australia's system of listed and unlisted countries prevents Australian companies from claiming foreign tax credits for taxes paid in high-tax countries against income earned in low-tax countries.

Evidence of the problem

From the brief outline provided of the current law, the complexity of the legislation should be evident. The complexity of the legislation is also apparent from the number of sections in the 1936 Act dealing with the treatment of dividends paid by a foreign company resident in an unlisted country. Apart from sections 23AI, 23AJ and 47A, these include section 160AFCD, section 365, sections 370 to 380 and sections 458 and 459.

According to Treasury, non-portfolio dividends from companies resident in unlisted countries comprise only about 5% of all foreign non-portfolio dividends received by Australian companies[18]. Presumably at least some of these dividends will not give rise to an Australian income tax liability because of the availability of foreign tax credits or tax losses at the Australian level.

Solution

The exemption in section 23AJ should be expanded to cover all foreign non-portfolio dividends received by an Australian company. Non-portfolio dividends received from both listed and unlisted countries should be exempt from tax. Most of the legislative provisions dealing with the treatment of dividends paid by foreign companies to Australian companies could then be repealed.

The Treasury consultation paper states:

> "Exemption of non-portfolio dividends at the Australian company level increases the importance of ensuring that tainted income retained offshore at low rates of tax is subject to attribution[19]."

That statement would be correct if tainted income included only mobile passive income. If mobile passive income were not attributed under the CFC rules and dividends paid by CFCs resident in unlisted countries were exempt from Australian tax, there would be a significant incentive for Australian taxpayers to divert such income to companies resident in tax havens and hence to avoid Australian tax. However, two important qualifications should to be made to the statement in the consultation paper.

First, the current definition of "tainted income" includes income that is not mobile passive income (this issue is discussed later in conjunction with the definition of "tainted services income"). An expansion of the exemption for non-portfolio dividends should not prevent the CFC rules from being amended so that they do not apply inappropriately to income that is relatively immobile.

Secondly, because the current rules discourage the repatriation to Australia of profits earned by companies resident in unlisted countries, Australia is in effect not taxing those profits. Therefore expanding the exemption in section 23AJ will not significantly reduce the amount of tax collected by the Government but will provide Australian multinationals with the flexibility to keep profits offshore or repatriate them to Australia. On that basis, expanding the exemption should have little bearing on the scope of the CFC rules.

If the exemption in section 23AJ is expanded to cover all foreign non-portfolio dividends received by an Australian company, it would be sensible for section 23AH to be amended so that it exempts profits derived by an Australian company from carrying on business through a branch in an unlisted country. The exemption would mirror the active-income test applicable to CFCs resident in unlisted countries. Without such an amendment, a foreign

[18] Review of International Taxation Arrangements, Department of Treasury, August 2002, page 42.
[19] Review of International Taxation Arrangements, Department of Treasury, August 2002, page 43.

company operating through a branch in an unlisted country will be at a disadvantage compared to a foreign company operating through a subsidiary.

4.3.3 Non-portfolio interests in foreign companies

Current Law

Where an Australian company owns shares in a CFC and the CFC sells its assets, the profit derived on the sale of the assets will, with certain exceptions, not be attributed to the Australian company under the CFC rules. In particular, a profit made on the disposal of goodwill will generally not be attributable.

The main exceptions are where the profit is derived from the disposal of intellectual property, tainted assets or tainted commodity investments. “Tainted assets” and “tainted commodity investments” are defined in section 317 of the Act.

If the CFC is a resident of a listed country and the Australian company has a non-portfolio interest in the CFC, the profit derived by the CFC from the sale of its assets may be distributed as a dividend that is exempt from tax under section 23AJ of the 1936 Act, even if the profit has not been attributed under the CFC rules.

Where an Australian company owns shares in a foreign company that is not a CFC and the foreign company sells its assets, the profit derived by the foreign company may be attributed under the FIF rules. However, if the foreign company distributes that profit as an interim dividend, the profit will generally not be attributable (section 530 of the 1936 Act). Moreover, if the foreign company is a resident of a listed country and the Australian company has a non-portfolio interest in the foreign company, the interim dividend will generally be exempt under section 23AJ.

Problems with the current law

Where an Australian company makes a profit from the sale of shares in a foreign company, the profit is taxable, even if a profit made from the sale of the foreign company’s assets would not be taxable under the CFC or FIF rules. There is therefore a disadvantage in selling shares in a foreign company instead of assets of the foreign company.

However, in many instances it is commercially desirable to sell shares rather than assets; for example, the foreign company may have a licence or an interest in real property that under the laws of the foreign country is difficult to transfer from the foreign company to another person.

Solution

Where an Australian company has a non-portfolio interest in a foreign company, a profit made from the sale of that interest should be exempt from Australian capital gains tax, particularly if section 23AJ is expanded to apply to all non-portfolio dividends. Where the foreign company is a CFC, the exemption should apply if the CFC passes any of the following tests:

- the active income test;
- the active-business test; or
- the purpose test.

Where the CFC whose shares are sold owns shares in other CFCs, the whole of the capital gain should be exempt from tax if all of the CFCs pass any of the above three tests. If any of the CFCs fail all of the above tests, in principle a portion of the profit should be taxable. However, difficult questions of apportionment would arise. A more practical approach would be to exempt the whole of the capital gain unless the combined values of the CFCs that fail the above tests exceed a threshold of, say, 20% of the selling price.

Since the attributable income of a CFC is calculated on the assumption that the CFC is an Australian resident, the exemption should also apply where a CFC sells a non-portfolio interest in another CFC.

Such an exemption would be consistent with international trends and developments, particularly in Europe (eg the UK, Germany, the Netherlands, Denmark, Portugal and Spain all have similar exemptions). Without such an exemption, Australian multinationals will often be at a competitive disadvantage when they seek to invest in other countries.

Where the foreign company whose shares are sold is not a CFC, the exemption from capital gains tax should apply regardless of what types of assets the foreign company has. This is on the basis that the current law does not tax profits on the sale of underlying assets where those profits are distributed as a non-portfolio dividend to the Australian company.

Such an exemption, combined with an expansion of section 23AJ to cover non-portfolio dividends paid by companies resident in listed or unlisted countries, will mean that Australian multinationals would be able to decide whether to sell shares in foreign companies or assets of those foreign companies without being influenced by Australian tax considerations.

4.3.4 The tainted services income rules

We believe the simplest approach to dealing with the problem of tainted services would be to abolish the tainted services rule entirely. This warrants serious consideration, particularly given that the integrity concerns associated with the rule may, on closer examination, prove to be largely immaterial.

However, if the tainted services rule is not abolished entirely, we believe that the problems caused by the existing tainted services rule can be largely alleviated by amending the definition of tainted services income in two ways:

- confining its operation to services provided by CFCs to Australian resident associates; and
- adding an exemption that excludes from attribution all services provided by a CFC (including those provided to Australian resident associates) where the CFC is undertaking an active business of providing those services to, or directly for the benefit of, non-associates.

Current law

Services income that is classified as “tainted services income” derived by a CFC resident in an “unlisted” or “limited-exemption listed” country gives rise to attributable income that is potentially subject to Australian taxation on a current basis. All but seven countries (the US, UK, Canada, New Zealand, France, Germany and Japan) are within these categories.

Tainted services income is, with some minor exceptions, any income from the provision of services by such a CFC to any Australian resident or to any associated entity, wherever that associated entity is resident.

Exceptions are provided for:

- services provided by a CFC to another CFC which is resident in the same foreign country, provided certain additional conditions are met;
- the provision of food, accommodation, entertainment, recreation or instruction;
- the provision of services that are related to goods sold by the CFC where the goods were substantially altered by the CFC or created by the CFC; and
- certain services provided by CFC subsidiaries of Australian financial institutions.

The Australian entity that holds the interest in the CFC deriving tainted services income is required to ensure that the CFC has applied Australian transfer pricing guidelines in charging for its services, to undertake detailed tax calculations to determine the amount of attributable income and foreign tax paid thereon, and to maintain appropriate records to support such calculations. As a general rule, Australian tax managers are required to devote more time to the compliance management of the tainted services income rules than the equivalent "tainted sales income" rules, as the tainted services rules are more wide-ranging.

Problems with the current law

There are three fundamental problems with the existing definition of tainted services income:

- it causes attribution of income that is, essentially, "active" business income and thereby hinders the growth of Australian-based service and knowledge companies;
- it inhibits the establishment of shared services centres outside Australia by Australian-based multinationals, needlessly restraining their operational efficiency and, in this respect, placing them at a disadvantage when compared to their major international competitors, as foreign CFC rules (for instance, the US rules) generally treat services income far less severely; and
- it creates excessive tax compliance obligations on Australian-based businesses.

These problems largely arise as a result of changes in the global business environment since the introduction of the CFC rules, as well as the impact of the 1997 amendments to the CFC rules that replaced "listed" countries with "broad" and "limited" exemption lists:

The existing law was founded on the premises that services income was ancillary to the "core" manufacturing and trading economy, highly mobile and difficult to value. Rapid and significant changes in the global economy and marked improvements in the capacity of tax authorities to more rigorously assess the value of cross-border services means that the original foundations of the tainted services rule are no longer sound.

It was recognised, under the original CFC design framework, that services income was not inherently "passive". Most services income was not treated as attributable when earned by CFCs resident in listed countries. As this included (prior to the 1997 amendments) most of Australia's major investment destinations, the range of potentially attributable services was considerably narrower than at present. The introduction of those amendments has, in light of the dramatic expansion in the importance of the service sector, compounded the problem.

As a result, the tainted services rule has become increasingly misaligned with international business practice and is constraining international business activity by Australian enterprises in this vital sector of our economy. A re-examination of the premises on which the existing rule is based is clearly appropriate.

Such a re-examination reveals that the provision of services is no longer an ancillary or subsidiary part of the Australian and global economy. The growth of the service sector in the global economy is well documented. The overall character of that industry has also changed dramatically. In some areas (such as telecommunications), service industries are capital intensive, and the delivery of services is dependent on the creation of expensive and complex infrastructure. In these areas, there is no greater, and sometimes far less, mobility than exists for traditional manufacturers and traders. This is simply a reflection of the fact that these operations are active, complex, businesses.

Even in other, less capital-intensive, service industries, overriding commercial considerations mean that there is only a limited degree of mobility. Most of these industries require proximity to relevant infrastructure (not just material infrastructure, but advanced legal systems, financial services systems and the like) and to their actual or potential customers.

The enhanced role of the services sector within the general economy has been replicated to a large extent within multinational groups, for a number of different reasons. During the 1990s, many businesses adopted international supply chain processes that resulted in many more intra-group transactions and relationships. The range and complexity of international joint ventures has also increased the range of cross-border services that are provided between associated entities. And the need for competitive efficiency has resulted in groups seeking to establish centralised shared services arrangements.

Finally, Australia's transfer pricing laws have, in practice, been significantly strengthened during the 1990s. Commonly understood pricing methodologies can be, and are being, used to ensure that related party transactions involving the provision of services are undertaken on appropriate arm's length terms. Accordingly, the retention of the rules in their existing form on this basis is also no longer warranted.

Evidence of the problem

Example 1 - Telecommunications service providers

> Australian telecommunications companies expanding offshore must achieve critical mass in order to compete with the major global carriers. This expansion often occurs through joint ventures because:
>
> - foreign ownership rules often require significant local ownership;
>
> - particular countries may have unique economic, political, regulatory, cultural or technical factors that make it difficult for foreign companies to enter the market alone; and

- some opportunities require a larger or riskier investment than one company will comfortably make on its own.

Such joint ventures would almost invariably constitute CFCs for Australian tax purposes.

The joint venture group entities may provide telecommunications services to:

- local (foreign) customers;

- unrelated Australian resident customers, or non-resident customers who use the services in connection with an Australian branch; and

- other JV group entities, the joint venturers, or entities that are associates of any of these entities.

The ventures themselves will normally involve investment in significant tangible and intangible assets (eg, undersea cables worth hundreds of millions of dollars) to provide services to a large number of customers. These ventures can only be described as active businesses, generating active business income. Due to both local regulatory issues and transfer pricing laws, it is very difficult to move either the infrastructure or the customers to render the resulting income mobile. Nevertheless, where the services are provided to the second and third of the above categories of customers, they will fall within the tainted services rules, resulting in Australian tax compliance obligations and potential Australian tax liabilities.

New ventures will often not pay dividends for a number of years (in order to fund a growth strategy), so that the payment of current Australian tax under the attribution rules can result, in effect, in a permanent, rather than merely a timing, cost. The result is that Australian carriers are more likely to pass up these opportunities than their competitors (eg, from the US or the UK) who do not normally face the same tax cost under their own CFC regimes.

Example 2 - Installation and maintenance services

Australian based engineering or technology companies that wish to sell non-generic (ie, complex or “high tech”) products outside Australia will generally be required to provide assistance in installing and maintaining those products. The provision of those services will usually require the full-time presence of highly skilled personnel based in the foreign country and the most fruitful exploitation of a particular foreign market will often require the establishment of a CFC in that country which would employ the personnel.

The simplest and most commercially attractive means of dealing with the foreign customer in such situations is through a sale, installation and maintenance contract with the Australian parent entity (customers would normally seek the comfort of dealing with that entity rather than the smaller local subsidiary). That parent entity would then be required to enter into a sub-contract with its CFC to provide the required local installation and maintenance services.

