Review of International Taxation Arrangements

A consultation paper
prepared by the Commonwealth
Department of the Treasury

August 2002

ISBN 0642 74162

Views expressed in this paper are those of the Treasury. They are being published as a contribution to public discussion of the issues. They should not be considered as necessarily representing the views of the Treasurer or the Government.

Printed by Canprint Communications Pty Ltd

Table of Contents

FOREWORD

This consultation paper represents the first stage in fulfilling the Government's commitment announced in *Securing Australia's Prosperity* to review aspects of Australia's international tax arrangements. The paper was prepared by the Commonwealth Department of the Treasury.

The Treasurer announced on 2 May 2002 that the review would consider at least four principal areas:

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

The taxation treament of foreign expatriates also is an important issue for consideration.

This paper outlines a number of options for discussion as part of consultations to be undertaken by the Board of Taxation. These options are set out on page vii.

Consultation process

This paper provides a basis for public consultations to be conducted by the Board of Taxation. The Board is due to report to Government by the end of 2002.

The Board of Taxation is an independent, non-statutory body established to advise the Government on the development and implementation of taxation legislation and the ongoing operation of the tax system.

The Board will publish a consultation plan on its web site: www.taxboard.gov.au

Further copies of the consultation paper may be obtained:

- from the Board of Taxation web site: www.taxboard.gov.au;
- by email to internationaltax@taxboard.gov.au; or
- by telephone from Jodi Wood on (02) 6263 4366.

The closing date for written submissions to the Board of Taxation is **31 October 2002**. Submissions may be sent:

by email to:
internationaltax@taxboard.gov.au

by post to:
The International Taxation Project
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

OPTIONS FOR CONSULTATION

This paper explores a range of international tax issues that may affect the attractiveness of Australia as a place for business and investment and identifies options for consultation. The consultation process to be conducted by the Board of Taxation will provide an opportunity to consider these issues in detail.

Some options are interrelated, and the implementation of certain options may need to be balanced against the adoption of others to achieve an overall package of reform. Revenue constraints and tax system integrity are also important considerations.

Attracting equity capital for offshore expansion

A key issue raised by the business community concerns a possible tax bias in favour of domestic investment that can affect the cost of capital for Australian multinationals undertaking direct investments offshore. This issue is the focus of the options discussed in Chapter 2.

Option 2.1 for consultation: after further considering the effect on Australian companies of the dividend imputation bias at the shareholder level, to consider three alternative options:

A: providing domestic shareholder tax relief for unfranked dividends paid out of foreign source income;

B: allowing dividend streaming of foreign source income; and

C: providing franking credits for foreign dividend withholding taxes.

Promoting Australia as a location for internationally focused companies

International tax issues that may affect the attractiveness of Australia as a corporate base from which to operate global and regional businesses include the controlled foreign company rules; Australia's international tax treaty network; the treatment of income repatriated from direct investment offshore; conduit income arrangements; and company residency tests. These issues are the focus of the options discussed in Chapter 3.

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

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

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

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

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

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

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

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

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

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

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

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

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

Promoting Australia as a global financial services centre

International tax issues that may affect Australia's future as a global financial centre include the application of the foreign investment fund provisions and the CGT treatment of investments by non-residents in Australian managed funds. These issues, and the treatment of foreign trusts, are the focus of the options discussed in Chapter 4.

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

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

Option 4.3 for consultation: to consider exempting Australian managed funds that follow widely recognised indices from the foreign investment fund rules.

Option 4.4 for consultation: to consider exempting complying superannuation funds from the foreign investment fund rules.

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

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

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

Option 4.8 for consultation: to consider amending the CGT rules so that a distribution of income to which a non-resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain that arises from Option 4.6), does not reduce the non-resident investor's cost base in a unit trust.

Option 4.9 for consultation: to consider proceeding with the recommendations of the Review of Business Taxation rationalising the application of current rules to foreign trusts.

Option 4.10 for consultation: to consider proceeding with the recommendations of the Review of Business Taxation in relation to transferor trusts.

Option 4.11 for consultation: to consider specific tax issues outside the Government's current tax reform programme where the lack of separate entity treatment inappropriately impedes the use of branch structures.

Improving Australia's tax treatment of foreign expatriates

Issues concerning the taxation of mobile skilled foreign expatriates working in Australia are the focus of the options discussed in Chapter 5.

Option 5.1 for consultation: to consider whether to proceed with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred CGT liability.

Option 5.2 for consultation: to consider addressing the double taxation of employee share options through bilateral tax treaty negotiations and possible consequential changes to Australia's domestic tax law treatment.

Option 5.3 for consultation: to consider whether to proceed with the Review of Business Taxation recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A.

Option 5.4 for consultation: to consider the Australian Taxation Office establishing a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.

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

The review of Australia's international tax arrangements examines possible impediments to Australian companies expanding offshore, attracting domestic and foreign equity, and affecting holding companies and conduit holdings from locating in Australia.

This review forms part of the Government's ongoing programme of business tax reform, including the delivery of an internationally competitive 30 per cent company tax rate, and capital gains tax (CGT) and other reforms that increase flexibility for domestic business and make Australia a more attractive destination for overseas investment.

Australia is enjoying the benefits of increased integration with the global economy, with high rates of economic growth, rising productivity, strong export growth and the swift uptake of new technologies. Increased integration provides greater opportunities and choice for Australian business — choice in investment location, place of residence, and head office functions. Tax arrangements can influence these choices, although usually they are not the most important factor.

To maintain Australia's status as an attractive place for business and investment, the tax system needs to continually adapt to the increasingly integrated global business environment.

Australia also needs to be responsive to international trends and developments in other countries' tax systems, particularly those countries — such as the United States, Japan, certain European countries and New Zealand — which are a major source or destination of capital, and those countries which compete with Australia for investment and business.

Global integration

Since 1980-81, the stock of foreign capital invested in Australia has almost quadrupled from 32 per cent of gross domestic product (GDP) to 121 per cent in 2001-02. While Australia remains a net capital importer, the increase in total capital invested offshore has risen also — from 9 per cent of GDP in 1980-81 to 62 per cent in 2000-01.

Increased integration with the global economy has also involved reduced barriers to trade in goods and services; an increased proportion of international trade arising from intra-group sales; rapid growth in bilateral treaties to facilitate cross-country investment; agreements and convergence on regulatory issues and standards; improved telecommunications; and the increased mobility of certain segments of the workforce (particularly highly skilled workers).

Greater integration and increased levels of Australian direct investment abroad create challenges for Australian businesses operating in the world economy. Some companies with substantial offshore investments have had to decide, for example, whether they can compete successfully while retaining their head office in Australia and how best to access domestic and global capital markets.

Companies now are faced with greater choice in meeting these challenges. Choices exist over the place of residence of the parent company and its subsidiaries, over the location of global and regional head offices and related headquarter functions, and over stock exchange listings. Often the location of these functions may be split between more than one country.

Why tax matters

The effect of tax on investment

Tax arrangements can affect the level and country location of foreign direct (non-portfolio) investment. For investors, the tax systems of the country of the investor, the potential recipient country, and even of third countries, may all be relevant in determining where and how they invest. Where tax is important, transparency, simplicity in the law, and tax administration also matter.

However non-tax factors, such as market proximity, usually are more important in determining the location of direct investment. Other significant non-tax factors include the quality of infrastructure, location of other like firms in an industry, presence of related industries, labour force skills and productivity, and political and economic stability.

Tax often is more significant in determining the location of investment between countries within a region (for example, countries within Europe) than between regions (for example, Europe and Asia). The relative importance of taxation and the other factors also varies between industries and types of investment.

Portfolio flows of capital, particularly flows of debt, usually are more sensitive to tax considerations than direct (non-portfolio) investments. However, non-tax factors such as market size and openness, efficiency of transactions, and information asymmetries are also important determinants of cross-border portfolio flows.

As integration and liberalisation of world markets, including capital markets, increases and the number of multinational companies grows, investment and capital flows may become more sensitive to taxation arrangements.

Tax and its effect on other country location decisions

Tax considerations also can influence the place of residence of multinationals and the location of regional holding companies. The movement offshore last year of the parent company of an Australian multinational was primarily undertaken to reduce foreign tax. In the United States, a number of corporate groups have recently changed, or are considering changing, the place of incorporation (and nothing else) of the parent company to neighbouring low tax jurisdictions, avoiding US company tax on the foreign source income of these groups.

A recent Productivity Commission survey found that while firms involved in headquarters relocations were attracted by improved access to world markets and proximity to investors, the Australian tax regime was the most important influence subject to government control.

The location of managed funds also is often sensitive to any tax on the income flowing to investors arising from the location of the entity. For example, Australians seeking to invest in offshore managed funds often use a mirror fund established in Australia as it provides a better tax outcome.

Some international trends in taxation

Quantitative comparisons between countries help in comparing tax systems, although differences in classifications, accounting treatments, and methodologies used mean they should be used with caution.

Qualitative trends — such as the trend in recent decades for developed countries to introduce rules taxing some elements of residents' foreign source income retained in offshore entities (as exemplified by Australia's controlled foreign company (CFC) and foreign investment fund (FIF) rules) — are also important, although often harder to measure.

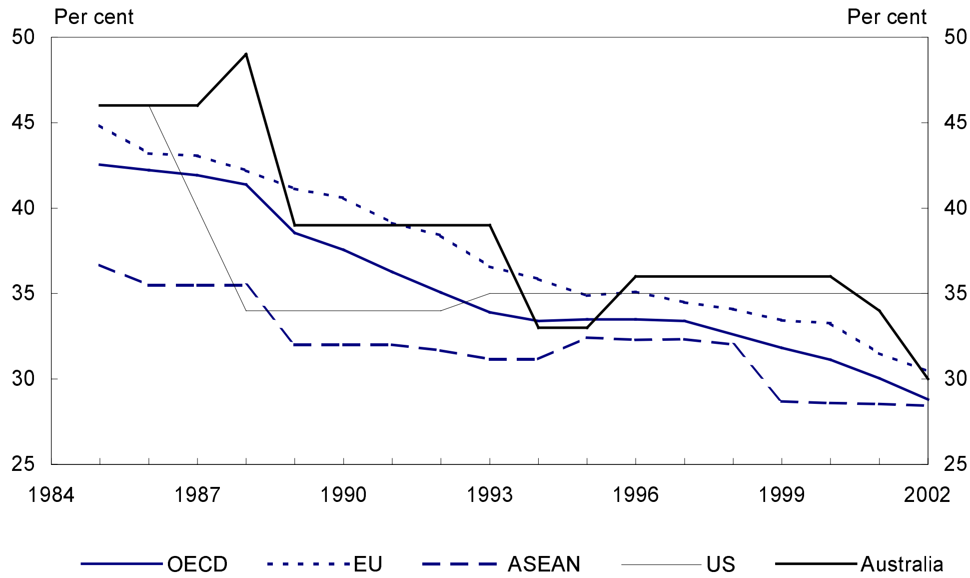
Quantitative trends

Average total tax revenue as a share of GDP for Organisation for Economic Cooperation and Development (OECD) member nations increased from 32.6 per cent in 1979-80 to 34.8 per cent in 1989-90 and to 37.3 per cent in 1999-2000. At the same time, company tax rates have fallen.

Falling company tax rates

A worldwide trend (particularly in the European Union) is for company tax rates to decline (Chart 1.1), although that decline as yet has not translated into reduced company tax revenues. Company tax revenues have been stable, partly because a broadening of the company tax base has generally accompanied rate reductions.

Chart 1.1: Historical trends in company income tax rates



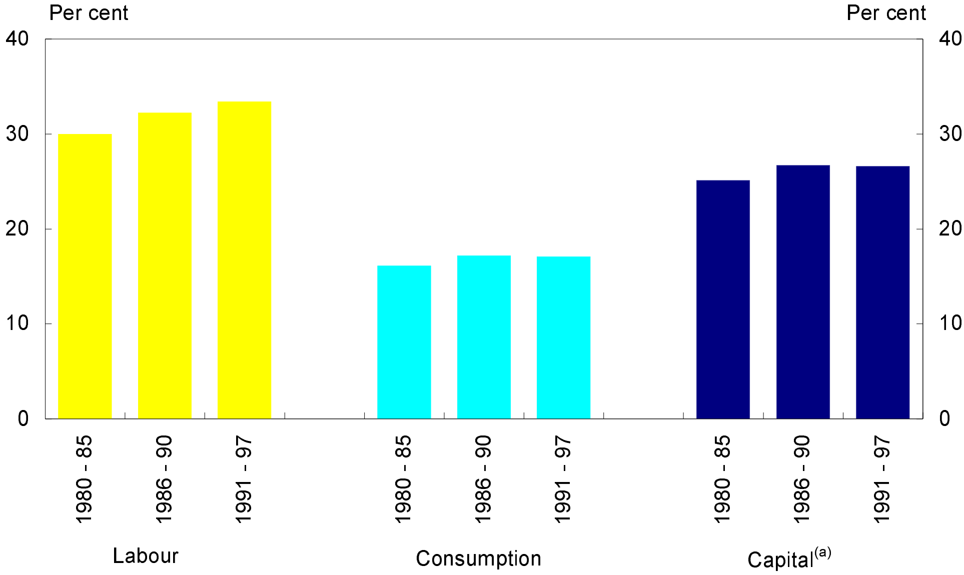
Source: OECD, KPMG, PricewaterhouseCoopers and Ernst & Young.

Company tax rates continue to decline in some countries. Ireland intends to have a 12.5 per cent rate on trading income by 2003; Singapore recently reduced its rate from 25.5 per cent to 24.5 per cent and aims for 20 per cent by 2005; Belgium plans to reduce the basic company tax rate from 39 per cent to 33 per cent; and Canada expects to reduce its federal company tax rate from 28 per cent to 21 per cent by 2004 (although a surtax and provincial taxes would continue to apply).

Stable capital income taxation

Over the last decade, the OECD average effective tax rate on capital income appears to have stabilised while the average effective rate of tax on alternative tax bases, labour income in particular, has increased (Chart 1.2). The increase in the average effective tax rate on labour income was mainly due to higher social security taxes.

Chart 1.2: OECD average effective tax rates on labour, consumption and capital



Source: OECD.
(a) Based on gross operating surplus, to abstract from different national accounting treatments of depreciation.