Those services would fall within the tainted services rule, notwithstanding the fact that the local CFC is carrying on an entirely active, and not mobile, business.

If, instead, the Australian company were able to convince the foreign customer that it should enter into split contracts - purchasing the product from the Australian parent and the services from the CFC - the services income would not be tainted (although its character would, of course, not have changed in the least). While some Australian businesses are sufficiently “CFC aware” to at least explore this possibility, the option of splitting contracts may not be viable due to customer concerns.

The existing rule in this situation creates an unnecessary impediment for Australian companies seeking to internationalise from an Australian base.

Example 3 - Shared services agreements

Multinational groups will frequently seek to establish a centralised or shared service location in one company rather than having the services wastefully duplicated in each of the operating entities in the group. Such service locations for the Asian region, for example, would typically be located in Singapore or Hong Kong, as both countries have the relevant infrastructure to support these activities.

The establishment of such a service centre by an Australian-based group, or by a joint venture in which an Australian venturer is a major party, will automatically entail CFC attribution and associated compliance costs. These costs are not imposed on most other foreign-based competitors, and place Australian-based groups at a competitive disadvantage.

Australian investors also face problems where they acquire new foreign businesses. Where those businesses are well established they tend to have a settled pattern of intra-group services. The Australian acquirer will often find it extremely difficult to manage the attribution issues and associated compliance costs arising from these services as the CFC business personnel are often reluctant to change their generally efficient servicing arrangements. This can result in Australian taxpayers being "locked" into attribution compliance costs.

Solutions

If the tainted services income rules are not entirely removed, the problems caused by the existing rule can be largely alleviated by amending the definition of tainted services income in two ways:

- confining its operation to services provided by CFCs to Australian resident associates; and

- adding an exemption that excludes from attribution all services provided by a CFC (including those provided to Australian resident associates) where the CFC is undertaking an active business of providing those services to, or directly for the benefit of, non-associates.

This change should be relatively simple to draft. While the "active business" test element of the proposal would require detailed consideration, it may be possible to draw on similar exemptions already provided in the FIF rules.

The change would remove an unwarranted constraint on Australian enterprises seeking to internationalise, place Australian-based companies operating in the service/knowledge sector on a more equal footing with their major foreign competitors by removing the automatic tax penalty that arises on the establishment of foreign shared services centres and enable Australian-based companies to participate more freely in international joint ventures.

This proposal should not give rise to any material integrity concerns:

- the measures are targeted to provide relief to active businesses;

- many of those businesses are not in any event "highly mobile"; and

- the measures do not provide an opportunity for Australian based businesses to merely shift internal support functions – which are highly mobile - offshore in order to defer Australian tax (although it is considered unlikely that such an opportunity would, in practice, give rise to significant integrity concerns);

The measures do provide an opportunity for Australian based businesses to provide services to Australian customers from an offshore location without attribution under the CFC rules, and the potential impact of this will require careful consideration. Our preliminary view is that while there will be some situations where the use of an offshore service company is commercially viable, proximity to customers and appropriate infrastructure will mean that this will be the exception rather than the rule.

4.3.5 Outstanding technical issues

There are a number of outstanding technical and policy issues that we believe should be addressed as a matter of urgency. A process therefore needs to be established to address these outstanding issues that have already been brought to the attention of the Australian Taxation Office. These issues are listed at Appendix A.

4.4 Medium term reforms

In the medium term, we believe that the following reforms can be implemented:

- expand CFC rollover relief;
- increase the number of broad exemption listed countries;
- introduce two additional "safe harbour" measures to improve the operation of the CFC rules: an active business test and a purpose test;
- allow Australian companies to invest in strategic international joint ventures without unnecessary CFC constraints;
- narrow the application of the transfer pricing rules for CFC attribution purposes;
- eliminate the quarantining, by class of income and by CFC, of losses incurred by CFCs;
- repeal section 47A;
- attribute income derived by a CFC only to taxpayers who own shares in the CFC at the time the income is derived; and
- attribute capital gains made by CFCs as capital gains rather than as income.

4.4.1 Expand CFC Rollover Relief

Current law

Transfers of "tainted assets" (which include shares and many intangibles) by CFCs qualify for CFC rollover relief only where the transfer is between CFCs that are part of a 100% owned group and where one of the following additional conditions is met:

- both companies are resident in the same broad exemption listed country, or the recipient company is resident in Australia;

- the transferor is resident in a broad exemption listed country, the recipient is resident in a non-broad exemption listed country and the asset was used by the transferor in carrying on business in a non-broad exemption listed country; or
- both companies are resident in a non-broad exemption listed country.

In the case of CFCs resident in broad exemption listed countries, CFC rollover relief also extends to:

- disposals of assets involving the loss, destruction or compulsory acquisition of the assets, provided certain conditions are met;
- transfers of assets to a 100% group company resident anywhere, provided the transfer will immediately or ultimately give rise to a tax liability for the transferor in the broad exemption listed country; or
- cancellation of shares, rights and options and issuance of replacement shares, rights and options in the same company, provided certain conditions are met.

Problems with the current law

Australian-based multinational groups continually need to undertake or contemplate reorganisations of their asset holding structures in order to improve operating efficiency, to undertake joint ventures or simply to deal with constantly changing foreign regulatory and tax rules. These reorganisations do not result in any realisation of a gain to the group so that any material Australian CFC liability that would be crystallised as a result of the reorganisation normally makes it prohibitively costly.

CFC rollover relief is so narrowly confined that many reorganisations cannot be undertaken because of the Australian CFC attribution cost. This severely restricts the ability of Australian-based multinationals to rearrange their offshore holding structures in the most commercial and tax efficient manner. No major international competitors are so constrained in this regard.

Evidence of the problem

Example 1 - Joint venture transactions

Many joint venture transactions will, under the current CFC rules, generate attributable income upon their inception. This can be the case where, for instance, the joint venture is required to be established through a scrip-for-scrip transaction.

Example 2 - Transactions that qualify for rollover relief in broad exemption listed countries

While broad exemption listed countries have tax systems that, under our CFC rules, are recognised as being fundamentally similar to the Australian system, this recognition does not extend to rollover relief. Those countries sometimes allow for rollover relief in situations where it would not be provided under the Australian rules.

Some frequently encountered examples include the "substantial shareholding relief" rules in the UK, and US rollover rules that allow for asset transfers between companies that are less than 100% group companies (80% common ownership being the normal US threshold).

While each of these countries has many tax rules that vary from their Australian equivalents, these differences are normally disregarded under our CFC rules, on the basis that disregarding these differences produces significant tax compliance savings and eliminates unwarranted restrictions on ordinary commercial activities without causing integrity concerns. The same logic applies equally to these rollover transactions.

Example 3 - Scrip for scrip transactions between non-wholly owned foreign companies

Scrip for scrip transactions by CFCs will, in most circumstances, not qualify for CFC rollover relief, despite the fact that the transactions merely involve the exchange of one economic interest for a similar economic interest having the same value. Scrip for scrip transactions are allowed in the domestic Australian context, but their absence in the international context means that Australian groups may be forced to forgo commercial venturing opportunities that are available to foreign competitors.

Example 4 - Interposing new foreign holding companies

The offshore expansion of Australian groups is invariably an ad hoc affair, driven by commercial opportunities that are identified from time to time. Many groups have holding structures for their foreign investments that, with the passing of time, have become inefficient (for instance, they may be incompatible with the group's management or business structure or expose the group to unsustainable withholding tax costs on the flow of profits through the holding structure).

The existing CFC rollover relief provisions provide some scope for reorganisations to occur where the particular inefficiency can be addressed by having shares transferred between CFCs resident in limited-exemption listed countries. However, where the reorganisation requires the transfer of shares in a CFC that are held by an Australian resident member of the group to another CFC, there is a taxable event.

Example 5 - New Zealand Qualifying Amalgamations

The New Zealand Company's Act allows the merger of companies by way of amalgamation, which involves the consolidation of a subsidiary into a parent or several subsidiaries into a surviving sister company. The New Zealand taxation legislation recognises qualifying securities as tax neutral.

Under Australian CFC provisions Australian companies are required to apply the CGT provisions to the component parts of the amalgamation. This is particularly difficult as Australian companies legislation does not encompass this type of merger and our tax laws are not drafted with this type of transaction in mind.

Solutions

The various CFC constraints facing Australian-based multinationals that wish to restructure can be largely eliminated in one of two ways:

- introducing a series of specific CFC rollover reliefs; or

- by introducing, along the lines of recent initatives by several European countries, a general exemption for group restructures that are treated as tax-free in the foreign jurisdiction or jurisdictions where they are undertaken, provided there is no dominant purpose of Australian tax avoidance associated with the restructure. This exemption could then be supplemented by specific Regulations allowing for particular approved classes of transactions.

The first potential solution to the various CFC constraints facing Australian-based multinationals that wish to restructure is to extend CFC rollover relief to cover situations where:

- a CFC resident in a broad exemption listed country undertakes a transaction that qualifies for rollover relief under the taxation laws of that broad exemption listed country;

- assets are transferred between CFCs that are members of the same wholly owned group, regardless of the residency of the CFCs;

- a CFC transfers shares in another company (controlled or uncontrolled) to another CFC, whether or not wholly owned, in exchange for shares;

- a CFC transfers shares in a CFC to a non-controlled foreign company in exchange for shares;

- an Australian resident transfers shares in a CFC to another CFC, where all companies are members of the same wholly owned group; and

- there is a New Zealand tax concession for qualifying amalgamations.

If the proposals are introduced, they will:

- considerably improve the competitiveness of Australian businesses in the international arena (having regard, for instance, to the greater flexibility available to US and UK based groups);

- by increasing their capacity to periodically restructure, reduce the exposure of Australian businesses to unnecessary international tax costs, particularly in relation to the distribution of profits back to Australia; and

- reduce the cost of managing international tax planning.

These proposals should ultimately be revenue neutral from the Australian tax perspective. All assets that are the subject of the proposals remain within the Australian CGT net. In essence, the proposals provide an opportunity for Australian businesses to undertake transactions presently avoided, without any material cost to the revenue.

The second potential solution to achieve the same result would be to provide a general exemption for group restructures that are treated as tax-free in the foreign jurisdiction or jurisdictions where they are undertaken, provided there is no dominant purpose of Australian tax avoidance associated with the restructure. This exemption could then be supplemented by specific Regulations allowing for particular approved classes of transactions.

Whatever their form, the changes will require careful thought and legislative planning. In particular, it will be necessary to focus on measures to ensure that:

- no unwarranted tax-free cost base uplifts are made available as a result of the introduction of new scrip for scrip rules; and

- the provision of wholly owned group rollovers regardless of the residence of the CFCs does not result in a material cost to the revenue.

In addition, amendments to s. 47A of the 1936 Act may be required to allow for some of the proposed rollovers.

To this end, consideration should be given to the establishment of a working group with representatives from Treasury, the ATO and business to deal with this.

4.4.2 The number of broad exemption listed countries

We recommended above that CFCs resident in broad exemption listed countries be entirely exempt from the CFC rules. Regardless of whether or not that recommendation is accepted, it should be possible to reclassify some of the limited exemption listed countries as broad exemption listed countries.

Current law

Where a CFC is resident in a broad exemption listed country, its potentially attributable income is far more limited than is the case with CFCs resident in other countries. Essentially, the attributable income is confined to untaxed capital gains on tainted assets and concessionally taxed interest, royalties and certain offshore income, as well as income or profits dealt with under tax concessions that are specified in the Regulations to the 1936 Act.

There are currently seven broad exemption listed countries: the US, UK, France, Germany, Canada, Japan and New Zealand. This has been the case since amendments creating the broad exemption list category were introduced in 1997. Prior to that time, the limited attribution regime applied to approximately sixty countries, including most countries in Europe and the Asia-Pacific region.

Problems with the current law

The original listing approach in the CFC rules was designed on the basis that the sixty or so countries that were listed had a tax rate and a tax system broadly comparable to that of Australia. In order to balance integrity with a degree of simplicity in the system, it was presumed that income derived by a resident of a listed country had been fully taxed and should therefore not be subject to tax again in Australia by way of attribution. It was nevertheless recognised that some significant tax deferral opportunities existed in a number of these countries, and the rules allowed for those concessions to be specified in the Regulations so that attribution would occur where profits were sheltered from foreign tax under those concessions.

The 1997 amendments were the result of concerns by the ATO and Treasury that it was not possible to effectively monitor the tax deferral opportunities in so many countries. Consequently, the majority of countries were moved off the list, leaving only seven.

The removal of those countries from the list has meant that Australian-based multinationals with CFCs resident in those countries are required to make attribution calculations under rules that were designed solely to deal with attribution from tax havens or low-tax jurisdictions – so that, for example, a CFC resident in Sweden or Austria is treated on the same footing for attribution purposes as one resident in the Cayman Islands. This has fundamentally compromised the design of the whole system. Moreover, it has not eliminated the need for the ATO and Treasury to remain aware of foreign tax concessions – they must continue to monitor the remaining broad exemption listed countries and regulate to deal with potentially applicable new concessions.

Australian-based multinational groups must thus undertake CFC reviews and make attribution calculations that were designed for companies operating in tax havens, even though most of their CFCs are based in jurisdictions with comparable tax rates to Australia.

This has created excessive compliance requirements and needless attribution of income, without any material benefit to the Australian revenue base.

In many instances, the attributed income has been subject to foreign tax at a rate equal to or higher than the Australian corporate tax rate (although complex foreign tax credits calculations are required to be made by taxpayers to get to this result);

Attribution of untaxed or lower taxed income more commonly occurs only where taxpayers are commercially unable to avoid it (in a sense, a "windfall" gain to the revenue), or are less "tax aware" or are unable to afford to be tax aware.

Evidence of the problem

While the majority of Australia's outbound investments are located in the seven broad exemption listed countries, Australia's largest outbound groups have also made significant investments in other countries, either directly or as participants in joint ventures. Given the focus of these groups on international supply chain processes and centralised service centres, there is also a large volume of intra-group transactions that take place between broad and limited-exemption listed and unlisted countries. Moreover, many investors commence their overseas expansion in the Asia Pacific region, and mostly transact in non-broad exemption listed countries.

The requirement to apply "tax haven" designed CFC rules to complex large groups, and to smaller investors operating in tax jurisdictions that have broadly similar tax rates to Australia's, has resulted in a significant increase in the CFC tax compliance obligations placed on Australian businesses.

The complexity of the rules, and their lack of clear and targeted exemptions, mean that most outbound investors are in danger of inadvertently creating attributable income. It is almost impossible for outbound investors to set out clear guidelines for operating within the constraints of the CFC rules that can be followed by commercial personnel operating CFC businesses. Furthermore, a comprehensive guideline would generally be impossible to enforce in the context of CFC commercial operations (and almost always impossible where there is a joint venture).

Consequently, without generating a material increase to the Australian revenue, CFC tax compliance:

- it is incapable of being managed in a simple and cost-effective way; and
- requires unwarranted but continually increasing investment by Australian businesses.

Solutions

It is clear that a better balance can be struck between the maintenance of integrity and the management of tax compliance costs.

A stepped approach maybe the best way to deal with this issue. As an initial step, companies that are resident in countries currently classified as broad exemption listed countries should be exempted entirely from the CFC rules.

At the same time, it should be possible for a working group to determine a short list of countries that have the potential to be classified as broad exemption listed countries. Priority should be given to those countries that are attracting or have the potential to attract the largest share of Australian outbound investment, excluding those (if any) whose tax systems are self-evidently not comparable to the Australian system.

In assessing the eligibility of countries on that short list, the following criteria, among others, would be relevant:

- the degree of access to information by the ATO and Treasury as to tax concessions in those jurisdictions that are potentially applicable to passive income or tainted income and the ability to conduct investigations in an open and transparent manner;

- the extent to which officials in a foreign country monitor the development of new types of transactions, monitor transactions for tax avoidance and amend the tax legislation where appropriate to the degree that Australian officials do; and

- the constraints that the country faces in granting significant new passive income tax concessions (eg., EU tax harmonisation directives make it harder for EU members to introduce new tax concessions and increase the publicity given to any such proposed measures).

These criteria should be developed in consultation with business and once developed, should be clearly articulated. Ultimately, a practical assessment will need to be made, as there are no clear and simple criteria that can be used as a selection mechanism. The original design of the system recognised this fact, by allowing countries to be included on the list with their potentially offensive rules excluded through the Regulations.

Finally, it should be possible to ensure that the listing process does not atrophy by monitoring the number of additional tax concessions (if any) that need to be added to the Regulations each year. The frequency of such additions, and the countries to which they relate, should provide a useful test as to the appropriateness of the list.

Open and continual discourse, with regular six monthly reviews, would mean that future additions or deletions could be handled relatively easily so that the right balance is maintained in the face of changing tax laws around the globe.

4.4.3 "Safe harbour" measures to improve the operation of the CFC rules

Current law

Where a CFC is resident in a broad exemption listed country, CFC attribution occurs, in essence, when the CFC derives certain narrowly defined categories of income or gains that are subject to concessional tax treatment in that country.

Where a CFC is resident in any other country, attribution occurs, in essence, when the CFC derives a far wider class of income or gains, regardless of whether or not that income or those gains are subject to tax in that country.

Aside from the less rigorous attribution requirements applicable to broad exemption listed country CFCs, there are two "safe harbour" measures in the existing rules:

- a de minimus exemption contained in section 385(4) of the 1936 Act, which prevents attribution occurring in relation to broad exemption listed country CFCs where, in broad terms, the attributable income for the year is less than $50,000; and

- the "active income test" contained in section 432 of the 1936 Act, which, in broad terms, prevents attribution occurring where the "tainted" (potentially attributable) turnover of the CFC is less than five per cent of its total turnover for the year.

Under the existing law, attribution can potentially occur regardless of whether or not there is any tax saved by the group through earning the income or gains in the foreign country instead of in Australia, and irrespective of the fact that there may have been no relevant purpose of Australian tax-avoidance in relation to the activities of the CFC.

Problems with the current law

In order to comply with our CFC rules, Australian-based multinationals are required to ascertain each year whether their CFCs have derived any of the specified income or gains, and then determine whether any of those amounts need to be attributed and make the required attribution calculations (conversion to Australian dollars, calculation of foreign tax credits etc).

These compliance obligations have materially increased as a result of the 1997 amendments that reduced the number of countries eligible for concessional treatment as broad exemption listed countries.

These changes have meant that the existing law has become unbalanced in its focus on integrity measures and is placing excessive and unnecessary compliance burdens on Australian businesses operating outside Australia.

Evidence of the problem

The time spent by Australian businesses investing overseas in managing their CFC compliance obligations has, at least since the introduction of the 1997 amendments to the CFC rules, grown steadily and significantly under the combined pressure of those amendments, the general rigidity of the rules, the lack of simple and focused exemptions, and the growing complexity of international business transactions.

Many large corporations with extensive offshore activities have found that the time spent in managing CFC compliance has increased by up to 50% since the 1997 amendments, and most have been unable to develop any systems to enable these compliance activities to be simplified in any meaningful way. The most common expectation is that, as international business activities expand further, compliance obligations will continue to increase exponentially. In some cases there is also a concern that the integrity of those compliance activities will be undermined (it is sometimes proving impossible for the calculations to be made according to the letter of the law and "reasonable estimates" are already being made).

In essence, the existing approach under the rules is to impose attribution on a wide category of items and provide some narrow and strictly confined exceptions to attribution. The wide targeting means that businesses are constantly exposed to situations of inadvertent or unreasonable attribution, and are unable to provide simple working guidelines for CFC personnel that would remove the need to deal with complex attribution and the foreign tax credit calculations that attribution brings with it.

Solutions

A number of measures that are recommended in this submission will go some way to relieving the CFC compliance burden on Australian businesses, in particular, extending the number of broad exemption listed countries and confining the scope of "tainted services income".

Nevertheless, if we are to better redress the balance between integrity and compliance management, serious consideration should be given to the introduction of two additional safe harbour measures. The first measure would introduce an "active business" test into the CFC rules. The second measure would introduce a "purpose test" into the rules.

These measures will make the rules more effectively targeted and significantly reduce the compliance burden on Australian businesses that is created by the comparatively indiscriminate approach that underlies the present system.

The active business test

An active business test could involve the introduction of rules that are more appropriately focused than the existing active income test. Those rules may be modelled on the equivalent test already provided in the FIF provisions, or possibly on the Exempt Activities rule contained in the UK CFC provisions.

In essence, such a rule would provide that a CFC is exempt from CFC attribution in a given income year provided its assets are predominantly used to carry on an active business. That business may be defined on an exclusionary basis, so that the following companies would not qualify for the exemption:

- those whose predominant activity is the earning of passive income; and
- those who are predominantly engaged in providing services to or trading with an Australian resident controller or a resident associate of that controller.

Companies that are, directly or indirectly, holding companies for subsidiaries that satisfy the active business test would also qualify for the exemption, as may companies that undertake commercial share-trading activities.

The development of this exemption would require careful drafting, but there are, as noted above, a number of precedents that can be drawn upon to simplify this process.

The purpose test

In addition to the above measures, a purpose test could potentially involve the introduction into the CFC provisions of a rule which prevents attribution occurring where:

- any reduction in Australian tax - achieved as a result of a particular item of profit or income being derived by the CFC rather than in Australia - was minimal, or was only an incidental purpose of the CFC in deriving the income or profit; and
- in establishing and maintaining the operations of the CFC, there was at most an incidental purpose of reducing Australian tax.

The design of this safe harbour rule is entirely consistent with the fundamental objective of the CFC rules, which is to prevent the use of CFCs as a means of reducing or avoiding Australian tax, without discouraging foreign investment by Australian companies where that investment is principally motivated by non-tax commercial objectives.

The proposal would obviously require the introduction of a carefully drafted new rule. However, aside from the concept of a "reduction of Australian tax" and some other relatively minor definitional points, the new rules would involve concepts (such as that of "incidental purpose") with which Australian business taxpayers are already familiar.

Moreover, the use of a purpose test in the CFC context will not involve groundbreaking work. Other OECD countries, most notably the UK and Italy, have such a test. The rule proposed above is based on the equivalent UK CFC concession, so that it should be possible to draw significantly on UK experience in developing and explaining the rule, although it would be necessary to “Australianise” the test.

It will, of course, be important to ensure that this safe harbour measure does not cause integrity problems. To a significant extent, this can be done through the normal ATO audit program.

4.4.4 Investing in strategic international joint ventures

Current law

Where an Australian-based multinational participates in a foreign joint venture and holds a 50% interest in that joint venture, all the foreign joint venture companies will be categorised as CFCs under the general CFC definition. Categorisation as a CFC can also extend to situations where the Australian venturer holds no more than a 40% interest in the venture if there is no other party that has management control.

Problems with the current law

The general definition of a “CFC” provides a sound basis for determining the scope of the CFC rules, and captures all foreign companies that should be within those rules, having regard to their intent.

However, in some situations the definition captures foreign companies where the requisite degree of control does not, in fact, exist. This is the case with some international joint ventures.

These joint ventures are not “controlled” by the Australian venturer. While that venturer may have an equal say in the running of the venture it cannot treat it like a foreign company in which it has a majority interest. In practical terms, this means the venture is not a vehicle that is easily used to defer Australian tax on passive income.

Evidence of the problem

Over the last decade, joint ventures have become an increasingly common commercial device for companies expanding internationally. They are often necessary simply to meet regulatory requirements in a foreign jurisdiction, but are equally important from the Australian perspective as a means whereby Australian companies obtain sufficient critical mass to penetrate foreign markets (many Australian companies lack the capital on their own to challenge larger foreign competitors).

The application of Australia’s CFC rules to those ventures means that the Australian venturer is generally operating under tax laws that are more restrictive than those applicable to the foreign venture party. Neither the US nor New Zealand, for instance, will generally treat 50/50 joint venture companies as being within their respective CFC rules.

This creates an impediment for Australian companies seeking to internationalise from an Australian base.

Solutions

This joint venture impediment can be substantially removed for Australian investors by modifying the CFC rules so that 50/50 joint ventures are excluded from the definition of a CFC.

A modification to the CFC rules along these lines will place Australian companies on a more even footing with foreign competitors in building strategic international alliances.

4.4.5 Transfer pricing rules for CFC attribution purposes

Current law

Australia's transfer pricing rules overlay the CFC rules. In making CFC calculations, Australian-based multinationals are required to apply these transfer pricing rules to all relevant related party cross-border transactions undertaken by each CFC.

Problems with the current law

The existing law approaches the problem of value shifting through transfer pricing in the CFC context in an entirely untargeted manner. The approach essentially requires compliance with transfer pricing measures regardless of whether such compliance is necessary, having regard to the objectives of the CFC rules.

This all-encompassing approach reflects the global tax environment at the time the original rules were drafted. Australian transfer pricing rules at that stage were entirely undeveloped, as were the rules in almost all foreign jurisdictions.

Over the last ten years, however, the focus of international tax authorities on transfer pricing has increased dramatically, with the result that opportunities for tax planning that contravene the objectives and intent of the CFC rules are limited.

Moreover, in many situations the failure to apply arm's length standards on a transaction would not result in any loss to the Australian revenue and would merely create a foreign tax exposure that would be an outright cost to the Australian group.

Accordingly, the requirement to indiscriminately apply Australia's transfer pricing rules in the CFC context causes unnecessary compliance costs and can create unwarranted exposure to irrecoverable foreign tax costs.

Evidence of the problem

Perhaps the most common situation where Australia's CFC requirements create these problems is where funding is moved between CFCs.

Example 1 – Movement of funding between CFCs

> Where a CFC resident in Thailand has lent funds interest free to a CFC resident in Malaysia, the application of Australia's transfer pricing rules would deem the Thai company to derive a notional interest return. The CFC rules would then have to be applied to determine whether that notional income ought to be attributed back to Australia and taxed. This would be the case even if neither

the Thai nor Malaysian tax authorities were interested in the transfer pricing issue.

Assuming that the Thai company made the loan interest bearing, it is unlikely that there would be any tax pick-up in Australia under the attribution rules, as a tax credit for Thai tax paid on the interest would be available. The failure to charge interest, therefore, would not result in any loss to the Australian revenue. However, the charging of interest may expose the Thai company to Malaysian interest withholding tax. This would be an entirely unnecessary tax costs in the event that the Thai revenue authorities would not have required interest to be charged on the loan.

Some Australian companies deal with this problem by having surplus funds returned to Australia as exempt dividends and then re-invested in another CFC, normally by way of redeemable capital. It makes little sense for companies to be compelled to use such expedients, and in some situations even this alternative is not viable due to foreign withholding taxes on dividends.

A similar situation arises in the case of the provision of services by a shared services company in a CFC group.