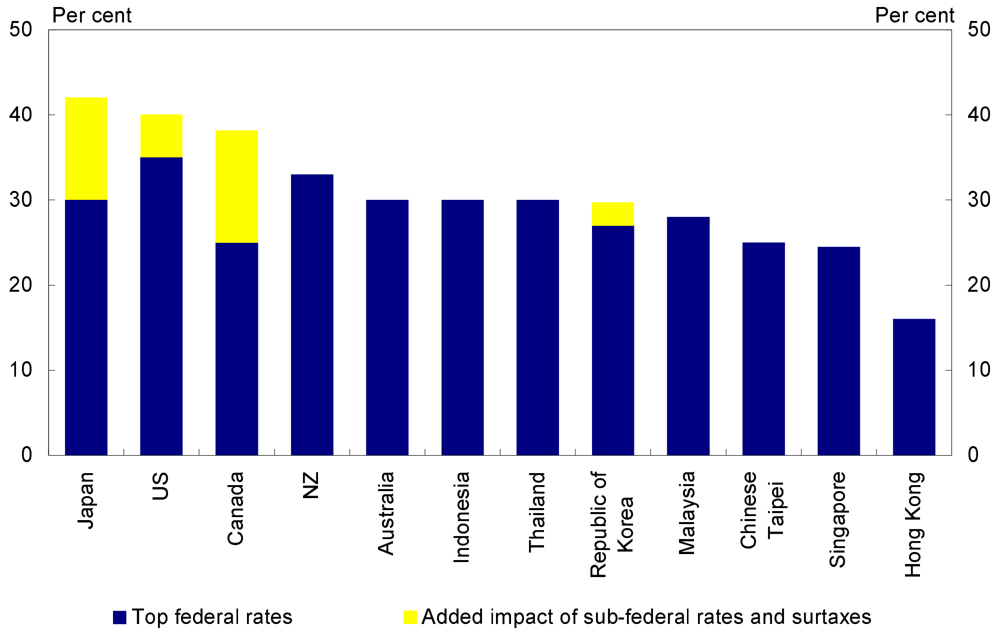
With more global capital and commodity markets, increased efforts to reduce non-tax barriers to investment, and increasingly mobile capital, some countries have reduced taxes on capital income. For example, Nordic countries operate 'dual income tax' systems that combine progressive taxation of labour income with a flat proportional tax on capital income. Other European countries also tax some elements of capital income, such as interest, at relatively low, flat rates.

However, even within Europe, where concerns over capital mobility are more pressing than for Australia (due to greater geographical proximity and fewer non-tax barriers to cross-border investment flows between member countries), differences between countries in capital income taxation remain.

How Australia compares

Australia's rate of company tax is internationally competitive, and competitive even within the Asia-Pacific region (Chart 1.3).

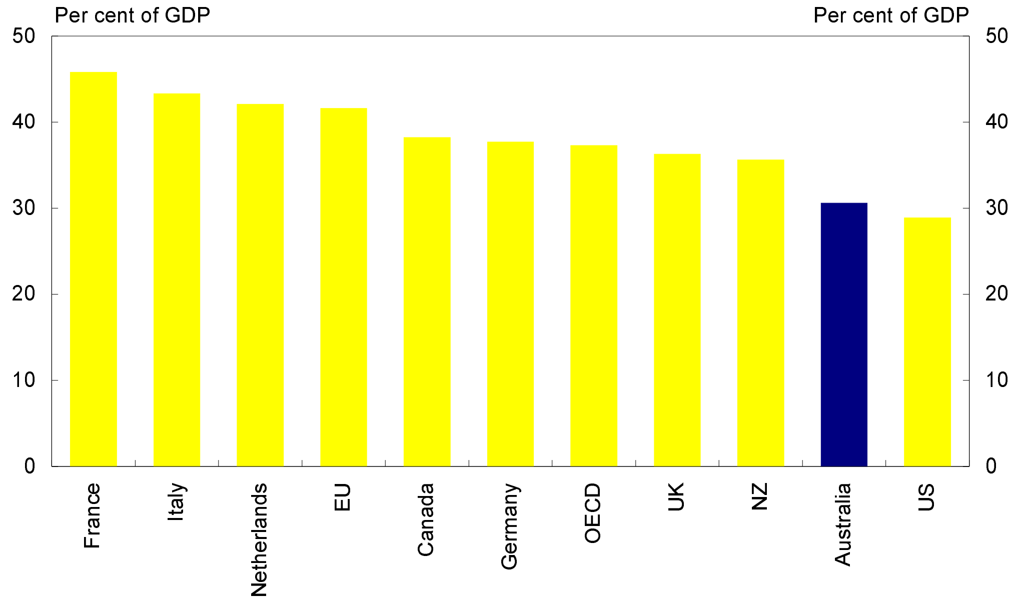
Chart 1.3: Australia's company tax rate relative to selected Asia-Pacific economies, 2002



Source: OECD, KPMG, PricewaterhouseCoopers and Ernst & Young.

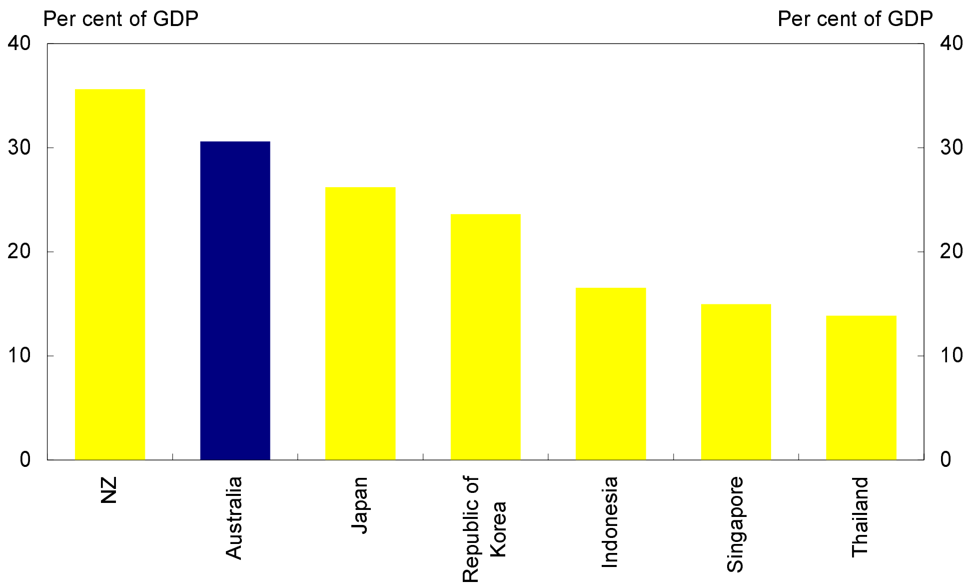
Australia's overall tax burden, measured by total tax revenues as a share of GDP, is relatively low compared to other OECD countries, although higher than most major regional economies (Charts 1.4 and 1.5).

Chart 1.4: Australia's total tax burden relative to OECD countries, 1999



Source: OECD.

Chart 1.5: Australia's total tax burden relative to selected Asia-Pacific economies, 1999



Source: OECD and International Monetary Fund.

Principles of international tax

Australia's international tax arrangements revolve around the basic concepts of residence of the taxpayer and source of the income. Residents of Australia in general are taxed on their worldwide income, from both labour and capital. Non-residents are only taxed on income considered to have an Australian source.

International tax arrangements commonly are assessed against three economic neutrality benchmarks. These benchmarks are *capital export neutrality*, *capital import neutrality* and *national neutrality*. Australia's current international tax arrangements reflect a mixture of all three benchmarks. These concepts and benchmarks provide a conceptual basis for examining in more detail the key elements of Australia's current international tax arrangements, and are further explained in Attachment A.

This paper raises a number of options based around the capital import neutrality benchmark to reduce company level tax on direct investment offshore to improve the competitiveness of Australian companies operating overseas and raising capital internationally. For individual investors and funds, the options are based on balancing capital export and national neutrality benchmarks.

Issues for consultation

This paper explores a range of international tax issues that may affect the attractiveness of Australia as a place for business and investment. The consultation process to be conducted by the Board of Taxation will provide an opportunity to consider these issues in detail.

Chapter 2 explores a key issue raised by the business community concerning a possible tax bias in favour of domestic investment that can affect the cost of capital for Australian multinationals undertaking direct investments offshore.

Chapter 3 explores a range of international tax issues that may affect the attractiveness of Australia as a corporate base from which to operate global and regional businesses. These issues include the CFC rules; Australia's international tax treaty network; the treatment of income repatriated from direct investment offshore; conduit income arrangements; and company residency tests.

Chapter 4 examines several international tax issues that may affect Australia as a global financial centre, including the application of the FIF provisions, and the CGT treatment of investments by non-residents in Australian managed funds.

Finally, Chapter 5 examines issues concerning the taxation of mobile skilled foreign expatriates working in Australia.

The paper outlines a number of options for consultation. Some options are interrelated, and the implementation of certain options may need to be balanced against the adoption of others to achieve an overall package of reform. Revenue constraints and tax system integrity are also important considerations.

Already the Government is progressing some other tax issues with an international aspect, such as uncertainty over the income tax treatment of foreign exchange gains and losses, and treatment under the CFC rules of limited partnerships established overseas. Consequently, these issues are not considered in detail in this paper.

CHAPTER 2: ATTRACTING EQUITY CAPITAL FOR OFFSHORE EXPANSION

Australia is a small open economy with significant flows of outbound and inbound capital. Offshore expansion allows Australian businesses to grow and exploit their expertise in other markets.

To expand offshore, Australian multinationals need to access both domestic and foreign sources of equity capital. The business community has raised concerns that the dividend imputation system favours (at the shareholder level) domestic investment, increasing the cost of capital for Australian multinationals undertaking direct investments offshore.[1] This chapter explores these issues and outlines options for consultation.

Before considering possible options for reform, an assessment of the extent of any tax bias is important, along with its possible impact on the cost of capital for Australian companies. The latter issue is of particular importance, and should be further explored during consultations.

The overall tax bias for or against direct investment offshore

Under dividend imputation, Australian resident shareholders receive franking credits on dividends paid by resident Australian companies only for Australian company tax paid. Australian resident shareholders do not receive credits for foreign company tax (usually the main tax on a company's offshore investments) paid by a branch or offshore subsidiary of an Australian company (Figure 2.1).

1 References to direct investment offshore are to an Australian company's foreign branches and non-portfolio interests in foreign companies.

Figure 2.1: Current imputation arrangements for Australian companies

	Resident shareholders	**Non-resident shareholders**
Australian taxed income	Gross income assessable, with full credit for Australian company tax paid. Excess credits refundable.	Dividends exempt from withholding tax.
Foreign taxed income	Net income is assessable. No credit for foreign taxes paid.	Dividends exempt from withholding tax.(a)

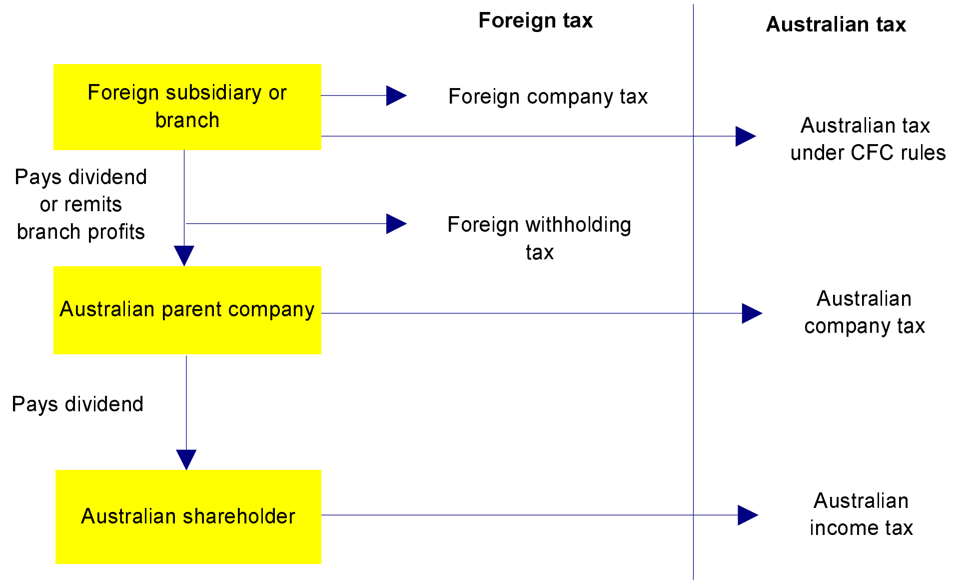
(a) If paid from foreign dividend account.

However, the imputation system is just one of many elements of Australian and foreign tax systems affecting direct investment offshore. If other elements create an overall bias favouring offshore investment, then modifying the imputation system alone could increase, rather than reduce, distortions. An overall bias favouring foreign investment by Australian resident individuals and funds would be difficult to justify.

Resident individuals or funds investing equity offshore via an Australian resident company may face Australian taxation at three points, and foreign taxation at two points (Figure 2.2).

A foreign subsidiary can pay foreign tax on its offshore profits, and on the distribution of profits back to the Australian parent. The Australian company can pay Australian tax on the foreign profits, both before or on repatriation, and finally, the ultimate shareholder can pay tax when those profits are distributed (or shares are sold).

Figure 2.2: Potential taxation points for a direct investment offshore



Dividend imputation only affects the tax payable at the final stage. These arrangements illustrate the importance of considering changes to the tax treatment of different points of taxation together rather than separately.

In practice, Australia does not generally tax foreign profits retained in an offshore subsidiary, or on repatriation of those profits to an Australian parent. Importantly, dividends that Australian companies pay to their shareholders can be treated as if paid out of Australian taxed profits first. This significantly reduces the possibility of shareholder level taxation of foreign source income for some companies.

The effective tax rate on a foreign investment (as against a comparable domestic investment) therefore will depend on numerous factors. These include the effective company tax rate in the foreign jurisdiction and any withholding taxes imposed; the distribution policies of the offshore subsidiary and the Australian resident parent; and the marginal tax rate of the Australian shareholder. The interplay of these factors may create an outcome different to that of a comparable domestic investment (Table 2.1).

Table 2.1: The overall tax bias on direct investment offshore

Investment[a]	Individual: Pre-tax return required (per cent)	Individual: Difference from benchmark (percentage points)	Superannuation fund: Pre-tax return required (per cent)	Superannuation fund: Difference from benchmark (percentage points)
Benchmark domestic investment	10.0	-	10.0	-
High tax country – 40 per cent foreign company tax, 10 per cent dividend withholding tax	16.2	6.2	23.4	13.4
Comparable tax country A – 25 per cent foreign company tax, 10 per cent dividend withholding tax	12.0	2.0	15.1	5.1
Comparable tax country B – 20 per cent foreign company tax, 5 per cent dividend withholding tax	10.8	0.8	13.1	3.1
Low tax country – 15 per cent foreign company tax, no dividend withholding tax	9.8	-0.2	11.6	1.6

(a) The illustrative investments are for 5 years, with the individual or fund selling their interest at the end of the period. It is assumed that a higher proportion of income from the domestic investment (70 per cent) than from the foreign (40 per cent) is distributed each year to the shareholder. The individual is assumed to be on the top personal tax rate.