Solutions

We recommend that the operation of Australia's transfer pricing rules in the context of transactions between CFCs be targeted only on those areas where they are required from a CFC integrity perspective. Therefore, if the existing section 23AJ exemption is retained, the transfer pricing rules should be confined to cross-border related party transactions that would allow value to be shifted from unlisted countries to broad or limited-exemption listed countries. If the section 23 AJ exemption is extended to cover all non-portfolio dividends, it should be possible to confine the application of the transfer-pricing rules even further.

This would reduce needless tax compliance obligations and allow Australian based multinationals to better manage foreign tax costs.

Given that this recommendation is directed towards the better targeting of integrity measures, the revenue cost should be negligible.

4.4.6 The quarantining of losses incurred by CFCs

Current law

When the attributable income of a CFC is calculated, each item of income must be allocated to one of the following classes:

- interest income;
- modified passive income;

- offshore banking income; and
- other income.

It is then necessary to determine to what class of income each notional allowable deduction relates and to deduct each notional allowable deduction from the relevant class of income.

If the notional allowable deductions relating to a particular class of income exceed the income of that class for a particular year (i.e. there is a loss for that class), the loss cannot be deducted from income of any other class or against Australian-source income derived by the CFC or by the attributable taxpayer. If may be possible to carry the loss forward and to deduct it from income derived in future years, provided that that income is of the same class as the income to which the loss relates.

Problems with the current law

The rules for dealing with losses incurred by a CFC are unreasonably restrictive. In particular, the current method of dealing with such losses creates the following problems:

- separate computations of attributable income may be required for each of the four classes of income.
- a CFC may make an overall loss in a particular year but nevertheless have attributable income. For example, in a particular year, the CFC may make a loss on its active business (the income of which would usually fall within the “other income” class) but may also derive passive income (such as dividends) and incur few expenses to deduct from the passive income. In those circumstances, the passive income may be attributable even if the loss incurred from carrying on the active business exceeds the passive income.
- if a CFC makes an overall loss in a particular year and does not have any attributable income, the CFC’s attributable taxpayers cannot offset the CFC’s loss against income attributed from other CFCs, against other foreign-source income derived by the attributable taxpayers or against Australian-source income derived by them. They may therefore be unable to use the CFC’s losses. Compare that treatment to the treatment of branches; if a taxpayer makes a loss from carrying on business through a foreign branch instead of through a CFC, the taxpayer may be entitled to deduct the loss from the taxpayer’s other foreign-source income.

Evidence of the problem

The complexity that arises from having to allocate each item of income to different classes adds to a taxpayer’s compliance costs.

For example, where a CFC carries on a manufacturing business and deposits surplus cash into a bank account, interest derived from the bank is likely to be classified as interest income, but income from the sale of manufactured goods would be “other income”.

Where a CFC carries on a banking business and as part of that business holds a portfolio of shares, dividends derived by the CFC would be passive income, but the fees and interest income derived by the CFC are likely to be “other income”.

Example 1 – Subsidiaries in a loss position

> Assume an Australian multinational has Chilean mining subsidiaries which are commencing mining operations. Some of these subsidiaries are in a loss position because they have substantial deductions but (because the mining operations are in a start-up phase) little income from mining.
>
> Notwithstanding that they are in a loss position, they fail the active income test because they generate passive income, typically on capital which is being held for deployment in the mining business. This passive income will be attributed under the CFC rules, and the costs incurred in the mining business cannot be offset against the passive income.

Solutions

The different classes of income should be abolished so that only one computation of attributable income is required. If under the CFC rules a CFC makes a loss, that loss should be allocated to the attributable taxpayers in the same way as attributable income is allocated, and the attributable taxpayers should be allowed to deduct the loss from the attributable income of other CFCs or from other foreign-source income they derive.

4.4.7 Repeal section 47A

Current law

Section 47A deems certain types of transactions entered into by the CFCs resident in unlisted countries to be dividends for Australian tax purposes.

Problems with the current law

As mentioned earlier, section 47A is a particularly complicated provision that may entail significant compliance costs. It applies in a wide range of circumstances and sometimes limits unreasonably the transactions a CFC may enter into, even if the transactions are entered into on arm's length terms.

Evidence of the problem

The complexity of section 47A is evident from a quick reading of the section.

Two examples of the circumstances in which section 47A may unreasonably limit the types of transactions a CFC enters into have been provided earlier (see the discussion on non-portfolio dividends).

Solutions

At the very least, section 47A should be redrafted and simplified and should be amended so that it has no application to arm's length transactions, such as loans made on arm's length terms and the subscription for shares at an arm's length price. Ideally, the section should be abolished.

4.4.8 Attribution of income derived by a CFC

Current law

The attributable income of a CFC is calculated for the statutory accounting period of the CFC. That attributable income is then included in the assessable income of entities that are attributable taxpayers at the end of the statutory accounting period.

Problems with the current law

Where a taxpayer buys shares in a foreign company during the foreign company's statutory accounting period, income derived by the foreign company during that statutory accounting period but before its shares are acquired by the taxpayer may be attributed to the taxpayer; in other words, there may be retrospective attribution. That is clearly inequitable. Moreover it will invariably not be possible for the purchaser and the vendor to adjust the purchase price of the shares appropriately to reflect the retrospective attribution, because the vendor is not an Australian company and therefore is not subject to Australia's CFC rules.

In 1995 the CFC rules were amended to ensure that capital gains made by a foreign company before its shares are acquired by an attributable taxpayer will not be attributed. However, the amendment applies only if the foreign company has not previously been a CFC. If the foreign company has been a CFC at any time before its shares are acquired by a particular attributable taxpayer, the attributable taxpayer may be taxed on capital gains derived by the CFC during the statutory accounting period but before the acquisition by that attributable taxpayer.

Solutions

Amend the CFC rules so that, where shares in a foreign company are acquired directly or indirectly by an Australian resident, only income and gains derived by the foreign company after the acquisition may be attributed to that taxpayer.

Consideration should also be given to ensuring that the cost base of assets held by a CFC are based on their market value at the time the CFC is acquired by the attributable taxpayer (where, for instance, there is a change of more than 50% in the ownership of the CFC).

The rules dealing with foreign investment funds provide a precedent for apportioning attributable income by reference to the date of acquisition of shares in the foreign company.

4.4.9 Attribution of capital gains made by CFCs

Current law

If a foreign company makes a capital gain that is attributable under the CFC rules, section 456 of the 1936 Act includes the capital gain in the attributable shareholder's assessable income as income rather than as a capital gain. If an attributable shareholder has capital losses, those losses cannot be offset against the attributable income.

If an Australian taxpayer carries on business through a branch in a foreign company and in the course of carrying on that business makes a capital gain, the gain is generally taxed under Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (1997 Act). If the taxpayer has capital losses, those losses can generally be offset against the capital gain.

Problems with the current law

The existing law creates a bias in favour of operating in foreign countries through a branch rather than through a subsidiary. In addition, the treatment of attributable capital gains made by a CFC is inequitable. The CFC rules operate by looking through the CFC to the income derived by the CFC and applying Australian tax rules to determine the attributable income. On that basis, it is difficult to understand why a capital gain made by a CFC should be taxed as income rather than as a capital gain.

It is sometimes argued that the current treatment of attributable capital gains is justified because, if the gain were not attributable and instead were distributed as a taxable dividend, the dividend would be taxed as ordinary income. There are two flaws in that argument:

- The argument incorrectly assumes that attributable income determined in accordance with the CFC rules is a substitute for dividends. It ignores the fact that the CFC rules apply Australian tax principles to the underlying income earned by a CFC and in effect integrate the CFC with the attributable taxpayer, at least to the extent that the CFC makes a profit from the derivation of low-taxed mobile income. If attributable income were intended to be a substitute for dividends, the computation of attributable income would logically have to be based on the book profits of the CFC (i.e. on the amount available for distribution) rather than on Australian tax principles.

- The argument assumes that the capital gain will eventually be distributed as a dividend to the attributable taxpayer. However, it is equally conceivable that the attributable taxpayer will realise the benefit of the capital gain by selling the shares in the CFC, particularly if the taxpayer is able to obtain the one-third or one-half exemption ("discount") available in certain circumstances under Part 3-1 of the 1997 Act.

Solution

The CFC rules should be amended so that, where a CFC makes an attributable capital gain, Parts 3-1 and 3-3 of the 1997 Act apply to the gain rather than section 456 of the 1936 Act. If an attributable taxpayer has a capital loss, the attributable taxpayer should be allowed to offset the capital loss against the attributable capital gain and include only the net capital gain (if any) in assessable income.

4.4.10 The sale by non-residents of non-resident interposed entities

The Treasury consultation paper raises, as Option 3.6, whether consideration should be given 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[20].

Current law

Non-residents of Australia are subject to CGT on the disposal of CGT assets having the "necessary connection with Australia". Shares in non-resident companies are not assets that normally have that connection, so that a sale or disposal by a non-resident of shares in a non-resident company will not give rise to a CGT liability for the seller. This is the case regardless of whether or not the shares in the non-resident company being sold or disposed

[20] A Tax System Redesigned, *Review of Business Taxation*, Report, July 1999, Recommendation 21.7.

of give the seller an indirectly held interest in an Australian resident company.

As part of the Review of Business Taxation, it was proposed to introduce a rule treating such disposals as potentially subject to CGT.

Problems with the proposal

The proposal involves an extraordinary extension of Australia's taxing rights and is, we believe, fundamentally flawed for the following reasons:

- in order for the measure not to create havoc for non-resident investors it would need to be extremely carefully targeted. Given the enormous range of situations that would need to be excluded from its operation, this will almost certainly make the measure one of the most complex in our tax system;

- the measure could require the deeming of a tax liability in the indirectly held Australian resident entity in order for any tax to be collected. This would:

    - leave any resident shareholder in the company exposed to the burden of the tax in the event that a non-resident chose to sell its interest "up the chain", a matter over which they would normally have no control;

    - leave the Australian company exposed to tax in situations where it may not even be aware that there has been a triggering change of ownership up the chain;

    - place tax risk on the purchaser of the shares in the interposed entity (as well as on any other shareholder in the ultimate Australian resident company) in a situation where they would not expect such risk to exist (as the proposed rule would be contrary to normal international practices), so that they would rarely recognise the existence of the liability in advance;

    - expose the non-resident to double tax, as many countries would deny a credit for Australian tax paid in these circumstances;

- the rule would likely require valuations to be undertaken in many situations: for instance, where the Australian company held non-Australian assets, or where the interposed foreign company held non-Australian assets;

- the rule would not sit comfortably with Australia's double tax treaties. Such a unilateral extension of Australia's taxing rights would almost certainly be viewed by our treaty partners as unwarranted and would hinder attempts by Australia to re-negotiate treaties on more favourable terms for Australian taxpayers; and

- the relative novelty of the rule, and its complexity, will create a very strong impression (in those potential foreign investors who find out about it) that Australia is not a particularly attractive destination for foreign investment.

The proposal would thus create unwarranted complexity in the tax system, cause inadvertent breaches of the law, create hidden tax exposures for unwary foreign and domestic investors and, for probably a relatively small revenue gain, make Australia appear to be a far less attractive investment destination than it otherwise is.

Solution

We strongly urge that the proposal be dropped from the legislative agenda.

4.5 Tax Treaties

4.5.1 Future treaty negotiations

Option 3.5 of the Treasury consultation paper deals with consideration of whether the recently negotiated Protocol to the Australia-US tax treaty provides an appropriate basis for future treaty negotiations or whether alternative approaches are preferable.

Current Situation

Australia has not yet published a “model” tax treaty. Prior to the signing of the Protocol to the Australia-US treaty on 27 September 2001, it was said that the Australia-Romania treaty of 2000 represented a virtual model.

The form of Australia’s tax treaties is generally consistent with the OECD’s Model Tax Convention on Income and on Capital, the current version of which was updated as of 29 April 2000.

Treaty negotiations typically involve at least two meetings of the negotiating teams, with perhaps a six-monthly interval between meetings. This is followed by agreement, signature, ratification and the exchange of instruments of ratification.

The Protocol to the Australia-US treaty was relatively swiftly negotiated in the period between March and September 2001. However, in addition to the consultation and negotiating processes, the legislative and Parliamentary processes can be cumbersome and lengthy. Although Australia ratified its signature on 3 July 2002, the exchange of instruments of ratification is yet to take place. Consequently, the Protocol is yet to enter into force.

Problems with the current situation

The elapsed time between the commencement of treaty negotiations and the entry into force of the relevant treaty has rarely been less than two years. It is usually much longer. But even before that period begins, both parties must agree that negotiations are required. Accordingly, the treaty process is not responsive to rapid changes in either economic or commercial circumstances.

Australia’s emphasis on source-country taxing rights (excepting on dividends) makes its negotiating stance somewhat defensive. The treaty partners who are most highly valued by Australia are capital exporters and less likely to be seeking source-country taxing rights. Accordingly, the perceived needs of the negotiating parties are not mutual.

There remains an unresolved issue between Australian tax advisers and the ATO concerning whether or not Australia’s older tax treaties operate to exempt residents of the other countries from CGT. It is regrettable that this issue has not been settled by the Australian courts.

Whilst the Protocol to the Australia-US treaty, when it comes into force, will represent a significant modernisation of Australia's approach to tax treaty negotiation, it contains some flaws in its detail, and some shortcomings in its scope.