Table 2.1 examines an investment by a resident individual or superannuation fund through an Australian company, where the company can choose to directly invest domestically or offshore. It shows the difference in the pre-tax rate of return required for alternative investments to achieve the same after-tax return to the investor. Investments in comparable and highly taxed countries require a higher pre-tax rate of return, reflecting a higher effective tax rate. However, for the individual, the investment in the low-tax country provides a marginal tax advantage. This reflects tax deferral benefits from retaining profits offshore in a low tax country.

The general direction and extent of the possible overall tax bias for direct investments offshore by resident individuals or funds through an Australian resident company are summarised in Table 2.2.

Table 2.2: Summary of the overall tax bias on direct investment offshore

Direct investment in:	**Nature and extent of tax bias as against a comparable domestic investment**
High tax country	Clear overall tax bias against the direct investment offshore, arising from the high level of foreign tax and the imputation treatment of foreign source income. The higher the dividend pay-out ratio to the underlying resident shareholders, the greater the bias.
Comparable tax country	Some overall tax bias against the direct investment offshore arising from the imputation treatment of foreign source income. The higher the dividend pay-out ratio to the underlying resident shareholders, the greater the bias.
Low tax country	Overall tax bias in favour of direct investment offshore for individuals unless the dividend pay-out ratio to the underlying resident shareholders (or to the Australian parent if the host country is not 'listed') is high. Tax bias against the investment offshore is maintained for the superannuation fund.

In 2000-01, most Australian direct investment offshore was in comparably taxed countries with tax systems broadly similar to Australia's (Table 2.3).

Table 2.3: Australian direct investment offshore by destination, 2000-01

Country	**Percentage of total**	**Country list**
United States	54.7	Broad exemption listed
United Kingdom	17.4	Broad exemption listed
New Zealand	7.2	Broad exemption listed
Hong Kong (SAR of China)	3.0	Unlisted
Asia not elsewhere stated	2.3	Mix of limited exemption listed and unlisted
Singapore	1.8	Limited exemption listed
Canada	1.4	Broad exemption listed
America not elsewhere stated	1.0	Mix of limited exemption listed and unlisted
Other	11.2	Mixed
Total	**100.0**	

Source: ABS Cat. No. 5352.0.

On average, there may be an overall tax bias at the *shareholder level* against Australian companies directly investing offshore. However, circumstances will differ between particular companies and types and place of investments; company tax planning and distribution policies; and the interplay of other factors. Some direct investment offshore may be tax advantaged overall. At the Australian *company level*, a tax bias against direct investment offshore is only likely where a foreign country has higher company level taxes than Australia.

The impact on Australian business of a shareholder level tax bias against direct investment offshore

The possible bias at the shareholder level against direct investment offshore can affect the cost of capital for Australian multinationals or companies considering offshore expansion. The cost of capital for a company is essentially the pre-tax rate of return required on an investment to satisfy investors in the company. However, how much any bias against direct investment offshore actually affects the cost of capital for Australian business needs to be further explored.

A tax bias against direct investment offshore funded by domestic equity capital would suggest that the cost of domestic capital for offshore investment is adversely affected (Table 2.1). However, world capital markets may set the required pre-tax rate of return for small open economies. In these cases, a tax bias against direct investment offshore that arises at the resident shareholder level should not affect a resident company's cost of capital. Instead, the non-resident investors determine the cost of capital. As they do not benefit from dividend imputation on domestic or offshore investments, they are unaffected by any tax bias facing resident shareholders. Resident shareholders may be largely 'price-takers', and compensating them to reduce a bias would provide them a windfall gain without reducing the cost of raising capital for offshore expansion.

While capital is not perfectly mobile between countries, large, internationally recognised, Australian multinationals may have sufficient access to international capital markets such that the availability of franking credits for their resident shareholders may not significantly affect their cost of capital. For smaller Australian multinationals and companies considering offshore expansion, access to international capital markets may be more restricted, and the domestic capital market may be a more important source of funds. For these companies, often in the process of rapid expansion, the effect of any shareholder level tax bias against direct investment offshore may be more significant.

Options for reducing a shareholder level tax bias against direct investment offshore

A classical company tax system existed in Australia before 1987. A return to this system would remove any bias between foreign and domestic investments that arises at the shareholder level. Shareholders would receive no credit or recognition for tax paid at the company level, whether Australian or foreign.

However, a very large number of Australian companies, mostly small to medium-sized enterprises, do not invest offshore. Only around 16,700 Australian companies reported earning foreign source income in 1999-2000; this represents only around 2.8 per cent of the total number of resident companies that lodged returns that year. Around 600,000 companies reported no foreign source income. Returning to a classical company tax system would impose considerable costs on these companies and their shareholders, and potentially damage Australia's share owning culture.

Returning to a classical company tax system also could reintroduce or magnify many of the distortions and problems that dividend imputation was designed to address. For example, it could reintroduce the domestic bias in favour of debt funding, increase distortions associated with companies' distribution policies, and affect the investment portfolio choices of investors.

Imputation also acts as an incentive for Australian multinationals to pay Australian rather than foreign company tax, and remain resident in Australia so as to frank dividends.

Most OECD countries without a dividend imputation system still provide a degree of tax relief at the shareholder level. Shareholder relief can take the form of applying lower rates of personal tax on dividends, providing a notional tax credit, or exempting part (or all) of a dividend from a shareholder's assessable income. These alternative approaches to shareholder relief provide a uniform tax treatment at the shareholder level for dividends paid by resident companies. Tax relief is given irrespective of whether domestic or foreign tax is paid or the underlying source of the company's income from which dividends are paid.

Adopting a system of shareholder relief, with no link between Australian company tax paid and the shareholder relief received, would be more consistent with recent overseas trends (Appendix 2.1). A shareholder relief mechanism along these lines could be simpler for business and reduce any shareholder level tax bias against direct investment offshore. However, removing the link between Australian company tax paid and shareholder tax relief could have a significant negative impact on company tax revenues. The effects on different shareholder classes would also vary depending on the nature and extent of shareholder relief provided. Taxpayers on low marginal tax rates (and tax-exempts who benefit from franking credit refunds) in particular would be likely to receive less direct benefits than currently available under the dividend imputation system.

There would also be significant transitional issues. For example, whether companies with large existing stores of franking credits should have a transitional period to distribute existing credits to shareholders.

Several alternative options, that involve less significant change for taxpayers, could remove or reduce a bias at the resident shareholder level against direct investment offshore by Australian companies. These are:

- retaining the imputation system while providing shareholder relief for unfranked dividends paid out of foreign source income — Option A;
- permitting the 'streaming' of dividends paid from foreign source income by Australian companies — Option B; and
- providing franking credits for foreign dividend withholding taxes paid by Australian companies — Option C.

Option 2.1 for consultation: after further considering the effect on Australian companies of the dividend imputation bias at the shareholder level, to consider three alternative options:

A: providing domestic shareholder tax relief for unfranked dividends paid out of foreign source income;

B: allowing dividend streaming of foreign source income; and

C: providing franking credits for foreign dividend withholding taxes.

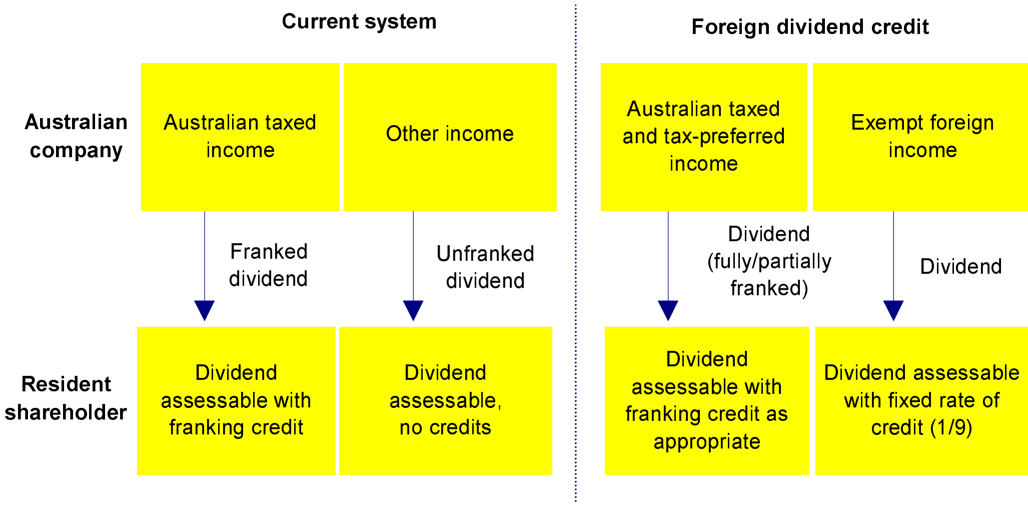
Option A: paying domestic shareholder relief for unfranked dividends out of foreign source income

This option would run as a separate system alongside the current dividend imputation rules, providing limited shareholder tax relief on unfranked dividends paid out of designated foreign source income. Of the three options, it is most targeted in addressing the possible shareholder level tax bias.

A foreign dividend credit

For example, Australian non-corporate resident shareholders could receive a non-refundable tax credit of say one-ninth of the dividend when an Australian company pays unfranked dividends. The credit would be included in a taxpayer's assessable income (Figure 2.3 and Appendix 2.2). To be eligible, the unfranked dividend would need to be paid out of a designated category of foreign source income. For corporate shareholders, the treatment of unfranked dividends paid out of foreign source income is discussed in Chapter 3.

Figure 2.3: Foreign dividend credit (Option A)



The existing imputation system would continue to apply to Australian taxed income (and domestic tax preferred income), while the credit would only apply to unfranked dividends paid out of foreign source income.

Rules would identify the relevant foreign source income at the company level and allow it to be passed to shareholders. Foreign source income subject to Australian company tax would not be included, as it would be franked. An existing account, such as the foreign dividend or foreign income accounts could be used, and similar distribution rules as for franking credits could apply.

Overall, this option would reduce a bias at the shareholder level against direct investment offshore, while maintaining the benefits of the current dividend imputation system. The credit would need to be set at a low rate because it is provided without reference to foreign tax paid offshore, which may be low.

Perhaps more importantly, a low rate of credit would avoid any need to quarantine expenses and use of the credit.

Option B: allowing dividend streaming of foreign source income

Dividend streaming would allow Australian companies to pay franked dividends to shareholders who benefit most from franking (for example, resident shareholders such as superannuation funds) and unfranked dividends to those who benefit least or not at all (for example, non-resident shareholders). Streaming could be limited to a company's foreign source income (however measured).

The current law uses structural rules and anti-avoidance provisions to prevent streaming. All shareholders are allocated franking credits equally — a 'pro-rata' rule. The simplified imputation rules that took effect from 1 July 2002 maintain this position. However, dual listed company (DLC) structures allow, in effect, a form of streaming that falls outside the anti-dividend streaming provisions.

The obligation to pro-rate franking credits among all shareholders accords with shareholders' economic and legal interests. Shareholders share equally in all the profits of a company, whatever their source and regardless of whether they are subject to company tax or not (Table 2.4). The policy decision not to fully extend the benefits of franking credits to non-resident shareholders is common in other countries' imputation systems.

Table 2.4: Comparability between economic ownership and a pro-rata tax allocation

		Resident shareholder	Non-resident shareholder
Australian source income	Economic and legal interest?	Yes	Yes
	Equivalent tax interest?	Yes	Yes
Foreign source income	Economic and legal interest?	Yes	Yes
	Equivalent tax interest?	Yes	Yes

Allowing the streaming of foreign source income would allow companies and their shareholders to assume — for tax law purposes — that non-resident shareholders in a company had first interest in the non-Australian taxed foreign source income of the company, and second interest in all other income (Table 2.5).

Table 2.5: Divergence between economic ownership and tax under dividend streaming

		Resident shareholder	Non-resident shareholder
Australian source income	Economic and legal interest?	Yes	Yes
	Equivalent tax interest?	No - enhanced	No - diminished
Foreign source income	Economic and legal interest?	Yes	Yes
	Equivalent tax interest?	No - diminished	No - enhanced

Both resident and non-resident shareholders could benefit from dividend streaming. If the beneficiaries are the resident shareholders, then dividend streaming could reduce a bias, at the resident shareholder level, against offshore investment. If the beneficiaries are non-resident shareholders, then streaming may reduce Australian source tax on foreign equity investments in relevant Australian companies (which may reduce the cost of foreign capital).

However, dividend streaming only benefits companies with non-resident shareholders. Furthermore, the extent of benefit depends on the proportions of non-resident shareholders, foreign source income and level of profit distributions. Maximum benefits would occur when the proportion of non-resident shareholders equalled the proportion of dividends treated as being from foreign source income. Smaller Australian multinationals or companies contemplating offshore expansion (that may be most affected by a bias) may have a relatively small non-resident shareholder base; therefore, the benefit to them may not be significant.

Legislating to allow dividend streaming could be the simplest option to implement. Current efforts to prevent streaming create legislative complexity and increase administrative and compliance costs. DLCs already effectively stream foreign source income.

Dividend streaming could take several forms.

Unfettered dividend streaming

The Government could remove all restrictions on dividend streaming to simplify imputation provisions. However, streaming of domestic tax-preferred income in addition to foreign source income raises wider policy issues.

Streaming of foreign source income from an Australian parent company

The Australian parent company would need to record designated foreign source income (probably measured on a repatriation basis) in a separate account, so foreign source income only could be streamed to non-residents. As for Option A, it could use an existing account like the foreign dividend or foreign income account.

Streaming of foreign source income from a foreign subsidiary — stapled stock streaming

Instead of an Australian parent company directly paying all shareholders (resident and non-resident) dividends, its foreign subsidiary could directly pay dividends to non-resident shareholders. This approach could reduce exposures to Australian and foreign dividend withholding taxes and allow non-resident shareholders to better access home-country shareholder relief mechanisms.

The current law does not prevent Australian companies from establishing stapled stock arrangements to allow a foreign subsidiary to pay dividends, but does prevent any Australian franking credit streaming benefit. When non-resident shareholders receive dividends from the foreign subsidiary, the franking account in the Australian company still must be debited, as if the Australian company had directly paid the dividends.

Stapled stock streaming would allow for the streaming of an Australian company's unrepatriated foreign source income. However, some companies may not find this arrangement practicable or attractive.

The form of dividend streaming already available to DLCs is similar to a stapled stock arrangement. A DLC involves an Australian resident company and a company resident in another country (so far the United Kingdom) entering into arrangements to operate as a single economic entity. Shareholders in the Australian resident company (more likely to be Australian residents) can receive franked dividends; whereas shareholders in the overseas resident company (more likely to be non-residents) receive in effect unfranked dividends paid out of foreign source income. As the overseas company is not a subsidiary of the Australian company (but rather one of two parent companies that have agreed to act together as one), the anti-dividend streaming provisions do not apply.

Option C: providing franking credits for foreign dividend withholding taxes

The Review of Business Taxation recommended providing franking credits for foreign dividend withholding tax paid by Australian companies. The Government has deferred implementing this measure until the outcome of this review.

The Review of Business Taxation argued this recommendation would partially reduce the bias against foreign investment; reduce the extent to which foreign dividend withholding taxes could discourage the repatriation of profits from offshore; and achieve comparability between offshore investments made through Australian companies and those made directly by individuals or superannuation funds.

While these are valid reasons, their continued relevance needs to be considered in light of the recent protocol to the Australia-United States tax treaty and the position of other major recipients of Australian direct investment offshore. Once the protocol takes effect, little or no foreign dividend withholding tax will be paid by Australian companies for investment in the United States, the United Kingdom and New Zealand. This amounts to around 80 per cent of all direct investment offshore (Table 2.3). This will also apply to some other countries in which Australian companies invest.

Consequently, this option would only reduce a tax bias against direct investment offshore and improve repatriation incentives in limited cases. Furthermore, if tax treaties (such as in the United States protocol) provide for a rate of withholding tax on non-portfolio dividends at a zero or low rate (and a higher rate for portfolio dividends), it will not be necessary to provide franking credits to achieve comparability with investments made directly by Australian individuals or funds in foreign companies.

Aspects of this option also raise integrity concerns. Because Australia refunds excess imputation credits, dividends could be routed through Australian conduit companies to cash out the foreign dividend withholding tax. Another problem is Australia's limited scope to obtain verifiable information from offshore jurisdictions to substantiate claims of foreign dividend withholding tax paid. Companies also could generate additional franking credits through offshore share trading in foreign companies.

Such concerns demonstrate why extending this option to provide franking credits for underlying foreign company taxes is unattractive. Such an extension also would require reintroducing a full foreign tax credit system at the Australian company level.

Appendix 2.1: An international trend away from dividend imputation

In recent years, some countries have moved away from dividend imputation as a method of providing shareholder relief (Table 2.6). While the choice of the replacement system varies considerably, all remove or reduce any previous imputation bias against foreign source income at the shareholder level.

Table 2.6: Countries recently replacing a dividend imputation system

Country	Moved to	EU member state?
Germany	Partial shareholder relief (half dividend exemption) from 2002 for individuals.	Yes
Ireland	Classical (with low company rate) from 1999.	Yes
Singapore	Shareholder relief (dividends exempt) to be introduced from 2003.	No
United Kingdom	Shareholder relief (statutory rate of credit and lower, dividend specific, personal tax rates) from 1999.	Yes

Ireland reverted to a classical company tax system from 1999. Shareholders are fully assessable on dividends received and tax paid at the company level is not recognised. However, a phased reduction to a 12.5 per cent company tax rate (by 2003) on trading income provides significant offsetting relief to domestic taxpayers.

More commonly, a system of providing some tax relief on dividends received by shareholders without referring to the actual amount of tax paid at the company level has replaced dividend imputation. Shareholder relief mechanisms take various forms — exempting half the amount of the dividend in Germany; (proposed) fully exempting it in Singapore; and allowing a partial tax credit while lowering (dividend specific) personal tax rates in the United Kingdom.

The drivers of change overseas

Several factors explain the international trend away from imputation systems but their relative importance varies between countries.

Most countries seek to improve or maintain international competitiveness and their ability to attract foreign investment. Singapore cites this as a primary reason for reform. Depending on the degree of shareholder relief the replacement system provides, moving away from imputation can help reduce company tax rates. A low headline company tax rate can attract foreign direct investment.

The administrative complexities of imputation also motivate change. For companies, classical taxation dispenses with the need to keep franking accounts, and for individuals, the need for gross-up-and-credit-style rules. Furthermore, associated rules against dividend streaming and franking credit trading become fewer. However, countries adopting a system of shareholder relief in preference to dividend imputation may achieve fewer benefits and introduce further complexities; for example, they may need to quarantine relevant expenses against dividends received.

Perhaps most importantly for European Union member states, treaty obligations associated with their membership have influenced domestic company tax policies.[2] These obligations seek to remove distortions (including from taxation) to the free movement of capital between member states and ensure greater neutrality in the treatment of European Union residents. They result in varying degrees of reform, ranging from substantial modifications (Germany) to more modest amendments (France and Norway).

Implications of overseas trends for Australia

While the overseas trend is away from dividend imputation, that trend alone is not a reason for Australia to abandon dividend imputation. Some important factors driving overseas change — such as obligations arising from membership of the European Union — are not relevant to Australia.

Also the taxation and non-taxation environments are different. For example, Australia has one of the highest levels of direct personal share ownership in the world, at around 40 per cent; whereas direct share ownership in Germany is relatively low at around 13 per cent.[3] Furthermore, companies are a common form of business organisation in Australia; whereas in Germany a relatively high percentage of business is conducted by unincorporated entities for cultural and historical reasons. These differences mean that the degree of change and impact of moving away from imputation would be considerably greater for Australia than for Germany.

---

2 The 1957 Treaty of Rome (which provided for the creation of a common market based on the free movement of goods, people, services and capital) and more recently the European Council's Parent-Subsidiary directive of 1990, are particularly relevant, as are related judgments by the European Court of Justice.

3 Australian Stock Exchange, 2000, *Share Ownership Survey*, ASX, Sydney, available at: http://www.asx.com.au.

However, the overseas experience indicates that as cross-border capital flows increase, an imputation system that focuses on domestic capital and investment flows will become less relevant to the decisions of companies and their shareholders. Hence it is less likely to achieve its original objectives.

Appendix 2.2: Examples of the imputation reform options

Below are examples of how Options A and C would operate for four classes of resident shareholders — tax-exempts benefiting from franking credit refunds (Table 2.8); superannuation funds (Table 2.9); and individuals on 31.5 per cent and 48.5 per cent marginal tax rates (Tables 2.10 and 2.11). Low-rate resident taxpayers would be affected like superannuation funds.

Option B, dividend streaming, is not illustrated, as the implications for shareholders would differ between companies depending on their ownership structure, the form of streaming allowed and other factors.

The starting point for the examples is an Australian company earning $1,000 of taxable Australian income, and receiving $90 of dividend income from an offshore subsidiary in a listed country (exempt income). The dividend received is net of $10 of dividend withholding tax levied by the foreign tax authority. A small amount ($40) of tax-preferred Australian income is also earned by the Australian company. Following the payment of Australian company tax of $300 (on the Australian assessable income), the company is able to pay an $830 dividend to its shareholders (Table 2.7).

- The foreign dividend credit (Option A) operates together with the imputation system, with both franking and 'other' credits provided. The 'other' credit amount ($10) is calculated as the amount of the cash dividend received by the shareholder that relates to the exempt foreign income ($90) multiplied by 1/9.

- Under the franking credits for foreign dividend withholding tax option (Option C), the $10 foreign withholding tax incurred by the Australian company is recorded in the franking account, and not separately distinguished in the dividend paid to the shareholder.

The 'other non-refundable credits' row (Tables 2.8 to 2.11) shows the shareholder relief given in Option A. This credit is assumed to be used first by the shareholder, and then the refundable franking credits second. A negative sign on the amount of personal income tax paid by each shareholder indicates a refund of tax. As for franking credits, the non-refundable credit is also included in the recipient's assessable income.

Table 2.7: Imputation reform options — taxation at company level

Australian company level	**$**
Australian taxable income (w)	1000.0
Australian company tax paid (x)	300.0
Exempt foreign dividend income (y)	90.0
Tax preferred (exempt) Australian income (z)	40.0
Foreign dividend withholding tax paid on exempt dividend	10.0
Total cash available to be paid as dividend (w - x + y + z)	**830.0**

Table 2.8: Imputation reform options — effect on tax exempt shareholder currently benefiting from franking credit refunds

		Option A	**Option C**
Shareholder level	**Current system**	**Foreign dividend credit**	**Franking credits for DWT**
Cash dividend received from Australian company (j)	**830.0**	**830.0**	**830.0**
plus franking credits	300.0	300.0	310.0
plus other non-refundable credits	-	10.0	-
Amount included in shareholder's assessable income	**0.0**	**0.0**	**0.0**
Shareholder tax liability	0.0	0.0	0.0
less other non-refundable credits	-	10.0	-
less franking credits	300.0	300.0	310.0
Income tax paid (k)	**-300.0**	**-300.0**	**-310.0**
After tax income received (j - k)	**1130.0**	**1130.0**	**1140.0**

Table 2.9: Imputation reform options — effect on superannuation funds (15 per cent tax rate)

		Option A	Option C
Shareholder level	**Current system**	**Foreign dividend credit**	**Franking credits for DWT**
Cash dividend received from Australian company (j)	**830.0**	**830.0**	**830.0**
plus franking credits	300.0	300.0	310.0
plus other non-refundable credits	-	10.0	-
Amount included in shareholder's assessable income	**1130.0**	**1140.0**	**1140.0**
Shareholder tax liability (15 per cent rate)	169.5	171.0	171.0
less other non-refundable credits	-	10.0	-
less franking credits	300.0	300.0	310.0
Income tax paid (k)	**-130.5**	**-139.0**	**-139.0**
After tax income received (j - k)	**960.5**	**969.0**	**969.0**

Table 2.10: Imputation reform options — effect on individual on 31.5 per cent marginal tax rate

		Option A	Option C
Shareholder level	**Current system**	**Foreign dividend credit**	**Franking credits for DWT**
Cash dividend received from Australian company (j)	**830.0**	**830.0**	**830.0**
plus franking credits	300.0	300.0	310.0
plus other non-refundable credits	-	10.0	-
Amount included in shareholder's assessable income	**1130.0**	**1140.0**	**1140.0**
Shareholder tax liability (31.5 per cent rate)	356.0	359.1	359.1
less other non-refundable credits	-	10.0	-
less franking credits	300.0	300.0	310.0
Income tax paid (k)	**56.0**	**49.1**	**49.1**
After tax income received (j - k)	**774.1**	**780.9**	**780.9**

Table 2.11: Imputation reform options — effect on individual on 48.5 per cent marginal tax rate

		Option A	Option C
Shareholder level	**Current system**	**Foreign dividend credit**	**Franking credits for DWT**
Cash dividend received from Australian company (j)	**830.0**	**830.0**	**830.0**
plus franking credits	300.0	300.0	310.0
plus other non-refundable credits	-	10.0	-
Amount included in shareholder's assessable income	**1130.0**	**1140.0**	**1140.0**
Shareholder tax liability (48.5 per cent rate)	548.1	552.9	552.9
less other non-refundable credits	-	10.0	-
less franking credits	300.0	300.0	310.0
Income tax paid (k)	**248.1**	**242.9**	**242.9**
After tax income received (j - k)	**582.0**	**587.1**	**587.1**

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

International tax arrangements can affect the attractiveness of Australia as a location for Australian-based multinationals and regional holding companies. Issues in this chapter focus on:

- controlled foreign company (CFC) rules;
- Australia's tax treaty network with other countries and treaty processes;
- treatment of income repatriated from direct investment offshore;
- conduit income arrangements, particularly in respect of the capital gains tax (CGT) rules; and
- determination of the place of residence of a company.

Better targeting the controlled foreign company rules

The purpose of Australia's CFC rules is to prevent residents accumulating 'tainted income' taxed at low or zero rates in foreign entities. The rules target tainted income as it is highly mobile between countries and poses a greater revenue risk than other less mobile income. Active income from running a business is generally exempted to ensure the competitiveness of Australian companies.

At least 21 countries, mostly OECD members, have CFC rules. However, their CFC rules vary considerably, reflecting different policy objectives and choices in trading off revenue protection and economic efficiency, with minimising compliance and administration costs.

Broadly, Australia's CFC rules apply to residents' shareholdings in foreign companies the residents control. Residents subject to the rules include in their assessable income their proportion of the CFC's tainted income, subject to certain exceptions. A CFC's tainted income comprises passive income (such as dividends, interest and capital gains on certain assets) and tainted sales and services income. If a CFC is located in a 'broad exemption listed country', then

Australian residents include a narrower range of income in their assessable income.

Current CFC rules are complicated. They give rise to considerable compliance costs for Australian-located businesses and may impede the efficient restructuring of Australian multinational groups. Some technical and small to medium policy issues also need consideration.

Improving rollover relief for corporate restructuring

The potential application of CGT to the disposal of a CFC's tainted assets (which include shares) may impede the restructuring of an Australian multinational or regional holding company's offshore operations. The competitiveness of Australian companies could be affected adversely if the CFC rules prevent them from using the most efficient group structure, or make it more costly to restructure.

Rollover relief is available for CFCs but is seen to be inadequate. Where relief is available, it generally is based on domestic rollover relief provisions. In particular, rollover relief is available for certain asset transfers between wholly-owned group companies. This relief is modified to reflect both the particular circumstances of CFCs and the categorisation of countries into broad exemption, limited exemption and unlisted. These modifications aim to protect the integrity of the CFC rules and prevent non-portfolio dividends from companies in unlisted countries being routed through a listed country.

There may be scope to provide some further rollover relief without undermining the CFC rules, for example, in scrip-for-scrip cases, but this needs to be further explored, given the complexity of the issues involved. Ideally, rollover rules should allow Australian companies to restructure their offshore operations without significant impediments, while maintaining the integrity of the CFC rules.

Other options for consultation discussed below, if implemented, could affect the need for rollover relief and its design. A CGT exemption for the sale of a non-portfolio interest in a non-resident company with an underlying active business (Option 3.10) would remove the need for rollover relief for such interests. A general exemption for foreign non-portfolio dividends Australian companies receive (Option 3.9) would allow some restrictions to be removed. For example, the scrip-for-scrip rollover available from December 1999 contains rules to prevent the circumvention of tax on non-portfolio dividends from unlisted countries by a scrip-for-scrip exchange between CFCs. The deemed dividend rules applying to asset transfers from unlisted to listed countries also could be removed.

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

Better targeting the tainted services income rules

Tainted services income is income from a CFC providing services to a related party or an Australian resident. These services can include performing managerial, architectural, scientific, transport, commercial and other professional services. Tainted services income generally is exempt from attribution for CFCs in broad exemption listed countries.

Tainted services income rules partly back up Australia's transfer pricing rules in maintaining taxing rights over Australian source income. However, they also can apply to Australian companies with active income from substantial offshore businesses. This can potentially affect the competitiveness of these operations (when owned by an Australian company) by increasing compliance costs and attributing income from particular transactions. This outcome sits uneasily with the anti-avoidance focus of the Australian CFC rules and the general exemption from attribution for offshore active income. The increased economic importance of services heightens the need to ensure that Australian resident companies are not competitively disadvantaged. The tainted services income rules also need to take into account the greater use of outsourcing and information economy growth (including Internet related issues).