These should not prevent it forming a basis for future negotiations, but it is to be hoped that there will be continuing improvements at both the policy and detail levels.

It is submitted that the OECD format for treaty lay-out and language is appropriate. It is well understood internationally and enhances the efficacy of treaty negotiations. Within that format and language, Australia can pursue a variety of policy objectives.

Evidence of the problem

The treaty system is extremely unresponsive to rapid change, notwithstanding the best efforts of those responsible. The most obvious example is the introduction of Australia's imputation system in 1987. This immediately relieved many foreign shareholders of Australian dividend withholding taxes, without any compensating benefit being achieved for Australian shareholders in treaty-partner countries.

Negotiations of revised treaties also tend to be interrupted. For example, the revised treaty with Germany was delayed by domestic German tax reform and the revised treaty with the Netherlands appears to have been frustrated by Australia's response to the decision in *FC of T v Lamesa Holdings BV* [97 ATC 4752].

It has been suggested that Australia was most reluctant to give up its 10% royalty withholding tax in the 2001 negotiations with the US. The rate was finally agreed to be reduced to 5%. Australia's defensive position on royalty withholding tax (absent a treaty, the rate is 30% with no relief for expenses) not only exemplifies its persistence with source-country taxation, but also demonstrates a surprising reluctance to reconsider the true source of royalty income. Both Australian domestic tax law and its tax treaties deem royalties to be sourced where the payer resides. In an increasingly technological global economy, it is regrettable that this does not recognise the costs and continuing commitments which are made outside Australia to create the subject-matter for which the royalty is paid.

Representatives of the ATO have suggested that they would like to see the question of CGT rights (under Australia's older treaties) challenged in the courts. However, they have also suggested that they have been unable to find a suitable case to litigate. This could suggest that there is some concern about the strength of the position taken by the ATO in Ruling TR 2001/12. At a practical level, there is some doubt as to whether the ATO has jurisdictional authority to collect CGT from non-residents not in Australia. Moreover, Australia's insistence on including CGT articles in future negotiations may be as much a hindrance as help.

In the Protocol to the Australia-US treaty, the following examples are provided of problems which have emerged:

- the concept of "fiscally transparent entities" has been introduced to Article 7 of the treaty without the concept being adequately defined;

- now that equipment rentals (payments for the use of industrial, commercial or scientific equipment) are to be excluded from the royalty definition, there is a new concern over the taxation of rents for "substantial equipment" as business profits. Anecdotal evidence exists that the ATO is seeking to reassess what is meant by "substantial";

- the 0% rate of dividend withholding tax requires that a *single* company holds at least 80% of the voting power in the company paying the dividend. Combined ownership by two or more commonly-owned companies will not qualify for 0% withholding tax; and

- the new Limitation of Benefits Article is essentially drafted from a US perspective and does not recognise certain aspects of Australian commercial structures (including dual listed companies and companies owned by Australian discretionary trusts).

Solutions

The new Protocol to the Australia-US tax treaty has demonstrated what can be achieved in more assertive treaty negotiations. It is submitted that the Protocol is a good start to a new approach, but it need not represent the upper limit of Australia's negotiating position. Australia should adopt its own published Model Treaty, which need not be based on the Australia-US Protocol.

The tax treaty process needs to be substantially abbreviated, so that the treaties can be more swiftly adapted to change of law in each of the contracting states.

Australia needs to be more prepared to give up its stance on source-country taxing rights (including capital gains taxing rights), especially where the other country is prepared, either unilaterally or by negotiation, to forego equivalent rights.

4.5.2 Priority for tax treaty negotiations

Option 3.7 of the Treasury consultation paper considers which countries should be given priority for tax treaty negotiations, taking into account negotiations under way 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.

Current Situation

Priorities for tax treaties are discussed at meetings of the Tax Treaties Advisory Panel (a subcommittee of the National Taxation Liaison Group). At the meeting held in May 2000, the following lists were provided of treaties then under revision and proposed new treaties:

Treaties Under Revision	Proposed New Treaties
China	Bangladesh
Italy	Brazil
Netherlands	Bulgaria
South Korea	Chile
Switzerland	Israel
Taiwan	Mauritius
	Pakistan

Also provided at this meeting was an extensive list of countries which have sought tax treaties with Australia and which had not yet been admitted to Australia's tax treaty program.

At the time of the meeting in May 2000, the Panel was advised that the US was showing little enthusiasm for renegotiation, but that there was some hope that the UK treaty renegotiations may begin in about September 2000. The Protocol to the Australia-US tax treaty has been concluded well in advance of the UK renegotiations. However, this is partly explained by an understanding that the UK treaty is the subject of a complete revision, not merely a Protocol.

In Australia, the initiative for a new tax treaty may arise in different departments of government. The priorities are not always set by Treasury and treaties are sometimes triggered for diplomatic reasons.

Problems with the current situation

Responsibility for the negotiation of tax treaties has recently been transferred from the ATO to the Department of the Treasury. Nevertheless, the individual members of the Treaties Unit have remained more or less the same. The Treaties Unit is not large, and is required to balance a number of priorities, responsibilities and accountabilities. The constant reordering of priorities is a feature of the Unit, as work is interrupted by:

- international affairs generally;
- political events in treaty partner countries;
- the whims of treaty partner negotiators;
- diplomatic happenstance;
- Australian tax reform; and
- the process of converting negotiated treaties into part of Australia's taxation law.

The Treaties Unit is required not only to have a sound understanding of Australia's domestic tax law, but also an appreciation of the principles of the tax laws of treaty partners and potential treaty partners. They are also required to have familiarity with the due procedures of foreign affairs, availability to travel overseas at short notice and strong negotiating skills.

It is clear that the Treaties Unit is under-resourced, especially taking into account the negotiations which will be required to satisfy Australia's obligations under the "most favoured nation" clauses in existing treaties.

Evidence of the problem

The apparent evidence is that the list of priorities which was current in May 2000 has not yet been materially advanced. Nevertheless, Australia has made significant headway in modernising its more important treaties with the UK and USA.

Some overseas countries pursue aggressive source-country taxation and the negotiation of treaties with those countries is desirable. For example, Israel has a classical company tax system with a company tax rate of 36%. Dividends paid out of after tax profits are the subject to a further 25% withholding tax. Some countries, such as Sweden and Singapore, have successfully negotiated the total elimination of this 25% Israeli withholding tax.

Solutions

Since it is foreseeable that Australia's tax treaty negotiation resources will continue to be stretched, it is important for the Department of the Treasury to ensure that the program is focussed. In the main, Australia has a good portfolio of tax treaties. It is more important that Australia should have meaningful, modern and relevant treaties with its major trading partners rather than simply extending the number of treaties in existence.

The recent update of the Australia-US treaty and the current Australia-UK negotiations are good examples of focussing on our highest priorities. However, it would be desirable for Australia to ensure that discussions with the US and UK do not conclude as soon as a treaty (or Protocol) is signed. In order to allow for more rapid changes to our most important treaties, it is submitted that the dialogue between countries should be ongoing.

The treaties with Japan (1969) and the Netherlands (1976) are overdue for renegotiation. Notwithstanding Japan's current economic condition, it continues to be a major trading partner. The Netherlands is an important treaty partner because many international organisations invest via the Netherlands; and for Australian investors in Netherlands companies, the Netherlands 15% dividend withholding tax is a significant burden which fails to reciprocate Australia's 0% rate on franked dividends.

4.5.3 Negotiating tax treaties

Current situation

The Treaties Unit currently consults with the private sector in at least two ways. The formal means of consultation is via the Tax Treaties Advisory Panel. Australian entities which have significant investments in, or an association with firms located in, treaty partner countries are also consulted informally.

The Panel has included representatives of the ATO, the Department of the Treasury, the Department of Foreign Affairs and Trade, the Australian Bankers' Association, the Australian Industry Group, the Corporate Tax Association, CPA Australia, the Investment and Financial Services Association, the Institute of Chartered Accountants in Australia, the International Fiscal Association, the Minerals Council of Australia, the Law Council of Australia and the Taxation Institute of Australia. At some meetings, additional representatives and observers have been invited to attend in relation to specific issues affecting them. For example, the Business Council of Australia and the American Chamber of Commerce in Australia were represented in discussions concerning the US negotiations on 18 May 2001.

Problems with the current situation

The meetings of the Tax Treaties Advisory Panel are too infrequent. Also, whilst the meetings have so far been constructive, they tend to have had "show and tell" characteristics on the part of the Treaties Unit, and sometimes the consultative questions put to the Panel are too late for the answers to be useful.

The traditional "confidentiality of bilateral negotiations" has a capacity to be used as an excuse for shortcomings in the consultative process.

Evidence of the problem

Only six meetings of the Tax Treaties Advisory Panel have been held in five years.

The draft of the US Protocol was presented to Panel members on 17 September 2001 for telephone discussion on 20 September 2001. A number of important issues were raised during that telephone discussion but it was absolutely clear that the process was so far advanced that these issues would not actually be further negotiated with the US. It is understood the Protocol was signed without further alteration on 27 September 2001.

On 28 August 2001, one Panel member had written to the Treaties Unit remarking that more information on the US Protocol was available from the newspapers than was available to the

Panel. It is believed that the newspapers were obtaining information from the US where the process was more transparent.

By contrast, there has been far greater transparency and consultation in Australia regarding the new tax treaty with the UK. Following a request by the Panel, the UK was asked whether they would agree to greater transparency. It is understood that the UK agreed to this, notwithstanding expectations to the contrary by the Treaties Unit

Solutions

The Tax Treaties Advisory Panel should meet more frequently, at least twice each year.

The Panel operates at minimal cost because external representatives are unpaid. Additional, paid consultation could also be arranged.

The diplomatic "secrecy" concerning treaty negotiations should be set aside, and the value of transparency and consultation should be agreed in advance with treaty partners, as exemplified by the current UK negotiations.

Legislative and Parliamentary processes could be streamlined to ensure speedier ratification of concluded negotiations.

Withholding tax on related party loans

Under the current law, the exemption from interest withholding tax only applies to loans between non-associated parties. However, there is no obvious policy basis for confining the exemption to borrowings that are sourced from overseas banks and financial institutions.

We believe that the interest withholding tax exemption should be extended to related party (inter-company) loans.

4.6 Promoting Regional and International Headquarter Conduit Companies

While Australia may be attractive as a research location, as an import market or as an exporter of goods and services, our tax environment creates barriers to Australia's attractiveness as a regional headquarters location.

In particular, we consider the following impediments need to be removed to attract and retain regional holding companies:

- the imposition of capital gains tax on the disposal of subsidiary companies located overseas if these are owned directly by an Australian company;
- the imposition of tax liabilities under the CFC rules if lower-tier disposals or re-organisations occur;
- the attribution of income of lower-tier CFCs where their income is considered to be tainted services or tainted sales income;
- foreign branch income derived from operations in unlisted countries; and
- other foreign sourced income not connected with a foreign branch.

These measures require implementation as an integrated package. It is useful but insufficient to deal with the measures in isolation, because the potential establishment of a regional headquarters location or a global segment headquarters in Australia will look to a combination of various factors.

4.6.1 Recommendations

First, we recommend that a general exemption for non-portfolio dividends received from foreign companies and for capital gains derived from the sale of non-portfolio interests in foreign companies should be provided to both foreign-owned Australian companies and Australian companies which are not foreign-owned.

We see this as preferable to capital gains tax concessions aimed solely at foreign-owned companies for reasons of OECD perception and competitive neutrality.

If this option is not accepted, we believe conduit relief for both non-portfolio dividends and capital gains should be provided to effectively wholly foreign owned Australian companies. Therefore, where a foreign resident sells an interest in an Australian company, a CGT exemption should be provided to the extent that the gain relates to foreign assets of the Australian company.

We believe conduit restructure relief to streamline the transfer of foreign subsidiaries should only be considered as a last resort since it does not provide a genuine conduit income exemption.

Second, we recommend further conduit measures to deal with known problems in the Australian system relating to the treatment of foreign source and foreign branch income.

Third, we make these conduit recommendations in the expectation that the reform of the CFC rules in relation to tainted income and other necessary reforms will be made, and note their importance in relation to conduit activities. We emphasise that solving CGT and dividend issues without solving the known long-standing CFC defects discussed in the Treasury consultation paper would not attract foreign-owned companies to Australia and would not produce the economic advantages sought.

4.6.2 General Exemption

Current Law

Under current Australian law, where a non-resident invests in foreign assets through an Australian company, the non-resident is often subject to Australian tax on foreign income that is generated from those foreign assets. Any gain on the disposal of those foreign assets is also generally subject to Australian tax.

This result is somewhat mitigated by the exemption provided by section 23AJ of the 1936 Act in respect of non-portfolio dividends received from foreign subsidiaries resident in “listed” countries. Further, foreign sourced dividends can generally be on-paid to a foreign shareholder by an Australian company without Australian withholding tax under the foreign dividend account provisions.

However, the following items remain subject to Australian tax:

- dividends received from foreign subsidiaries resident in unlisted countries (this is covered under CFCs section page);
- foreign branch income derived from operations in unlisted countries;
- other foreign sourced income not connected with a foreign branch;
- income attributed under the Australian CFC rules from foreign companies that are CFCs of the Australian company; and
- gains arising from the disposal of shares in foreign subsidiaries.

In addition, where a non-resident disposes of an interest in an Australian holding company, any gain is also subject to Australian tax regardless of whether it is attributable to Australian assets or foreign assets of the Australian holding company.