As the economic importance of services increases, so does the potential revenue risk. Changes to the tainted service income rules need to be weighed against the risk that services income may be shifted to a low tax country. For example, domestically produced services could be routed through a CFC back to Australian residents, perhaps more easily than goods. The legal ownership of assets that generate services also could be moved to a CFC in a low tax country.

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

Expanding the number of broad exemption listed countries to minimise compliance costs

The CFC rules use a broad exemption country list approach to reduce compliance costs as CFCs in these countries represent less of a revenue risk than CFCs in other countries. A CFC in a broad exemption listed country is not subject to attribution of its tainted income, except for passive income benefiting from designated concessions and other limited categories.

The seven broad exemption listed countries are: the United States, the United Kingdom, Japan, Germany, France, Canada and New Zealand. These countries comprise most of Australia's direct investment offshore (Table 2.3). Non-inclusion of a country on the list is a comparative, not negative, judgement about its tax system. Even a high tax country could have features in its tax system benefiting mobile passive income that makes it unsuitable for inclusion.

Before 1997, CFCs in 60 or so countries benefited from the narrower CFC rules that now only CFCs in broad exemption listed countries enjoy. The Government introduced the broad exemption country list because some other countries allowed tainted income to be accumulated at low rates of tax. This undermined the CFC rules.

It is possible that other countries could be added to the broad exemption country list. However, the detailed criteria used in assessing a country's suitability for inclusion (or exclusion) need to be clarified. Factors could include tainted income generally being assessable income, sufficiently comparable entity level tax rates, the presence of a tax treaty or an exchange of information agreement and an effective tax administration.

A country having a particular company tax rate, or a tax treaty with Australia, or being a major trading partner, or on the limited exemption list (see Option 3.9 below) cannot alone be used to decide if a country can be broad exemption listed. Many countries meeting these criteria would not tax tainted income sufficiently. However, the level of Australian outbound investment flows and the presence of a tax treaty could help decide which countries to consider for inclusion.

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

Other policy and technical issues

A number of technical and second order policy issues concerning the CFC rules need to be considered. Examples include aspects of the control tests, foreign exchange issues and the treatment of start-up companies. Already, the Treasury and the Australian Taxation Office (in consultation with industry) are considering problems with the treatment of overseas limited partnerships and other similar foreign flow-through, or 'hybrid' entities.

One approach to address the remaining issues would be to completely rewrite and simplify the CFC rules. However, this approach may be difficult to do in the short term and separately from a rewrite of the other attribution regimes. An alternative would be to address specific issues and technical matters of concern on a case-by-case basis.

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

Modernising Australia's tax treaty network

Tax treaties (or double tax agreements) govern the division of resident and source taxing rights between two countries. They aim to facilitate cross-border trade, investment and movements of people by preventing the double taxation of income arising from those activities. Provisions facilitating exchange of information between countries also help prevent fiscal evasion and assist with tax administration.

Australia's future treaty practice

As a net importer of capital and technology, Australia generally has emphasised its source taxing rights in its tax treaties. That has involved negotiating with treaty partners withholding tax rate limits for non-portfolio dividends and royalties higher than the norm in treaties between OECD member nations.

However, the higher levels of withholding tax may disadvantage Australian companies operating offshore against local competitors and competitors resident in countries that negotiate lower rates. The rapid growth in Australian direct investment offshore highlights the increasing importance of this disadvantage.

The high levels of withholding tax permitted under Australia's tax treaties also may detract from Australia's conduit arrangements. Conduit income is potentially subject to high levels of withholding tax, both when the Australian company receives it and when it is distributed to non-resident shareholders. The quality and range of Australia's regional treaty network may be particularly important for Australian regional holding companies.

Australia increasingly has chosen — on national interest grounds — not to fully exercise the taxing rights allowed under its treaties. Dividend withholding tax on franked dividends was removed in 1987 and the range of corporate bonds exempt from interest withholding tax has increased in recent years.

Australia's treaty practice has changed to reflect the increasing level of direct investment offshore and its limited use of its withholding tax rights. Since the mid-1990s, Australia has sought (consistent with its domestic law) a zero or low rate of dividend withholding tax on franked non-portfolio dividends paid to companies. Recently concluded treaties, such as with Russia, reflect the success of this approach.

The Review of Business Taxation emphasised renegotiating treaties with our major trading and investment partners (particularly the United States) to reduce dividend withholding tax rates. Recent protocols update the US and Canadian tax treaties. These protocols achieve rates of zero or 5 per cent on certain non-portfolio dividends to corporate shareholders.

The protocol agreed with the United States contained significant departures from Australia's previous treaty practice, while affirming Australia's rights to apply CGT (discussed further below). In particular, the zero to low rate of dividend withholding tax agreed for non-portfolio dividends applies to unfranked as well as franked dividends. The rate of royalty withholding tax is lower, and a zero rate of interest withholding tax applies to interest paid to a financial institution. These changes, while formally reducing tax on non-residents, will also benefit residents by reducing the cost to Australian businesses of foreign capital or of accessing foreign technology.

The protocol is a major step in modernising Australia's tax treaty network and provides significant net economic benefits to Australia. However, each agreement is a negotiated outcome which reflects the particular economic relationship between Australia and its treaty partner and domestic tax laws. Any negotiated outcome ultimately needs to meet the test of being, overall, in Australia's national interest. Revenue considerations are relevant to striking a balance between source and residence taxation. Maintaining future tax policy flexibility as much as possible also is important, as treaties typically span decades.

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

Taxing capital gains

Australia's treaty practice is to allow, in general, the source country to tax capital gains. (In contrast, most OECD countries only seek to tax capital gains when non-residents alienate real property or assets relating to a permanent establishment in that country.) This practice allows Australia's domestic CGT provisions to apply to non-residents. CGT applies to the sale by non-residents of non-portfolio interests in Australian public companies and unit trusts, and any interest in a private company.

However, 19 treaties pre-date the introduction of CGT in 1985 and have not been revised. This includes treaties with the United Kingdom, Japan, Germany, the Republic of Korea, the Netherlands, Switzerland and France. The Australian Taxation Office recently issued a tax ruling to the effect that pre-CGT treaties generally do not limit the application of each treaty country's domestic law to capital gains. However, some uncertainty about this issue exists within the business community, and may hinder investment into Australia from pre-CGT treaty countries. Also double taxation could arise because pre-CGT treaty partners are not obliged under the treaties to provide a credit for Australian CGT.

Australia has consistently maintained source country CGT taxing rights in post-CGT treaties and the US and Canadian protocols reflect this position. To address business uncertainty and avoid double taxation, Australia's other pre-CGT treaties should be updated to cover the taxation of capital gains.

A non-resident holding Australian assets through a non-resident company can dispose of the company, avoiding CGT. Accordingly, the Review of Business Taxation proposed that CGT apply (subject to certain conditions) to the sale by a non-resident of a non-resident entity that has underlying Australian assets. Doing so would reinforce Australia's ability to apply CGT to non-residents disposing of Australian assets. However, this measure is complex to target appropriately, and its implementation was deferred pending a review of tax treaty policy.

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

Australia's future treaty negotiation programme

Australia currently is negotiating or renegotiating tax treaties with several countries. Foremost among these negotiations are the treaties with the United Kingdom and Germany. Most favoured nation (MFN) clauses in some existing treaties also will affect the treaty negotiation programme. MFN clauses require a treaty partner country to enter into negotiations with a view to provide similar treatment to the other treaty partner if it subsequently agrees with a third country to a certain specified tax treatment.

There are MFN clauses on rates of withholding tax in Australia's tax treaties with the Netherlands, France, Switzerland, Italy, Norway, Finland, Austria and the Republic of Korea. These clauses will be triggered once the United States protocol takes effect. Other MFN clauses will be triggered if Australia agrees to a Non-Discrimination Article (for example, in the current negotiations with the United Kingdom). MFN clauses of this kind are in Australia's tax treaties with France, Finland, Republic of Korea, Spain and South Africa, and the agreement between the Australian Commerce and Industry Office and the Taipei Economic and Cultural Office.

While the triggering of the MFN clauses imposes certain obligations on Australia, it also presents an opportunity to relatively quickly negotiate protocols with a significant number of countries that meet Australia's policy objectives. In particular, agreement could be reached for zero or low rates of permitted dividend withholding tax (where the other country imposes such a tax) and to clarify Australia's rights to apply CGT.

In setting the treaty programme, however, business preferences need to be balanced against other competing interests (such as individuals moving between countries).

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

Improving consultation arrangements

Effective consultation arrangements with Australian business and other parties are important in achieving successful and timely treaty negotiations. Options to improve the transparency and effectiveness of current processes could include:

- publicly announcing pending talks with countries and inviting public submissions (as done for talks with the United Kingdom);
- maintaining a public status report identifying those countries where negotiations are underway and the stage they have reached;
- making better use of the expertise of the Tax Treaties Advisory Panel, including greater input into particular treaty negotiations; and
- consulting beyond any formal panel process to achieve appropriate external coverage, including directly approaching companies known to have significant interests in the other country.

These options need to consider the traditional confidentiality of bilateral negotiations.

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

Other tax treaty policy issues

Business has raised a range of secondary, although important, policy issues concerning Australia's tax treaty practice. These include the treatment of unit trusts and hybrid entities, the interaction between the source rules in treaties and those in the domestic law, and the design of 'limitation on benefit' articles (as in the recent United States protocol).

A revamped Tax Treaties Advisory Panel (discussed above) could provide an appropriate forum for considering these and other issues.

The treatment of foreign non-portfolio dividends at the company level

Australia exempts from company tax, non-portfolio dividends (and certain branch profits) received from 63 listed countries. Non-portfolio dividends from companies in listed countries comprise around 95 per cent of all foreign non-portfolio dividends Australian companies receive. Non-portfolio dividends from unlisted countries are generally taxable with a credit for foreign withholding tax and underlying company tax.

The existing exemption approach reduces compliance costs. It also provides an effective conduit regime at the Australian company level for income from direct investment offshore. Its policy rationale is to provide a broadly similar outcome to taxing these dividends with foreign tax credits. This is because the profits from which the dividends are distributed were comparably taxed offshore.

Listed countries fall into two categories. Broad exemption listed countries face limited application of the CFC rules, and limited exemption listed countries face the CFC rules in full. Countries, therefore, fall into three categories: broad exemption listed (seven countries); limited exemption listed (56 countries); or unlisted (the rest). Both broad exemption and limited exemption countries benefit from the non-portfolio dividend exemption.

Before 1997, one list was used for both exemption and CFC purposes. However, as not all listed countries levied tax on a sufficiently comparable basis, the Government introduced the new broad exemption listed category for CFC purposes only. All remaining listed countries were moved to the limited exemption list.

An alternative approach

The problems with the limited exemption list remain, with some non-comparable tax countries included. The number of countries listed, and sensitivities associated with removing a country, mean this problem is, to some extent, inevitable. An alternative is to abolish the list and provide a general exemption. That could substantially simplify the international tax rules and encourage repatriation of profits back to Australia. It also would better match the general approach of minimising Australian company tax on direct investment offshore, and the treatment of non-portfolio interests in unlisted countries under the thin capitalisation rules. The branch profit exemption rules could be similarly extended.

However, this option needs to be considered in light of any changes to the CFC and foreign investment fund (FIF) rules. 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. The options discussed in Chapter 2 also could affect this option.

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

Improving conduit income arrangements

Conduit income is foreign source income non-residents earn through an Australian entity. Conduit incomes arise for Australian multinationals (as they are likely to have non-resident shareholders and foreign source income) and for regional holding and joint-venture companies established in Australia.

Australian tax on conduit income can occur at either the entity level, on disposal of interests in the Australian entity, or on distribution (through withholding taxes). The general policy should be to avoid taxing conduit income (Attachment A). Conduit income can be highly sensitive to the application of domestic tax, particularly for regional holding companies and managed funds. A current example of this no-tax approach is the foreign dividend account.

However, potential benefits from providing conduit relief need balancing against legislative simplicity, avoidance of 'harmful tax practices', and ensuring that relief is limited to conduit income. It therefore would be preferable for conduit income to avoid Australian tax as a consequence of tax rules of general application, for example, by exempting companies' foreign non-portfolio dividends from listed countries.

The primary focus here is to improve the conduit income treatment for companies under the CGT and dividend withholding tax provisions. CGT and unit trust conduit issues are considered in Chapter 4.

Regional holding companies and capital gains tax

Multinationals establish holding companies to own the operating companies of the group in a particular region. Holding companies can assist in efficiently managing and controlling the business operations, better managing group income flows, tax planning and allowing easier acquisition or disposal of specific operations or assets.

A regional holding company established in Australia (or one arising from a foreign company acquiring an Australian multinational) may pay CGT when selling its regional subsidiaries ('Interest A' in Figure 3.1). If the holding company itself is sold, that sale is also subject to CGT ('Interest B'). Had the non-residents instead invested directly in the foreign subsidiary (or used a holding company in another country), they would not have paid CGT in Australia.

Figure 3.1: An Australian regional holding company

Some countries' general tax rules avoid conduit taxation in such cases. This can occur if a country does not have a general capital gains tax system (New Zealand), or if the sale by a company of non-portfolio interests in another company is generally exempt (Germany) or exempt if the company being sold is a trading company (as the United Kingdom is proposing). However, all these alternatives have significant domestic tax consequences, and are not considered further.

An alternative to these generalised approaches is to establish a conduit holding company regime to provide specific CGT exemptions. Disposals of both 'Interest A' and 'Interest B' could be exempt. A conduit holding company regime could cater for joint-venture companies. However, as discussed below, a conduit holding company regime would be complex, have significant compliance and administration costs, raise valuation problems, and potentially benefit non-conduit cases. It also may raise harmful tax practice issues.

The benefits of a conduit holding company regime could extend to non-resident portfolio interests in Australian multinationals. However, it would increase design and compliance problems. New Zealand has a conduit holding company regime that exempts companies from its CFC (and other) rules in the 'Interest A' case. That regime extends to non-resident portfolio investors, and is very complex. The New Zealand regime demonstrates some of the practical and design issues of a conduit holding company regime that extends to non-resident portfolio interest holders.

As providing conduit relief from CGT is highly complex, the following discussion offers only a preliminary examination of the issues.

Relief for disposals by Australian holding companies of foreign subsidiaries — 'Interest A'

A conduit holding company regime could prevent conduit taxation in the 'Interest A' case. Alternatively, a general, non-conduit specific, CGT exemption could apply to the sale of a non-portfolio interest in a foreign company where that company has an underlying active business. The 'conduit restructure relief' alternative, discussed further below, also could provide conduit relief in these cases.

A conduit holding company regime

A conduit holding company regime could exempt an Australian company from CGT on gains on the disposal of foreign subsidiaries (and possibly any non-portfolio interest in a foreign company) in proportion to non-resident shareholder ownership.