Problem with the current law

The Treasury consultation paper accepts that, as a general policy, conduit income should not be taxable in Australia because arguments supporting residence or source based taxing rights are not applicable and such income is likely to be highly tax sensitive. The paper indicates that there are two caveats to this policy, which can broadly be described as integrity concerns and concerns about harmful tax competition.

The Treasury consultation paper accepts that these tax considerations provide a strong disincentive for non-residents to hold their non-Australian investments via an Australian company. In turn, this provides a disincentive for using Australia as a regional headquarters location, particularly from a structural viewpoint. The Treasury consultation paper goes on to recommend consultation on options to provide conduit relief for regional holding and joint venture companies.

Evidence of the problem

We believe that it is evident that under current Australian law many categories of foreign sourced income derived by non-residents via an Australian company are currently subject to Australian tax.

Further, there is ample evidence in practice of foreign companies either not using Australia as a location for their regional holding company, or of foreign groups 'dismantling' an existing Australian based international holding company once the foreign group acquires the Australian entity.

It is abundantly clear that global companies operate on the basis of decentralised authority, and the significant trend of recent years has been for:

- the development of regional holding companies (referred to in this submission as "regional headquarters"); and
- the organisation within many global countries of individual service lines managed from particular companies, which may be located in different countries (referred to in this submission as "global segment headquarters").

Global groups planning to establish regional headquarters and global segment headquarters will consider a combination of factors in relation to each potential headquarters country, including:

- existing corporate operations, skilled staff and facilities in the potential candidate country;
- geographic and other communication issues;
- taxation factors for the range of service and share-ownership activities planned;
- stability of government and financial institutions; and
- security.

There will usually be a range of countries available for an investment. So taxation disadvantages can be a powerful attraction or deterrent, and can be the deciding factor in country selection.

The Australian tax profile for regional headquarters and segment headquarters is highly adverse, and this creates significant challenges for Australia. Thus:

- Australian subsidiaries of global groups miss out on the opportunity to be promoted to become regional headquarters or global segment headquarters, and
- a global company acquiring an Australian operation which has existing international activities, will typically dismantle the Australian headquarters activities in relation to international operations out of Australia.

Solutions

The consultative paper suggests that conduit relief might be provided where:

- an Australian company disposes of an interest in a foreign company; and
- where a foreign investor disposes of an interest in an Australian company which has foreign assets.

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

We also note that, in addition to CGT relief, consideration should also be given to other targeted measures to encourage the establishment of regional headquarter service activities in Australia. The provision of CGT relief is an important step in this process. However, it may be the case that a foreign group is prepared to locate a headquarter services entity in Australia whilst keeping its existing corporate structure in place.

4.6.3 Disposing of an interest in a foreign company

We recommend a general CGT exemption for the sale, by an Australian taxpayer, of a non-portfolio interest in a foreign company with an underlying active business, whether the Australian taxpayer is foreign-owned or not. This general exemption would follow the strong lead of European countries (including the major members of the OECD) in offering a participation exemption which has precisely this effect. This trend has gathered pace in 2001 and 2002.

The Treasury consultation paper confirms that such an exemption is justified since Australia's current CFC rules already exempt disposals of underlying active business assets by CFCs. Further dividends paid out of such profits are exempt where the foreign subsidiary is a resident of a listed country.

The proposed exemption would therefore be consistent with this outcome, except where the foreign company was not resident in a listed country or had substantial tainted assets or where the interest in the foreign company was only a portfolio interest. Further, if the exemption for non-portfolio dividends was broadened to cover all dividends, as proposed in Option 3.9 of the Treasury consultation paper, then this exemption could also be broadened.

In our view, this general exemption option is the most attractive for a number of reasons:

- it is the simplest from a structural perspective as it does not rely on testing the ownership of the Australian company selling the interest or receiving the dividend;

- such an approach would also eliminate any potential claims from the OECD and its members that the provision of such an exemption amounted to harmful tax competition, since the exemption would be generally available to both Australian and foreign owned companies;

- such an exemption would be consistent with the approach in several European countries including the Netherlands, the UK and Germany. We consider this an important element, as it would align Australia with international tax systems rather than perpetuating the current unique and hard to understand Australian style of international tax measures; and

- this measure would be a tax-neutral policy between Australian and foreign-owned companies, without boundary issues. This issue is whether a foreign-owned company should have a greater incentive to locate its regional and global headquarters in Australia than an Australian originated company which has 75% foreign shareholding. We think that both categories of companies should be treated similarly, otherwise wholly foreign-owned groups would be attracted to Australia (which we support), but international companies with Australian involvement would continue to have tax deterrents to basing their global headquarters activities in Australia.

The only practical issue with regard to this option relates to determining the active/passive business distinction, but this practical difficulty should not be insurmountable.

Australia already has an active business exemption in the FIF rules, which could be used as a starting point for designing an active business exemption for these purposes. The exemption in the FIF rules relies upon accounting records to determine asset values and provides a mechanism to apply the rules to groups of entities (with a minimum 50% ownership threshold).

This position is a development of our view since the BCA Discussion Paper, reflecting the strong European trend, including that in the UK, to follow the approach of a participation exemption.

4.6.4 A Conduit Holding Company Regime

Option 3.10 in Treasury consultation paper is a CGT exemption for foreign-owned Australian companies. Under this option, an exemption would be provided from CGT in respect of gains on the disposal of foreign subsidiaries (and possibly non-portfolio interests in any foreign company) to the extent that the Australian company is foreign owned.

If this option is introduced, it is imperative that relief should apply also to non-portfolio dividends received from companies resident in unlisted countries.

We do not see this as controversial since such income would clearly be foreign sourced and should therefore benefit from the exemption. Further, such income is generally being kept offshore indefinitely and so the cost to revenue of this measure should not be significant.

Provided that the Australian company is effectively wholly foreign owned, the entire gain or dividend should be exempted. The exempting company threshold for foreign ownership[21] would probably be appropriate since any Australian ownership would be minimal.

This would eliminate some of the practical difficulties with the exemption. Further, since there would be a minimum foreign ownership threshold, only genuine conduit income would be exempted3.

Provided that the Australian company is effectively wholly foreign owned, the exemption should also apply to :

- branch income derived from foreign operations of a wholly owned Austrlian company conducted in unlisted countries; and
- foreign source income not connected with a foreign branch.

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

4.6.5 Conduit Restructure Relief

Under Option 3.10 in the Treasury consultation paper, one possibility canvassed is to provide relief to corporate restructures that allow a conduit structure to be unwound, by providing a rollover to allow an Australian company to transfer a foreign subsidiary to its foreign parent without Australian CGT.

We believe that this option is the least preferable and should not be pursued because it does not provide genuine relief for regional holding companies.

This option runs counter to Australia's national interest, as it provides no incentive to retain the ownership of foreign subsidiaries in a tax neutral way below an Australian subsidiary in a foreign-owned group. This option does not provide an incentive for the use of Australia as a regional holding company location because it requires restructuring prior to a sale of the non-portfolio interest to a third party.

[21] Review of International Taxation Arrangements, Consultation Paper, *The Treasury*, p 45.

Such restructures would be likely to raise issues in the local country of the foreign subsidiary relating to, for example, transaction taxes and exchange control or foreign investment rules.

A pure restructure relief in Australia may also trigger CFC-like rules in the foreign parent jurisdiction.

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

4.6.6 Disposal by a foreign investor of an interest in an Australian company which has foreign assets

We believe such an exemption could be provided where an Australian company is wholly or partly owned by non-residents.

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

Where the non-resident sold an interest in an Australian company which had an unrealised or undistributed gain referable to foreign assets, the provision of an exemption would be more difficult. We believe that, notwithstanding the practical difficulties involved, relief should be provided in cases where the Australian company is effectively wholly foreign owned and the non-resident disposes of a non-portfolio interest. Again, the level of foreign ownership could be based on the exempting company rules.

The Treasury consultation paper suggests that valuation issues would arise in determining the extent to which a gain is referable to foreign assets as compared to Australian assets. We acknowledge the difficulties involved with this option but believe it would nevertheless be worthwhile to pursue. If a non-resident wished to take advantage of the relief, it would obtain the necessary valuations and perform the steps needed to qualify for the exemption.

We note that CGT Event K6 requires a similar determination in order to calculate the capital gain arising in respect of that CGT Event. The rules relating to that determination could be used as a starting point for designing this exemption.

4.7 The Company Residence Test

The current test for determining the place of residence of a company is uncertain and potentially onerous.

Any option that clarifies the existing law and reduces its associated administrative costs is to be supported. However, we believe that reform in this area should go further to consider the replacement of the central management and control test with an incorporation test.

4.7.1 Recommendation

We recommend a residence test based on country of incorporation. Such a test would be simple to apply in practice and would eliminate the administrative burden and the negative policy implications associated with the current test.

Current law

Under current law, a company incorporated outside Australia is tax resident in Australia if it carries on business here and has its central management and control in Australia or has its voting power controlled by Australian resident shareholders.

The statutory test for the residence of a company was introduced with the enactment of the 1936 Act. The common law test for the residence of a company at that time did not (and the common law test that still applies in the UK continues not to) deal separately with "carrying on business" as distinct from "central management and control". Indeed, in the leading case (De Beers Consolidated Mines Ltd v Howe (1906) AC 455), the key principle was stated to be "that a company resides…where its real business is carried on…and the real business is carried on where the central management and control actually abides".

In drafting the statutory test for ascertaining whether a company is resident in Australia, the common law test was expanded upon to take into account the place of incorporation and, for companies not incorporated in Australia, the threshold requirement that a company be carrying on business in Australia was set out as a separate test from central management and control. The requirement for "carrying on business" became a separate requirement alongside a new test relating to control by shareholders. It is implicit in this that the Australian legislature must have considered that, for the purposes of ascertaining whether a company is a resident of Australia under Australian taxation law, the common law test required some modification.

It is well established in case law that central management and control is the highest level of strategic management of a company. Malayan Shipping Company Limited v FC of T (1946) 71 CLR 156 is the only Australian authority of which we are aware in which the interpretation of the different elements of the statutory test has been considered. This case appears to link carrying on business with central management and control and includes a dictum to the effect that the two-part statutory test for corporate residence would be satisfied if the business carried on in Australia consisted of, or included, the company's central management and control.

The Malayan Shipping case should also be viewed in the context in which it was made. The assumption that the activities which constitute the "control" of a company always constitute the "carrying on of business" by the company may have been understandable as a matter of practicality in 1946. However, given the changes that have taken place since 1946 in the mobility of executives, advances in electronic communications, and corporate business practices, including the globalisation of business activities, this approach has obviously dated.

Problems with the current law

Under the current law it could be concluded that the holding of board meetings in Australia could result in a foreign company being deemed to be Australian tax resident.

There are potentially significant implications for non-Australian companies in becoming tax resident, such as the application of the Australian CGT and CFC rules. In addition, a change in residence from Australian to non-Australian, for example, a result of a change in the location of board meetings, can trigger Australian CGT on the worldwide assets of a foreign incorporated company.

The current test raises a number of practical uncertainties, including:

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

Australian multinationals will often invest offshore via joint ventures. If the investment is majority owned by the Australian company, the joint venture will be a tax resident in Australia if it carries on business in Australia. This test is potentially onerous given the broad range of activities that could constitute a carrying on of business. The mere location of executives or other employees in Australia, for example, would normally amount to carrying on business.

We understand that current ATO practice is not to treat CM&C alone as synonymous with carrying on business. However, this does not address the problems caused by the inclusion of a carrying on of business element in the residence test.

From a policy perspective, the current law has the following implications:

- it forces Australian executives to locate offshore in order to avoid the risk that an offshore subsidiary that is majority Australian owned could be considered to carry on business in Australia;
- it forces Australian executives to travel offshore to attend board meetings – even attendance via telephone or video conferences can be a problem;
- it encourages the appointment of non-Australian resident directors and executives to the management and boards of offshore subsidiaries and joint ventures; and
- it discourages the use of Australia as a location for the regional or global management of offshore incorporated companies.

None of these are in the long term interests of Australia as a regional headquarters and/or regional service centre.

Evidence of the problem

There is significant anecdotal evidence of the current residence test leading to sub-optimal commercial outcomes for Australian multinationals, such as:

- Australian based directors not being appointed to boards of foreign subsidiaries;
- Australian resident directors being forced to travel to offshore board meetings; and

- Australian resident directors having to avoid board meetings when they cannot, for whatever reason, travel offshore (and where attendance by phone or video-conference is problematic under the current test).

Furthermore, the residency rules have the added problem of reducing the involvement of an Australian parent company in the activities of their foreign subsidiaries. This results in either talented Australian managers, who could potentially manage from Australia using modern communication techniques, moving out of Australia, along with their families, managers and support teams, or residents in the foreign jurisdiction taking on these responsibilities to the detriment of Australian employment.

Some might argue that the costs of ensuring non-Australian residence for a foreign incorporated company are not significant. But this tax feature results in lost opportunities for Australia.

The restricted Australian involvement in, and supervision of, overseas subsidiaries reduces the ability to properly manage overseas operations. Further, the increased focus globally on corporate governance and closer involvement of the head company in each subsidiary's operations will intensify the adverse outcomes for Australia arising from this tax disadvantage.

Solution

The consultative paper discusses three potential benchmarks for determining the residence of a corporation:

- adjustment of the existing residence definition to provide that "exercising central management and control alone does not constitute the carrying on of a business";
- use of a "place of effective management" approach; or
- the place of incorporation of the subsidiary.