Eligible non-resident shareholdings

Under a conduit holding company regime, it would be difficult to account for all non-resident shareholdings. An Australian company would need to measure its non-resident ownership each time it disposed of a foreign subsidiary. Limiting relief to non-resident shareholders holding a 'significant' interest would be simpler. The level considered 'significant' would need to balance minimising compliance costs with providing as general a conduit exemption as possible.

If a significant interest required a non-resident to wholly-own (or very nearly wholly-own) the Australian company, this generally would be a relatively easy ownership test to apply. The exempting company rules already require such an ownership test. In this case, the sale of a foreign subsidiary also could be fully exempt from CGT. However, safeguards would be required so Australian residents cannot access the exemption by interposing a non-resident entity.

Flow through of conduit income benefits to non-resident shareholders — companies wholly-owned by non-residents

The benefit of the CGT exemption at the Australian company level should flow through to non-resident shareholders. An exempt conduit gain paid as a dividend to non-resident shareholders would require an exemption from withholding tax. A foreign income account (Option 3.11) would achieve this.

It would be more difficult where the non-resident shareholder sells the interest in the Australian company, and the exempt gain has not been distributed. The sale price would reflect the exempt gain, and potentially be subject to CGT. This claw-back of company level tax-preferences at sale of shares in a company is a basic feature of CGT. Non-resident owners often plan around this problem. Alternatively, the cost bases of the non-resident shareholders could be increased to reflect the exempt gains. Subsequent distributions of the exempt gains then would reduce the cost bases. Monitoring changes in non-residents' cost bases would involve compliance and administration costs and could require a separate tax account, even if a foreign income account was introduced.

Flow through of conduit income benefits to non-resident shareholders — companies partly owned by non-residents

For companies partly owned by residents (or non-eligible non-residents), it is more difficult to ensure that only the non-resident shareholders in the holding company benefit from a CGT exemption. Significant additional design, compliance and administration difficulties exist.

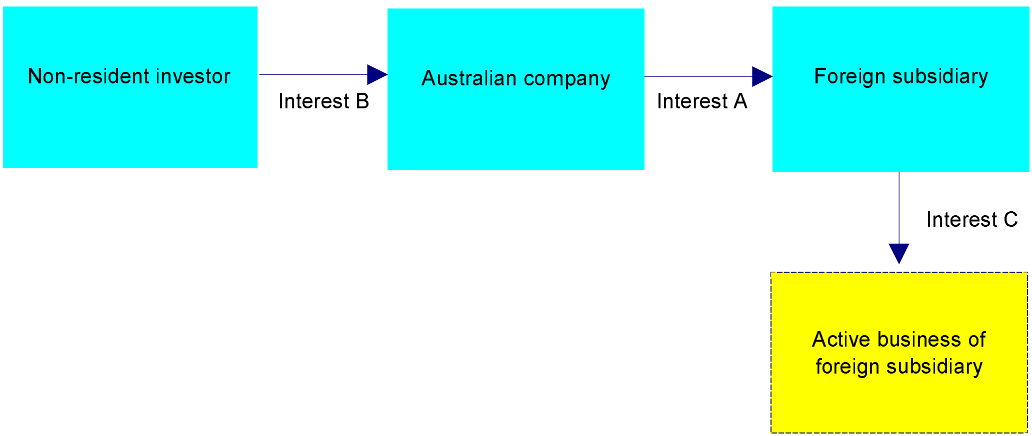
Reinvestment of exempt gains would transfer some of the benefit of the exemption from eligible non-resident shareholders to other shareholders. All shareholders would share equally the extra profits generated by the reinvestment of the CGT saved. If the exempt gains were distributed, the CGT exemption benefit should pass only to the eligible non-resident shareholders. To do so, a company would need to be able to discriminate between shareholders so it could pay an additional unfranked dividend out of the untaxed foreign gain to eligible non-resident shareholders.

The problem of preventing CGT effectively applying to retained exempt gains when eligible non-resident shareholders sold their interests in Australian companies also would be made more difficult.

Capital gains tax exemption for sale of a non-portfolio interest in a non-resident company with an underlying active business

A CGT exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business would alleviate most 'Interest A' concerns. It would benefit Australian multinationals and avoid many conduit holding company regime design problems, as the ownership of the Australian company would be irrelevant. Providing a general exemption is justified as Australia's foreign source income rules already exempt disposals of underlying active business assets by CFCs ('Interest C' in Figure 3.2).

Figure 3.2: Non-resident company with an underlying active business



Where the foreign subsidiary passes the gain on disposing of an underlying active business to the Australian company, the dividend currently is exempt if the foreign subsidiary is a listed country resident. Subsequent distribution to a non-resident shareholder also would be exempt from dividend withholding tax under the foreign dividend account rules. An exemption from CGT for selling 'Interest A' therefore would mirror this outcome, except where the foreign company was not in a listed country, or had substantial tainted assets, or the interest in the foreign company was only a portfolio interest.

A foreign income account (Option 3.11) also would be needed to achieve equivalence between the sale of 'Interest A' and a sale of the underlying business, as the current foreign dividend account rules do not exempt a dividend paid out of an exempt CGT gain from withholding tax.

However, this alternative raises design and compliance issues of its own, and needs to be explored further. In particular, it may be difficult to legislate and apply the active / passive business distinction. Australian companies might need to look through layers of CFCs to determine to what extent an underlying active business exists. While an Australian company is likely to have sufficient information in relation to its CFCs to undertake this inquiry, issues could arise in valuing the active and passive assets.

How the rules would work when a non-portfolio interest in a foreign company was not a CFC interest but was instead subject to the FIF rules also needs consideration.

Relief under a conduit holding company regime for disposals by non-residents of non-portfolio interests in Australian holding companies — 'Interest B'

Exempting underlying foreign gains on disposing of 'Interest B' interests supports a conduit holding company regime. However, such an exemption would create potential costs and difficulties. Not least, major valuation problems would occur in administering such an exemption, as non-residents would need to calculate the extent to which their gain is due to the Australian companies' unrealised gains in foreign subsidiaries.

To calculate those unrealised gains would require, as a first step, knowledge of the value of the underlying foreign subsidiaries at the time of sale of the non-resident's interest in the Australian company. This could be difficult to establish satisfactorily, as the sale contract is unlikely to disclose the individual market values of the underlying assets. In addition, non-residents would need to establish a cost base for the underlying asset, possibly separate from the cost base from the point of view of the Australian company. For example, if an Australian company purchased a foreign subsidiary for $1 million, and was then itself acquired by a non-resident at a time when its foreign subsidiary was worth $5 million, the appropriate cost base in this context would be $5 million.

Valuation issues would be more complex if multiple share classes were involved, and in circumstances where the unrealised gain was for an asset held through a chain of entities. Furthermore, how assets were used to secure finance also could be relevant.

A conduit restructure relief alternative to a conduit holding company regime

Problems with a conduit holding company regime arise from difficulties in accurately attributing and exempting foreign gains to various taxpayers. This is partly due to mixed combinations of resident and non-resident shareholders and domestic and foreign assets, inadequate information on values, changes in ownership over time, retention of exempt gains and the need for unequal distribution policies.

An alternative approach is to provide relief to corporate restructures that allow a conduit structure to be unwound. Conduit restructure relief would be different to proposed demerger relief provisions, as the latter would not allow rollover relief in situations where relief would take assets out of the CGT net. However, conduit restructure relief provisions, where appropriate, could draw on the principles of demerger relief provisions.

Conduit restructure relief would allow a non-resident shareholder to swap an indirect interest in the foreign subsidiary of an Australian company for a direct interest (Figure 3.3). Sale of the direct interest would then not be subject to CGT.

Figure 3.3: A swapping of interests under conduit restructure relief

Such restructuring could avoid tax on conduit gains for both 'Interest A' and Interest B cases. It would avoid many problems of a conduit holding company regime and arguably reduce valuation difficulties. Relief would not need to be limited to cases where non-residents had significant interests in an Australian company. Legislatively, it should be simpler.

However, the conduit restructure relief alternative is limited as it only extends CGT relief to circumstances where the non-resident exits the investment. It also requires investors to undertake a restructure to access tax relief, which may result in non-tax and foreign tax costs. Furthermore, using conduit restructure relief to avoid conduit taxation in such cases may be a less transparent mechanism for not taxing conduit income.

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

Establishing foreign income accounts

Unfranked dividends paid to a non-resident are generally subject to dividend withholding tax, with the rate depending on the non-resident's tax treaty status.

Unfranked dividends are dividends paid to shareholders out of company profits not subject to Australian company tax. Untaxed profits include a company's domestic tax-preferred income and foreign source income that is exempt (certain non-portfolio dividends and branch profits) or which is assessable (foreign portfolio dividends, capital gains and royalties), but for which foreign tax credits are available.

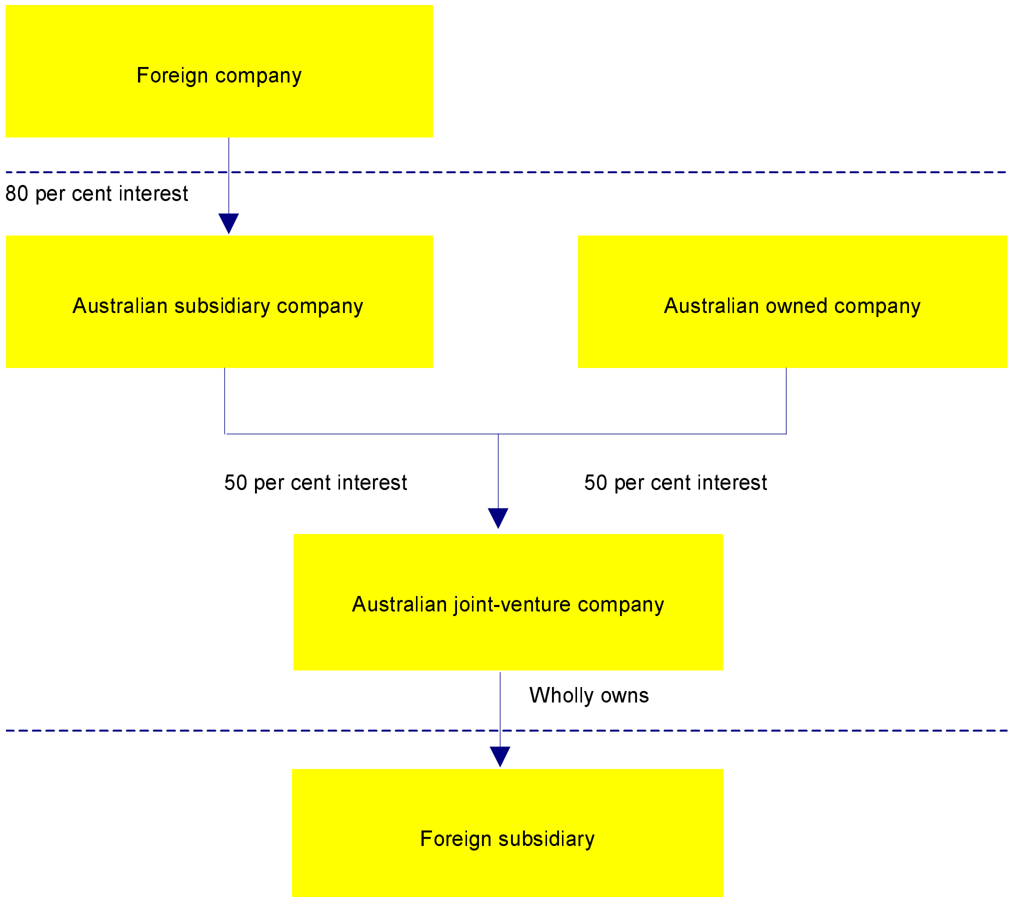
The foreign dividend account allows a withholding tax exemption for unfranked dividends paid out of non-portfolio dividends received from listed countries (and from unlisted countries to the extent that foreign tax credits are available).

The Review of Business Taxation recommended expanding the foreign dividend account to provide a withholding tax exemption for all conduit income an Australian company distributes. A foreign income account would replace the foreign dividend account. The Government has deferred implementing this measure pending the outcome of this review.

An in-principle case exists to establish foreign income accounts to provide conduit taxation relief. However, a final decision on the foreign income account, and its design, can only be made as part of final consideration of the imputation options in Chapter 2.

Whether the foreign income account also should be extended to allow effective flow-through of foreign income account amounts along a chain of Australian companies (Figure 3.4) is also interlinked with the Chapter 2 options.

Figure 3.4: Australian joint-venture company with underlying foreign partner



Current provisions usually exempt the receipt of non-portfolio dividends by the joint-venture company. However, as dividends are passed (unfranked) from the joint-venture company to the joint-venture parties, Australian company tax applies. Consequently, Australian company tax is imposed on the conduit income attributable to the foreign company, and the company level exemption for foreign non-portfolio dividends is effectively unwound for the Australian owned company. Current rules would prevent Australian company tax applying where the foreign company wholly-owned its Australian subsidiary.

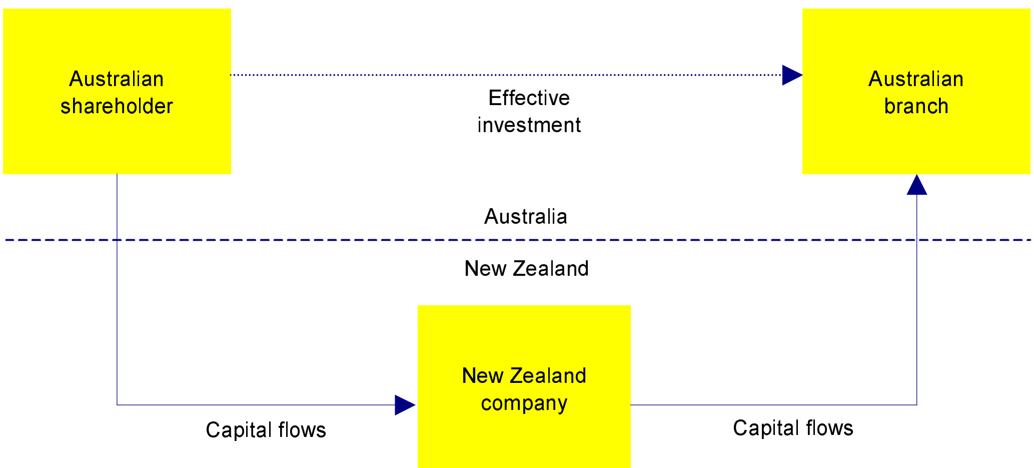
Option 3.11 for consultation: to consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1.

Trans-Tasman triangular tax

Australian and New Zealand governments have released a discussion paper on Trans-Tasman triangular tax. That paper outlines a proposed mechanism for the reform of triangular investment and is currently the subject of public consultations.