Adjusting the existing test is a partial but incomplete solution

We support the Option 3.12 proposal, as a partial solution to the problem, to clarify the residence test to ensure that merely exercising CM&C in Australia does not constitute the carrying on of business. This could be done by way of simple amendment to the legislative definition of residence to provide that a company shall not be deemed to carry on business in Australia as a consequence of exercising its central management and control here.

However we note the use of the words "exercising central management and control **alone"** (emphasis added) which points to the fact that this proposal will require further measures to:

- define what central management and control is; and
- define the outcomes if there is central management and control plus other problematic activities which will result in uncertainty and in due course in litigation and risks.

We therefore believe that any reform should go further than this and should re-examine the continuing appropriateness of a central management and control test.

It is arguable that a 60 plus year old test is no longer appropriate or necessary given modern business practice and the development of the following:

- CFC rules (which assess passive and tainted foreign income of non-Australian incorporated companies);

- CGT rules (which assess gains made in relation to investment in foreign companies); and

- transfer pricing laws (which assess the profits attributable to Australian activities and assets of non-resident companies), together with principles determining the source of profits and branch taxing rights.

All of these measures are designed to ensure that Australia captures its fair share of tax revenue. An additional measure that deems a foreign incorporated company to be Australian resident, and then seeks to tax its worldwide income, on the basis that it is managed and controlled from Australia and carries on some business here is, appears unnecessary and detrimental to attracting new business activities and management expertise to Australia.

Movement to a place of “effective management” test creates similar definitional issues to a central management and control test and does not address the policy concerns.

We would support a residence test based on country of incorporation. Such a test would be simple to apply in practice and would eliminate the administrative burden and the negative policy implications associated with the current test.

This would allow Australian groups operating globally to engage in supervisory activities in relation to offshore subsidiaries and operations and provide support services without the risk of those subsidiaries being treated as residents of Australia.

Some might query the potential revenue risks for Australia, in that there will be a tendency for companies controlled by Australians to be incorporated overseas. However, these concerns are misplaced for the following reasons:

- Australia has a powerful CFC regime that is designed to deal with subsidiaries incorporated in low tax jurisdictions. The CFC regime applies to companies which are controlled by Australian residents and which are incorporated in or resident in overseas jurisdictions, and attributes inappropriate types of income to Australian holders of the CFCs;

- Australia’s CGT rules result in a CGT event arising where a company changes its status from resident to non-resident, generating potential CGT exposures;

- Australia’s transfer pricing rules impose the requirement for any services provided to non-residents to be at market value. The transfer pricing rules provide an effective instrument for Australia to tax the true economic value of any services provided out of Australia to any foreign incorporated company;

- Australia’s withholding tax rules provide mechanisms for Australia to collect tax from payments made to non-residents; and

- Australia’s thin capitalisation laws have recently been strengthened to apply to inbound and outbound investment activities.

Thus, any notion that establishing a "post box" foreign incorporated company, serviced out of Australia, would somehow avoid Australian taxation and create material risk to the Australian revenue is misplaced.

We have also considered the recent US concerns about so-called "inversions" (basically the interposing of a tax haven holding company over a US company) and consider that these concerns are also misplaced for the following reasons:

- an incorporation test would potentially allow companies to restructure themselves out of the Australian CFC provisions, as has happened in the US. However, such a restructure would normally carry an Australian tax cost in relation to the sale of offshore subsidiaries/assets to the new foreign holding company. In addition, Australian tax would continue to be collected on dividends received by Australian resident shareholders and capital gains made on the sale of their shares;

- much of the concern expressed in relation to US inversions focuses on the potential for the subsequent stripping of US earnings, via royalties, interest or management fees, for example. As noted above, these concerns should be addressed by the application of the relevant transfer pricing, withholding tax and thin capitalisation regimes. The CFC rules would continue to operate in relation to companies that migrate but remain controlled by Australian residents (although this would not necessarily be the case for listed companies); and

- another concern expressed by US commentators is that inverting companies could take advantage of favourable treaties to reduce or eliminate US withholding taxes. This may require examination and possible renegotiation of the limitation of benefits articles in such treaties. Australia's treaties would need to be reviewed in any event for the impact of a change in the residence test on tie-breaker rules that operate based on the place of effective management.

4.7.2 A simple residency test

Australia has seen a series of "integrity measures" introduced in recent years which have resulted in highly complex law, which is difficult to understand.

We do not consider it necessary to create additional integrity overlays given the combination of existing design integrity measures referred to above, including:

- Australia's CFC regime for foreign incorporated companies;

- Australia's thin capitalisation rules;

- Australia's CGT rules which apply if a company changes its resident status from Australia;

- Australia's transfer pricing rules relating to services provided to non-residents; and

- Australia's withholding tax provisions on payments to non-residents.

The adoption of a place of incorporation test should not be surrounded by a mass of "integrity measures", which would create new complexity and which could frustrate this tax reform initiative.

The reform of the residence test is consistent with a review of the CFC rules. In particular, the move to an incorporation test for residence is consistent with a restatement of the policy of Australia's taxation of foreign companies.

The problem is real and is affecting the management of Australian owned foreign companies in a demonstrably detrimental way. The legislative solution is relatively simple and it may improve Australia's chances of being selected as the international or regional headquarters for new international businesses.

The recommended approach would also be appropriate to assist DLCs in managing their affairs and reduce compliance costs.

4.7.3 Treatment of a company that is a non-resident for tax treaty purposes

We support option 3.13 in the Treasury consultation paper, which will result in a harmonisation of the residency rules in Australia's tax treaties with the residency rules for domestic law purposes.

If a treaty provides for non-resident status for a company, we consider that to streamline compliance and enhance certainty, the non-resident status should be applicable for Australia's domestic law purposes.

This would remove the current complex operation of the treaty tie-breaker rules and their domestic effect in Australia.

5. Promoting Australia as a Global Financial Services Centre

5.1 The Foreign Investment Fund (FIF) rules

International tax issues that may affect Australia's future as a global financial centre include the foreign investment fund (FIF) provisions and the CGT treatment of investments by non-residents in Australian managed funds.

As acknowledged in the Treasury consultation paper, the current FIF rules are overly complex and result in high compliance costs for affected taxpayers and managed funds. Further, the rules catch investments beyond those at which they are targeted.

While the proposals contained in the Treasury paper may represent a reasonable first step, we believe that they do not go far enough to reduce the compliance burden borne by Australian business.

We therefore support the need to replace the FIF regime in the longer term. The options provided for consideration are not sufficient substitutes for a fundamental redesign of the FIF rules. We believe that the government should provide a commitment to undertake this redesign at the earliest opportunity.

Consistent with our recommendations for the CFC regime, we recommend that FIFs resident in countries on the broad exemption list be entirely excluded from the attribution rules.

We further believe that a consultative process needs to be established with business to examine how the numerous technical problems within the existing FIF rules can be addressed. We believe that a number of these issues can be addressed immediately and are discussed below.

We recommend that the Board of Taxation consults specifically with organisations such as International Banks and Securities Association Australia, Investment and Financial Services Association, the Australian Bankers' Association and their members with respect to the proposals contained in Chapter Four of the Treasury consultation paper.

5.2 Broad exemption listed countries and the FIF rules

We believe that there should be no attribution in respect of investments into broad exemption listed countries. Consistent with our recommendations for the CFC regime, we recommend that FIFs resident in countries on the broad exemption list be entirely excluded from the attribution rules.

These countries have comparable tax rates, a comparable tax base and their own attribution regimes and there is little scope for an offshore accumulation entity to be resident there.

We acknowledge that consideration would need to be given to providing an exception to this exemption where the entity invested into is exempt from tax in the broad exemption listed country and does not have a requirement to distribute its income and realised gains. This is an extension of the current exemption for investments in certain United States entities.

This exemption would allow some fund managers with a large global fund in a broad exemption listed country to access that fund rather than having to set up a new fund in Australia. If the foreign fund is distributing its income and realised gains then it is not an offshore accumulation entity and there is no deferral benefit from investing in it rather than in Australian funds.

5.3 Non-residents investing in unit trusts

The CGT provisions currently treat non-resident investors who invest directly, or through offshore managed funds, in certain Australian assets more favourably than if they were to invest via Australian managed funds. This results in a bias against Australian-based managed funds. This occurs because non-resident investors in Australian managed funds are effectively subject to CGT on underlying disposals of interest in assets that do not have 'the necessary connection with Australia'. Non-residents directly disposing of such assets are not subject to Australian CGT.

Notwithstanding that a foreign investor may hold less than a 10 per cent interest in Australian public companies via an Australian managed fund, they may still incur a capital gains tax liability on the disposal of their units in the managed fund. This will occur where the foreign investor (together with associates) beneficially owns at least ten per cent of units issued within five years of the actual date of disposal.

The prospect of incurring an Australian CGT liability in such circumstances creates a powerful disincentive for foreign investors to invest in an Australian managed fund, particularly a fund that is newly established or in the process of developing a critical mass, or when the underlying fund assets do not have the necessary connection with Australia (such as funds holding foreign assets).

We support Options 4.6 - 4.8 in the Treasury consultation paper to address the anomalous treatment of non-residents investing in unit trusts compared to direct investment, by specifically exempting the following from Australian tax:

- distributions by a unit trust of capital gains from disposals of assets without the necessary connection to Australia;
- disposals of non-portfolio interests in a unit trust relating to assets without the necessary connection with Australia; and
- distributions by a unit trust of foreign sourced income (exemption from cost base reductions).

We suggest that consideration be given to the provision of a further test to enable a 'look through' to the underlying assets of the unit trust where the application of the 'necessary connection with Australia' may result in an anomalous result.

We believe this will have a number of important flow-on benefits to the Australian economy, and Australian investors, in particular. These benefits include increased scale, by reducing the inefficiencies created by mirror funds, which will drive down costs for Australian investors. Further, these changes can be implemented by fund managers with very little change to existing systems.

Many managed funds use an underlying unit trust to achieve exposure to investment markets. For example, a unit trust offered to retail or superannuation investors may invest in a wholesale unit trust in order to achieve its investment objectives – the wholesale trust then pools these funds with other wholesale investors and invests in physical markets. For trusts with this structure, the application of the suggested tests regarding the necessary connection with Australia may yield an anomalous result.

5.4 Withholding taxes on distributions to non-residents

Currently, where a resident trust in the funds management industry makes a distribution to a non-resident it is required to withhold tax at a minimum of 29% from those taxable components that are not subject to interest, royalty or dividend withholding tax. Most non-resident investors consider this is a punitive rate and consequently seek to invest through other jurisdictions. The problem posed by the withholding obligations is particularly acute for funds which utilise foreign exchange hedging in respect of their foreign assets.

We recommend that consideration be given to providing an exemption for unit trusts which satisfy the definition of a fixed trust from the withholding obligations imposed on Australian trusts under sections 98(3) and (4) of the 1936 Act. A withholding tax rate of 15% is recommended if the exemption is not provided.

An amendment to the tax law to exclude Australian managed funds from the withholding obligations would result in additional employment opportunities for highly skilled workers and would strengthen the Australian equity and bond markets together with associated infrastructure. Further, these additional funds would provide for economies of scale to drive down costs for Australian investors.

5.5 Other exemptions from the FIF rules

The Treasury consultation paper suggests that existing FIF rules could be refined to ensure the current rules are better targeted and minimise compliance costs and other distortions.

One mechanism to achieve this is to exempt complying superannuation funds and indexed funds from the FIF rules.

We believe this proposed carve-out is too limited and suggest consideration be given to a broader carve-out for funds management/collective investment arrangements from the FIF rules, based on the following criteria:

- the taxpayer is a registered managed investment scheme or a Life Company registered by Australian Prudential Regulation Authority;
- if the taxpayer is not a Life Company, it is a fixed trust[22];
- the entity is a resident of Australia for tax purposes;
- if the entity is a trust, it is not subject to tax under Division 6B or 6C of the 1936 Act; and
- the ATO has not issued a notice to the entity to the effect that the trust/Life Company is not considered to be a genuine public offer vehicle.

[22] Definition of fixed trust, Appendix 1, Investment and Financial Services Association, October 2002, A response to the Consultation Paper, A Review of International Tax Arrangements.

5.6 Fund management services as an eligible activity

We support the proposal to amend the FIF rules to allow fund management services to be an eligible activity for the purposes of the FIF rules.

Such a change would make it easier for a number of overseas companies to fall within the FIF exemption.

5.7 Branches

Domestic tax law provides an uncertain and inconsistent approach to the taxation of permanent establishments, which fails to deliver a tax neutral outcome. In the absence of an effective branch tax regime, Australia will struggle to successfully compete for global financial services business. While we acknowledge that the separate entity approach to taxing authorised deposit taking institutions (ADI) represents a significant step in the right direction, improvements are still required in some areas. Importantly, the tax regime for non-ADI branches is far too complex, uncertain and highly disadvantageous and needs to be addressed.

We therefore support the need to consider specific tax issues outside the government's current reform program where the lack of separate entity treatment inappropriately impedes the use of branch structures.

We understand that a range of initiatives have been canvassed that would advance the neutrality and competitiveness of the Australian tax system as it applies to branches. We support this approach and note that these issues affect all permanent establishments to some extent, not just financial institutions.