A triangular investment is a particular conduit case, where the income flowing through the conduit vehicle to the non-resident investor has its source in the non-resident's country of residence (Figure 3.5).

Figure 3.5: A triangular investment



In Trans-Tasman triangular investments, an Australian shareholder in a New Zealand company receives no imputation credits for Australian tax paid by the New Zealand company or its branches and subsidiaries.

The Trans-Tasman triangular tax discussion paper outlines the pro-rata allocation method for resolving triangular taxation. Under that method, the location of companies in Australia or New Zealand would not affect Australian shareholders' ability to access imputation credits for Australian company tax paid and New Zealand shareholders' ability to access New Zealand company tax credits.

Some options for reforming Australia's dividend imputation system discussed in Chapter 2 could affect Trans-Tasman triangular tax.

Determining the place of residence of companies

For Australian tax purposes, the place of residence of a company is important in determining how its operations and profits will be subject to Australian tax rules and liabilities. It also determines whether a company will be able to distribute imputation credits to its shareholders, join a consolidated group and it determines the application (or not) of Australia's tax treaties to the company.

Currently, a company is treated as a resident if it is incorporated in Australia. If a company is not incorporated in Australia, it still is considered to be resident if it carries on a business in Australia and either has its central management and control in Australia or Australian resident shareholders control its voting power. These tests were introduced in 1930 and have remained unchanged.

Problems with current tests of company residency

Offshore subsidiaries of Australian companies, multinationals or regional holding companies can be treated as resident companies because of the application of the non-incorporation tests of residence. Dual listed companies (DLCs) also face risks under the non-incorporation tests. DLCs involve an Australian incorporated company and a company incorporated in another country entering into arrangements to operate as a single economic entity, while maintaining separate legal status, shareholdings and listings. If the global head office of the DLC is in Australia, then the foreign DLC partner risks being treated as an Australian resident company.

In practice, corporate groups (and DLCs) can arrange their affairs to ensure that the risk of related companies incorporated offshore being treated as resident for Australian tax purposes is minimal. However, those arrangements come at some cost and inconvenience that may be difficult to justify on policy grounds.

The central management and control test has other problems. While central management and control generally refers to where supervisory control of a company is exercised, in practice this often means considering where the board of directors meet. Where boards have directors from several countries and also hold meetings using videoconferencing, establishing central management and control may be more problematic and the application of the test more uncertain.

Changing the company residence tests

Applying residency concepts to companies, particularly when they are part of a multinational corporate group, is difficult. Consequently, the test of residence of a company for tax law purposes needs to be pragmatic, balancing factors such as compliance and administrative costs, integrity of the tax system, and the assertion of Australia's taxing rights against other nations' taxing rights.

Moving to a test of company residence based solely on place of incorporation, as in the United States, would address some business concerns. It would be simple for both taxpayers and tax administrators and provide a level of certainty in arranging corporate affairs. However, it may be relatively easy to use an incorporation residence test to minimise tax. In the United States some major corporate groups have used the incorporation residence test to change the location of their parent company (without any substantive changes in their operations, place of management or listing) to minimise US company tax liabilities, and start-up companies have been established in tax havens for the same reason.

Some features of Australia's tax system would reduce the risk to Australia of relying on place of incorporation as the sole test of residency. In particular, the dividend imputation system is only available to resident companies and Australia's taxation of the foreign source income of resident companies is arguably less aggressive than the United States. As in the United States, changing residence could also trigger CGT liabilities for the company as well as for shareholders. However, the events in the United States still justify caution in adopting an incorporation only test.

Largely, difficulties with the current tests of company residency arise because of uncertainty about applying the test that looks at whether a company's central management and control is in Australia and whether it carries on a business here. The Australian Taxation Office applies the test so that the 'carrying on of a business' is separate to the 'central management and control'. However, the case law is not entirely clear, and arguably, merely exercising central management and control itself may constitute the carrying on of a business. If this interpretation was to prevail, it would significantly broaden the range of the test, and some businesses might arrange their affairs (at some cost) to guard against this.

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

The residency of a company also is an issue for Australia's tax treaties. Only residents of treaty partners directly benefit from a particular tax treaty. Which treaty partner a company is resident of, in turn, affects the company's particular tax treatment.

Because countries use various tests of company residency, a company can be a resident of both treaty partners (for example, where it is incorporated in one country but has its central management and control in the other). Typically treaties insert tie-breaker rules to deal with these cases. However, a few Australian treaties do not include a tie-breaker, resulting in dual resident companies being denied treaty benefits.

Australia's tax treaties generally follow the OECD model approach for tie-breaker rules, giving preference to the country of the company's place of effective management. However, Australia has agreed in certain treaties, such as with Canada, to a company residence tie-breaker that looks primarily at place of incorporation. Where countries have a tax system comparable to Australia the revenue risk of a place of incorporation tie-breaker test may be reduced. However, many of Australia's current or prospective treaty partners prefer a tie-breaker focusing on the place of effective management.

Where a company is resident under Australia's domestic tax law, but is then treated as not being a resident under a tax treaty tie-breaker provision, the company is not a resident of Australia only for the purposes of the treaty. For other purposes of Australia's tax law, the company continues to be treated as a resident. However, in certain cases, the application of the domestic tax rules are modified for dual resident companies to prevent them obtaining possible tax advantages from that status.

Dual resident modifications could be avoided if the domestic definition of residency was altered so that it was overridden where a company was taken to be a non-resident as a consequence of applying a treaty tie-breaker. That is, a company resident under Australia's domestic tax law that is resident of a treaty partner under the relevant treaty tie-breaker would be treated as non-resident for all income tax purposes. The United Kingdom and Canada adopt this approach. While it could benefit some businesses, it has wide-ranging implications.

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

Chapter 4: Promoting Australia as a global financial services centre

Australia is a highly attractive location within the Asia-Pacific region for financial service providers. It has a large pool of highly skilled labour, and firms based here can achieve operating cost efficiencies, particularly in accommodation, technology and labour.

Funds managers active in Australia argue that a number of tax impediments prevent them operating to their full potential, for both their domestic and international clientele. Areas of principal concern are:

- application of the foreign investment fund (FIF) provisions to the funds management industry; and

- the capital gains tax (CGT) treatment of investments by non-residents in Australian managed funds (unit trusts).

Rationalising and improving the current tax treatment of foreign trusts is also important to the financial services industry, and could improve the integrity and simplicity of the tax system.

Foreign investment fund rules

FIF rules were introduced in the early 1990s. They prevent Australian residents from investing in offshore entities that accumulate (that is, do not regularly distribute income to investors) essentially passive income such as portfolio dividends and interest at zero or low tax rates.

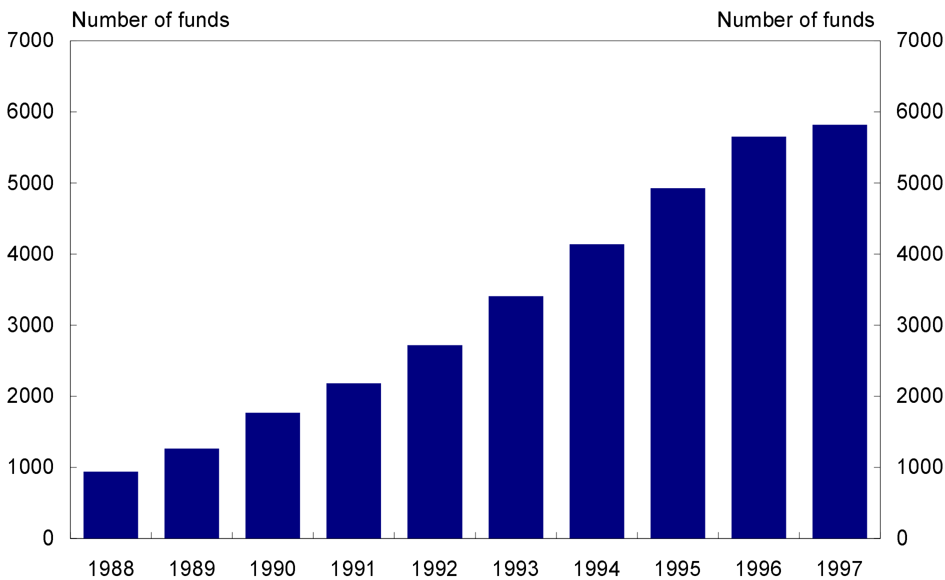
In part, FIF rules complement the controlled foreign company (CFC) rules (see Chapter 3) introduced around the same time. The FIF rules apply to significant interests in foreign entities that fall outside the CFC rules. However, they are more than just an adjunct to the CFC rules, and deal with portfolio investments as well. Given the rapid growth in cross-border portfolio investments and managed funds since the FIF rules were introduced, this second function assumes even greater importance.

The need for foreign investment fund rules

Allowing the unfettered use of offshore accumulation entities would enable resident taxpayers to reduce substantially the Australian tax payable on their passive investment income, even when they have no tax avoidance motive. Such an outcome would be contrary to the goal of taxing resident individuals on their worldwide income, pose a risk to the revenue base, and favour the use of particular offshore managed funds over Australian managed funds.

The global availability of investment opportunities in offshore accumulation entities located in tax havens and low-tax countries is substantial (Chart 4.1). Offshore accumulation entities also can be established in non-tax haven countries.

Chart 4.1: Number of funds in tax havens and low-tax countries[(a)]



Source: OECD.
(a) The number of funds added in 1997 only includes funds established in the first seven months.

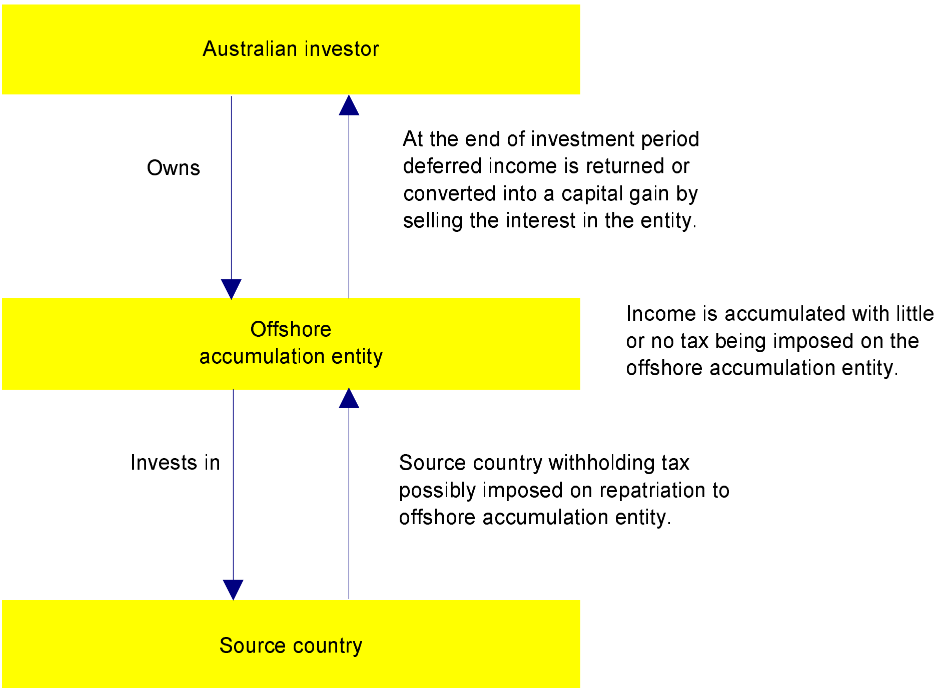
While the size of such funds is unclear, the OECD (1999) estimated that offshore funds managed over US$1 trillion in tax-free environments; one fund established in 1996 reportedly was seeded with US$32 billion in capital.[4]

4 OECD, 1999, *Taxation of Cross-border Portfolio Investment*, OECD, Paris.

The tax benefits from offshore accumulation of passive income

In the absence of FIF rules, investors can significantly reduce their tax by using an offshore accumulation entity. They can defer the derivation of income and convert income into capital (Figure 4.1).

Figure 4.1: The use of an offshore accumulation entity



An Australian investor benefits from deferral of Australian income tax until the offshore accumulation entity distributes the accumulated income. Furthermore, if Australian investors sell their interest in the offshore entity before the income is distributed, investors can convert the accumulated income into a capital gain. This would provide access to the 50 per cent CGT discount for individuals. However, Australian investors do not receive the credit for source country withholding tax imposed on the fund's income (for example, dividends and interest) that a direct investment into the source country or through an Australian fund would have attracted.

Effective tax rates for investments made through an offshore accumulation entity by a resident individual fall over the deferral period (Table 4.1). Investments in an offshore accumulation entity can be differentiated according to whether income is either received at the end of the period as a capital gain or as a distribution, and whether the entity's income attracts source country withholding tax.

Table 4.1: Effective tax rates (per cent) on alternative offshore investments for an individual on the top personal marginal tax rate[a]

	One year deferral	Three year deferral	Five year deferral	Ten year deferral
Benchmark direct investment	48.5	48.5	48.5	48.5
Conversion of income to capital gain, no source withholding tax[b]	24.3	22.6	21.0	17.6
Distribution of income, no source withholding tax	48.5	46.1	43.8	38.2
Conversion of income to capital gain, source withholding tax[b], [c]	35.6	34.4	33.2	30.7
Distribution of income, source withholding tax[c]	56.2	54.5	52.8	48.7

(a) Investments are assumed to have a pre-tax rate of return of 10 per cent from underlying investments.
(b) Conversion is assumed to allow the investor access to the 50 per cent CGT discount.
(c) The rate of source country withholding tax is assumed to be 15 per cent.

In general, significant tax advantages are available to a taxpayer using an offshore accumulation entity instead of directly investing or using an Australian managed fund. The benefits would increase if the investor's marginal tax rate falls at the end of the investment (for example, due to retirement).

Of the four offshore accumulation entity investment scenarios in Table 4.1, the most common in practice is the second — that is, negligible source country withholding taxes and investors able to access the CGT discount by disposing of their interest in the offshore accumulation entity rather than receiving a distribution. Increasingly, offshore accumulation entities are likely to receive income not subject to significant source withholding tax due to global trends in withholding taxes and investor practices.

An alternative foreign investment fund regime

A case exists for provisions to minimise the tax benefits available from investing in offshore accumulation entities. A number of OECD countries (including the United States, Canada, and New Zealand) have these provisions. However, the current Australian FIF rules are very complex, with high compliance costs for affected taxpayers and managed funds. Also the rules may catch certain investments in what are, in effect, active businesses.

One consequence of the FIF rules is that, to offer Australian investors international equity products, fund managers must establish fund structures in Australia that mirror their international fund offerings. Because of their smaller size, the Australian mirror structures are not as cost-efficient as their offshore counterparts. This process also means that a narrower range of international products are on offer to Australian portfolio investors. Thus, the FIF provisions limit both the choice and returns available to investors. The costly and administratively complex nature of offering international products to the Australian market under the FIF rules also may deter foreign fund managers from establishing or expanding their operations here.