6. Improving Australia's tax treatment of foreign expatriates

The proposals for taxation of foreign income and assets of temporary residents contained in Tax Laws Amendment Bill (No.4) 2002 (TLAB4) have now been reintroduced as Tax Laws Amendment Bill (No.7) 2002 (TLAB7).

The options in the Treasury paper cover:

- capital gains tax security deposit measures and CGT treatment of departing residents;
- the double taxation of employee share options;
- taxation of share options on ceasing of Australian residence; and
- establishment of an expatriate tax cell within the ATO

In addition, there are several other issues related to the treatment of foreign expatriates which, in our view, require urgent government attention:

- exemption of non-Australian workdays for temporary residents;
- introduction of an objective residency test for inbound residents; and
- addressing major inefficiencies in double superannuation rules.

Due to the much stronger international focus of business, it is common to have middle level and senior executives employed internationally. This occurs where:

- Australian origin executives are posted for shorter or longer terms overseas;
- foreign executives are posted to Australia within global companies; and
- Australian companies recruit scarce expertise in order to operate in a global environment.

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

Although we recognise that the level of personal income tax rates in Australia is a broader economic setting not relevant only to the international tax review, we emphasise that:

- the international tax environment for individuals is moving to lower tax rates; and
- individuals who are temporarily resident in Australia have foreign assets which are taxed harshly here.

Therefore, Australia's current tax law dealing with foreign expatriates in Australia presents an unfriendly and unwelcoming taxation environment when compared with most other developed countries.

6.1 Temporary Resident Measures

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

Problems with the current law

The current proposals before Parliament were designed to relieve foreign expatriates working in Australia from Australian tax on investments held outside Australia for a maximum of four years. This would have included both income tax arising from investments owned prior to arrival and purchased during their time in Australia, as well as any capital gains made from the sale of foreign assets while the person was in Australia.

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

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

TLAB4 was originally introduced on 30 May 2002 for debate in the Parliament. However, following opposition from the non-government parties, the measures were removed from the Bill in order that other important tax measures could be passed.

We welcome the government's commitment to these measures as expressed in the Treasury consultation paper. These measures will be particularly effective in the short to medium term as employees everywhere move from growth based to income stream investments.

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

- the measures will only benefit "wealthy" foreign temporary residents; and
- the government had provided no evidence that the Australian taxation of foreign temporary residents was uncompetitive in an international context.

We provide a response to the ALP view, to assist in the debate.

6.1.1. The problem is not about "Wealthy" Foreign Executives

These measures were not designed to benefit only wealthy executives employed in senior positions. When skilled employees are enticed to Australia, the excessive Australian tax on their personal income and investments is generally borne by their Australian employer under tax equalisation arrangements.

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

It is sometimes claimed that large companies can afford these costs, but it is not just large companies that need to recruit overseas talent. Small and medium sized companies, universities and government entities are also disadvantaged in this competitive market for talent.

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

6.1.2 Additional costs for Australian business

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

Example 1- Illustrating the costly outcome of the current tax treatment

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

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

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

Assumption A: Engineer has no geared or leveraged investments

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

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

Taxable Australian income
Australian tax payable @47%
Less contribution by employee
Australian tax payable by company
Add Fringe Benefits Tax gross up[23]
Total cost to company

Total tax paid on income

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

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

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

Assumption B: Engineer has a geared investment portfolio

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

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

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

Therefore, under these types of tax equalisation

[23] The employer pays Fringe Benefits Tax because the compensation to the employee for the incremental tax under the equalisation policy is a taxable fringe benefit.

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

The examples demonstrate the effect if the tax is borne by the employer and shows how the current law makes Australia unattractive for foreign employees.

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

6.1.3 Taxation treatment in overseas countries

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

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

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

Evidence of the problem

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

- the tax on tax issue raised above has the unintended consequence of over inflating the reported salaries of foreign workers relative to what the employee actually receives. This can cause problems within the company due to perceived salary differentials that do not actually exist;

- the high cost of bringing in necessary skills from overseas results in some inflationary effects on Australian salaries. In some scarce skill areas, Australian employees' salaries are increased as they are benchmarked against the all-up costs of employing foreign employees with similar skills; and

- in a broader context, in creates and exaggerates the impression in the media and the public mind of overpaid foreign executives when the real money is going to the ATO.

Solution

We suggest that the simplest solution would be to reintroduce TLAB7 and for the Senate to pass the rules.

6.2 CGT treatment of departing residents

Current law

Individuals resident in Australia, including temporary residents who cease to be Australian residents, face a CGT liability on the unrealised gains of certain assets via a deemed disposal rule. Individuals can elect to defer CGT until disposal, but then they also face CGT on any post-departure gains.

Problem with the current law

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

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

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

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

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

6.3 CGT security deposit measures

The problem

The Review of Business Taxation recommended that residents departing Australia should provide security for any deferred CGT liability arising from the deemed disposal of their assets[24]. This would require Australian residents to leave "adequate security" in favour of the Australian Government to cover any potential capital gain arising upon the eventual sale of the asset while a non-resident.

The US protocol does address the issue in new sub-article 13(6). Under that sub-article, a departing Australian resident who defers an Australian CGT liability will subsequently be relieved of that liability provided he or she is resident in the US when the relevant asset is subsequently disposed.

[24] A Tax System Redesigned, Review of Business Taxation, Report, July 1999, Recommendation 22.20.

Evidence of the problem

We strongly support the views expressed in the Treasury consultation paper that the implementation of these measures would be a costly and backward step in tax administration in this country. The measure would effectively eliminate any benefit to the individual in deferring the disposal of a capital asset and avoiding the cash flow impact that such a taxation event would create.

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

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

We note that, after careful policy analysis, the consultation for the TLAB7 temporary resident measures did not even consider this measure for consultation.

Solution

In order to provide certainty to Australian employers and employees, we recommend that this proposal be removed from consideration.

6.4 Reform of expatriate CGT in general

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

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

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

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

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

This approach is unlikely to persuade more people to come to Australia to share their skills.

Therefore we recommend the introduction of a domestic legislative resolution to these issues to provide certainty and stability for employers and international employees.

We welcome the introduction by the government of TLAB7 with a view to alleviating this problem for temporary residents. However, it does not deal with the converse problem for Australian residents departing overseas on working assignments for several years.

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

These issues are discussed in more detail in the BCA Discussion Paper[25].

Solution

We support the general approach to exemption for temporary residents which is contained in TLAB7.

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

- the entire system of deemed disposal be abolished for temporary residents working in Australia on temporary visas, consistent with recommendations 21, 23 and 25 of the BCA discussion paper;

- the entire system of deemed disposal be abolished also for domestic residents departing on temporary assignments; and

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

    - executives in Australia for periods up to five years would not be subject to Australian capital gains tax on their foreign assets; and

    - this concession would be progressively scaled back for two further years after the fifth year.

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

We recognise that there are two policy issues in these proposals.

First, for what period of time should a visitor be entitled to such concessions?

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

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[25] Removing Tax Barriers to International Growth, prepared by Michael Wachtel and Alf Capito, Andersen, for the Business Council of Australia, 11 December 2001, pp 108-119.

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

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

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

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

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

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

6.5 The double taxation of employee share options

The problem

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

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

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

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

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

Whilst it is possible that bilateral tax treaty negotiations might assist in dealing with some of the issues arising for foreign expatriates, it is unlikely that the results of those negotiations will provide comprehensive solutions. Indeed, the likely pace of future bilateral treaty negotiations would generally make the objectives sought by Option 5.2 as unachievable in the near term.

In general, Australia should not look to bilateral treaty negotiations to resolve problems of uncertainty in its domestic tax law. Furthermore, it is unlikely that sufficient numbers of treaties could be negotiated or renegotiated in the foreseeable future to resolve these issues purely in bilateral terms.

Australia should continue to observe the OECD work in this area so that its domestic tax policy is at least broadly consistent with that of other member countries.

Australia should amend its domestic law so that residence and source issues are embraced by the employee share option provisions, and so that the income tax interface with capital gains tax is clearer.

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

Solution

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

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

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

Third, while not strictly relevant to the international tax review, we recommend that Australia needs to resolve its domestic tax law first through a comprehensive review of the stock option provisions. Such a review would need to focus on:

- the interaction of the current Division 13A and the long term capital gains tax concessions; and

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

6.6 Division 13A cessation event

The Review of Business Taxation recommended treating a resident's departure form Australia as a cessation event for the purposes of Divisions 13A of the 1936 Act[26].

We strongly support the recommendation in the Treasury consultation paper to abandon further development of this measure. The arguments against this measure are the same as for those against the deemed disposal security deposit measures, which are set out at length above.

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

6.7 An ATO cell for expatriates

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

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

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

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

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

6.8 Other issues for consideration

There are a number of other issues that we believe the Board should be considering in its review of Australia's international tax regime. Many of these measures have been raised previously in the BCA discussion paper.

[26] A Tax System Redesigned, *Review of Business Taxation*, Report July 1999, Recommendation 22.19(a).

6.8.1 Non-Australian workdays

We note the Treasury's concerns that allowing an exemption for non-Australian workdays of temporary residents will create a tax bias in favour of temporary residents over Australian residents. However, the policy intent behind these measures is to increase Australia's international attractiveness as a home of regional head offices. The current Australian tax rules provide no incentive in this respect when compared to our neighbours, such as Hong Kong, Singapore, Thailand and Malaysia, who all offer this type of exemption.

Executives looking at where to locate an office will make their decision based on paying 47% on all of their income or between 17% and 35% on only a part of their income.

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

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

6.8.2 An objective residency test for inbound residents

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

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

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

6.8.3 Superannuation

The Treasury consultation paper notes, and we recognise, the government's moves to allow temporary residents to withdraw their superannuation contributions following their departure from Australia.

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

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

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

While we acknowledge the efforts of the government in this area through negotiation of social security agreements, the exemptions allowed in these treaties do not always reflect the commercial substance for the arrangement.

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

We recommend that:

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

- alternatively, if a full exemption cannot be achieved, then an alternative is:

  - to recognise contributions to foreign social security systems as being equivalent to Australian superannuation for the purposes of companies meeting their minimum support obligations; and

  - to allow Australian employers to claim deductions for contributions to foreign superannuation plans on account of temporary residents.

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

7. Glossary

1936 Act	*Income Tax Assessment Act 1936.*
1997 Act	*Income Tax Assessment Act 1997.*
ATO	Australian Taxation Office.
Broad exemption listed country	Countries whose tax systems are broadly comparable to Australia. Australian companies can generally claim an exemption for non-portfolio dividends and branch profits derived from activities that are taxed without concession in these countries.
CGT	Capital gains tax.
Conduit income	Foreign source income non-residents earn through an Australian entity.
Controlled foreign company (CFC)	A CFC is broadly a foreign company controlled by five or fewer Australian residents. Australia's controlled foreign company (CFC) rules aim to prevent residents accumulating "tainted income" taxed at low or zero rates in foreign entities. Tainted income comprises passive income, such as dividends, interest and capital gains on certain assets and tainted sales and services income.
Dividend imputation	The tax credits passed on to a shareholder, who receives a franked dividend. Imputation credits entitle investors to a rebate for tax already paid by an Australian company.
Dividend streaming	An arrangement that enables franked dividends to be diverted away from those that cannot get the maximum value from them, such as low tax rate or non-resident shareholders.
Dividend withholding tax (DWT)	A tax levied on unfranked dividends paid to non-resident shareholders.
Double tax agreement (DTA)	Treaty between two countries outlining each country's taxing rights over certain forms of income flowing between the two countries. Broadly such agreements are designed to prevent double taxation between these countries and ensure one of the countries has a taxing right over income.
Double taxation	Economic income is taxed more than once. Can occur under Australian law or from a combination of Australian and foreign laws where double taxation of taxable income is not corrected under the foreign tax credit system or a double tax agreement.

Foreign dividend account (FDA)	A mechanism by which certain conduit income can be passed on to foreign owners without bearing Australian tax.
Foreign investment fund (FIF)	The foreign investment fund measures operate to assess Australians on interests in amounts held offshore in a non-controlled foreign company or foreign trust.
Franked dividend	A dividend paid by a company out of profits on which the company has already paid tax. The investor is entitled to an imputation credit, or reduction in the amount of income tax that must be paid, up to the amount of tax already paid by the company.
Non-portfolio investors	Those investors who have an influential interest (however defined) in an entity. Interests of 10 per cent or more are generally treated as non-portfolio.
OECD	Organisation for Economic Cooperation and Development.
Residency	A company incorporated elsewhere is taken to be an Australian resident for taxation purposes if it carries on business here and has its central management and control in Australia or has voting power controlled by Australian shareholders.
Scrip-for-scrip	A corporate acquisition method whereby shares in the acquirer are issued to the shareholders of the target company in consideration for their shares in the target company. A non-cash corporate acquisition.
Tainted assets	Includes certain financial instruments and other non-business assets.
Tainted services income	Any income, with some minor exceptions, from the provision of services by a CFC resident in almost any country (only exclusions are US, UK, NZ, Canada, France, Germany and Japan) to any Australian resident or to any associated entity regardless of residency.
Thin capitalisation	A requirement for foreign-controlled Australian entities to be funded to a significant degree by equity (capital) rather than by debt to help ensure Australia receives an appropriate share of global business income tax revenue. For the same reason, Australian controlled foreign entities will be required to be funded to a significant degree by debt rather than equity.
Transfer pricing laws	Tax laws designed to ensure that international transactions are conducted at arm's-length prices.
Withholding tax	A tax deducted on income at its source.