Problems with the current FIF regime could be addressed in two ways. The regime could be replaced. This would be a long-term project and alternative approaches may not provide a better balance between maintaining the integrity of the tax system and minimising the costs for taxpayers. Alternative approaches to identifying offshore accumulation entities are discussed in Appendix 4.1. The appendix highlights the difficulties in devising alternative means of identifying offshore investments that should be exempt from FIF-type rules. These problems are caused by the paucity of information available to portfolio investors in offshore funds.

However, broader long-term consideration of a possible replacement for the current FIF regime may be worthwhile. A number of overseas jurisdictions — including the United Kingdom, New Zealand and the United States — are undertaking, or have proposed to undertake, a review of their FIF related rules. Developments in these countries may point to a more attractive approach than the current FIF regime.

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

Options for better targeting the current rules

Existing FIF rules could be refined to ensure the current rules are better targeted and minimise compliance costs and other distortions.

Australia's FIF rules start with the proposition that any interest in an offshore company or trust is a FIF interest, then provide for a range of exemptions that leave as attributable FIF interests only those that have (or may have) predominantly passive income and assets. In addition, some situations are exempt where the extent of tax advantage is relatively minor, either in relative terms (the 5 per cent balanced portfolio exemption) or absolute terms (the $50,000 de minimis exemption).

The step of identifying exempt FIF interests means investors must make inquiries to classify their investment. Difficulties may arise using the balance sheet method to determine the nature of non-resident entities' businesses. The balance sheet method requires access to, at least, the annual reports of the company. However, these may not be available, or may not be available on time due to a different financial reporting period from the investor. Even if they are available, they may not disclose the nature of operations of subsidiaries or the level of ownership in subsidiaries, which are necessary for investors to look through holding companies.

FIF interests that are not exempt are taxed on an attribution basis and attribution accounts need to be maintained to prevent double taxation when income is finally repatriated or the FIF interest is sold. The maintenance of accounts imposes significant compliance difficulties, particularly for Australian managed funds. This is because each investor in the fund must have separate attribution entries for each FIF interest. Moreover, attribution account percentages change and each account needs to be revised as unit holders enter and exit the fund.

Such compliance concerns often cause investors and their fund managers to avoid the complex FIF rules by selling sufficient non-exempt FIF interests immediately before year-end so that they fall within the 5 per cent balanced portfolio exemption. This behaviour partly achieves the aims of the FIF rules of imposing Australian tax and limiting deferral. The value of any income accumulated in a FIF will be reflected in the sale price and hence subject to CGT.

These direct compliance costs are substantial and the categorisation of exempt and non-exempt FIFs may give rise to portfolio biases. Some options may alleviate these problems and ensure the FIF rules provide a better balance between revenue risks and the costs imposed on taxpayers.

Adjusting the balanced portfolio exemption percentage

The FIF rules (together with CGT) remove much of the benefit of deferring investments in non-exempt FIF interests over and above the 5 per cent balanced portfolio exemption threshold.

Many Australian managed funds often need to sell down interests at year-end to fall within the balanced portfolio exemption, suggesting that the 5 per cent threshold is too low, and that even fund portfolios established on commercial terms risk falling within the FIF regime.

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

The appropriate treatment of index funds

Australian managed funds with investments that follow a widely recognised index (such as the Dow Jones) are unlikely to invest in offshore accumulation entities, because the index itself is likely to contain FIFs that are companies with active businesses subject to entity-level taxation. That is, a widely recognised index can be a proxy for a portfolio established on commercial terms.

Fluctuations in the index also would give rise to a re-weighting of the index fund, with assets acquired and sold to match the index. This regular disposal of assets could act as a further safeguard against accumulation due to the resulting realised capital gains, particularly if the fund had to use a first-in-first-out rule to determine asset disposals.

Not all index funds would be an appropriate proxy for a portfolio constructed on commercial terms. For example, an 'offshore hedge fund index' may favour investment in offshore accumulation entities. How closely a fund would have to correspond with the index that it purports to follow would need consideration.

Adjustment to the balanced portfolio exemption percentage (Option 4.2) could govern whether a specific exemption for certain Australian index funds is justified.

The position of Australian managed funds contrasts with an offshore fund with investments that also follow a widely recognised index. The offshore fund may be situated in a jurisdiction that allows accumulation to occur without taxation. It therefore would fall within the class of offshore interests to which FIF rules should apply.

Option 4.3 for consultation: to consider exempting Australian managed funds that follow widely recognised indices from the foreign investment fund rules.

Whether to exempt complying superannuation funds

Australian investors can benefit from investing in offshore accumulation entities (Table 4.1). For an investor with a 48.5 per cent marginal tax rate and able to access the 50 per cent discount for eligible capital gains, those benefits could be significant.

The benefits for taxpayers diminish as the marginal tax rate and the CGT discount they enjoy (if any) fall. Complying superannuation funds, which have a flat marginal tax rate of 15 per cent and are able to access only a one-third discount for eligible capital gains, would derive the least benefit from using offshore accumulation vehicles (Table 4.2).

Table 4.2: Effective tax rates (per cent) on alternative offshore investments for a complying superannuation fund[(a)]

	One year deferral	Three year deferral	Five year deferral	Ten year deferral
Benchmark direct investment	15.0	15.0	15.0	15.0
Conversion of income to capital gain, no source withholding tax[(b)]	10.0	9.2	8.5	7.0
Distribution of income, no source withholding tax	15.0	13.9	12.8	10.6
Conversion of income to capital gain, source withholding tax[(b), (c)]	23.5	22.9	22.4	21.2
Distribution of income, source withholding tax[(c)]	27.8	26.9	26.1	24.4

(a) Investments are assumed to have a pre-tax rate of return from underlying investments of 10 per cent.
(b) Conversion is assumed to allow the investor access to the 33 1/3 per cent CGT discount.
(c) The rate of source country withholding tax is assumed to be 15 per cent.

While complying superannuation funds still can reduce their effective tax rates by investing in offshore accumulation entities, the reduction does not increase an investment's after-tax rate of return as significantly as for a high marginal personal tax rate individual. For example, a 10-year deferred investment (with zero withholding taxes on fund income and end-of-period disposal) would increase the superannuation fund's annual after-tax rate of return from 8.50 per cent to only 9.30 per cent. The equivalent for an investor with a 48.5 per cent marginal tax rate and who accesses the 50 per cent CGT discount is an increase from 5.15 per cent to 8.24 per cent.

Complying superannuation funds are in a different position to resident widely-held managed funds. Income earned by widely-held managed funds generally is taxed at the member's marginal tax rates, and members can access any applicable CGT benefits. Accordingly, individuals could achieve the reductions in effective tax rates in Table 4.1 if widely held funds per se were exempt from the FIF rules.

The benefit of deferral and / or conversion of income to capital for a complying superannuation fund is low compared to other taxpayers. In addition, the costs arising from the FIF rules may be relatively higher for complying superannuation funds that hold offshore interests as part of a diversified portfolio. Exempting superannuation funds from the FIF rules, for example, would allow them direct access to global funds and could assist them in reducing management costs.

However, any decision to exempt complying superannuation funds would have to balance the continuing need to maintain tax system integrity against unduly imposing costs on taxpayers. The potential benefit that complying superannuation funds could obtain from any adjustment to the balanced portfolio exemption percentage (Option 4.2) is a major consideration.

Option 4.4 for consultation: to consider exempting complying superannuation funds from the foreign investment fund rules.

Funds management activities

The FIF rules attempt (circuitously) to identify as attributable FIF interests only those FIF interests that have (or may have) predominantly passive income and assets.

However, Australian investors with an interest in an offshore funds management business where the business itself does not hold significant levels of passive assets but manages funds, would have their income from the provision of funds management services and expertise treated as passive income and be subject to the FIF rules. This return should be treated as active business income, and not income from holding passive assets.

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

Improving the treatment of international investors in Australian managed funds

Australian managed funds primarily operate using unit trust structures. In general, non-residents who invest in Australian unit trusts are taxed the same as those who invest directly into Australia. Both cases avoid Australian taxation of conduit income. However, aspects of current arrangements, particularly those relating to the CGT provisions, may deter non-residents from using Australian managed funds to invest in Australian assets or manage offshore investments.

Facilitating inbound investment through Australian managed funds

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 diminishes the competitiveness of Australian-based managed funds.

The bias arises as non-resident investors in Australian managed funds are effectively subject to CGT on underlying disposals of interests in assets that do not have 'the necessary connection with Australia' — for example, portfolio interests in an Australian public company. Non-residents directly disposing of such assets are not subject to Australian CGT.

Exempting non-residents on unit trust income from the disposal of assets that do not have a necessary connection with Australia would remove this bias. For ease of compliance, it would be appropriate to test whether an asset has the necessary connection with Australia as if the trustee of the Australian fund is a non-resident. While this approach may not remove the bias in exceptional circumstances, compliance costs in testing the indirect interest of each non-resident unit holder would be significant.

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

Non-resident investors also are subject to CGT on disposing of non-portfolio interests in Australian unit trusts. Where a gain on such a disposal relates to unrealised gains on trust assets that do not have the necessary connection with Australia, applying CGT may disadvantage the Australian managed fund.

Had non-resident investors invested directly in the underlying assets or through an offshore managed fund, they would not have paid Australian tax on the unrealised gain. However, it may be very difficult to provide relief in such cases, as the gain also may relate to unrealised gains on Australian assets held by the unit trust that do have the necessary connection with Australia (such as real property or interests in a private company).

For example, if non-resident investors were taxed only on the part of the gain attributable to the fund's underlying assets that have the necessary connection with Australia, investors would need information on underlying market values and possibly cost bases of the assets held within the fund at the time of disposal. This would be even more difficult to gather if the Australian managed fund had invested indirectly in assets (for example, through a wholesale fund). Issues in reconciling the cost base of the non-portfolio interest with that of the underlying assets also would arise.

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

Improving conduit arrangements for Australian managed funds

Option 4.6 could improve conduit arrangements for Australian managed funds by addressing concerns that an Australian fund manager gives an Australian 'source' to capital gains made on foreign shares an Australian managed fund holds for foreign investors. As foreign shares are assets that do not have the necessary connection with Australia, capital gains on such assets would also benefit from the Option 4.6 exemption.

While difficulties would arise in providing an exemption for gains on the disposal of non-portfolio interests in unit trusts that are attributable to underlying assets without the necessary connection with Australia (Option 4.7), non-resident investors subject to CGT on disposing of non-portfolio interests in Australian unit trusts are effectively subject to CGT on foreign source income that flows through an Australian managed fund.

This problem arises from a CGT rule ('CGT Event E4') that, in general, reduces the cost base of units in a unit trust to the extent that a trust's distribution is not assessable, just as foreign source income paid to a non-resident unit holder is not assessable. When the units are finally sold, the previously distributed foreign source income could, in effect and on a delayed basis, be subject to Australian CGT. A similar issue would arise for exempt CGT gains if Option 4.6 is implemented.

If investors invested directly in the asset generating the foreign source income, or through an offshore managed fund, the foreign source income would not be subject to Australian CGT. Accordingly, this CGT rule can disadvantage Australian managed funds.

Option 4.8 for consultation: to consider amending the CGT rules so that a distribution of income to which a non-resident is presently entitled, but which is not assessable because the income has a foreign source (or a CGT exempt gain that arises from Option 4.6), does not reduce the non-resident investor's cost base in a unit trust.

Finally, as suggested in Chapter 3, issues concerning the treatment of unit trusts in tax treaties merit consideration as part of regular consultation processes on tax treaty policy issues.

Taxing foreign trusts

Rationalising the application of current rules to foreign fixed trusts

The Review of Business Taxation Recommendations 20.8 and 20.9 proposed removing the deemed present entitlement rules for foreign trusts. FIF rules alone would apply to foreign fixed trusts, except where foreign beneficiaries exist. In this case, the FIF rules would apply to the resident beneficiaries and the transferor trust measures for other amounts.

The Government deferred implementing the recommendations pending a review of foreign source income rules. The changes could simplify current arrangements and reduce compliance costs.

Option 4.9 for consultation: to consider proceeding with the recommendations of the Review of Business Taxation rationalising the application of current rules to foreign trusts.

Transferor trust measures

Transferor trust rules aim to prevent the deferral or avoidance of Australian tax through transferring property or services to offshore trusts. In practice, their main use is in relation to offshore discretionary trusts, as income earned from transfers to fixed trusts generally is taxed under the deemed present entitlement rules or FIF rules (subject to Option 4.9 above).

Broadly, the net income of the trust is attributed to the Australian resident transferring property/services to the trust, unless the trust is in a broad exemption listed country. Then only 'eligible designated concession income' and FIF income of the trust are attributed. Any income attributable to the transferor is reduced by income the beneficiaries or trustees pay Australian tax on. Exemptions are provided for certain transfers.

The Review of Business Taxation Recommendations 20.10 to 20.12 proposed removing some of the current exemptions for transfers, particularly the 'control test' for offshore discretionary trusts established before the transferor came to Australia or before the transferor trust rules were announced. The recommendations also proposed an amnesty applying to trusts affected by the removal of the exemptions.

The Government deferred implementing the recommendations pending a review of foreign source income rules. The changes would tighten the transferor trust rules to remove potential opportunities for tax avoidance through accumulation of passive income in offshore discretionary trusts.

Option 4.10 for consultation: to consider proceeding with the recommendations of the Review of Business Taxation in relation to transferor trusts.

Taxing branches

Branches (permanent establishments) are a legal structure through which international investment can take place. Branch structures can offer (non-retail) financial services businesses (established by foreign multinationals in Australia) some commercial advantages compared with alternative legal structures (such as subsidiaries).

The Review of Business Taxation Recommendation 22.11 proposed that the income tax law be rewritten over time to permit, in appropriate circumstances, separate entity treatment of dealings between a branch and other parts of the entity.

Where necessary the Government's business tax reforms have included consideration of whether separate entity treatment of branches is appropriate. However, there may be issues outside the current reform programme where the lack of separate entity treatment inappropriately impedes the use of branch structures.

Option 4.11 for consultation: to consider specific tax issues outside the Government's current tax reform programme where the lack of separate entity treatment inappropriately impedes the use of branch structures.

Appendix 4.1: Alternatives to the current foreign investment fund classification approach

Overview of existing classification of foreign investment funds

The FIF rules currently apply to residents who have an interest in a non-controlled foreign company or trust. They also apply to residents who hold foreign life policies.

An active business exemption covers interests in FIFs that are companies engaged in a wide range of activities. The exemption operates by either classifying a company listed on an approved stock exchange as falling within an approved category or by examining a company's balance sheet (and certain subsidiaries) to determine if it can be classified as principally engaged in eligible activities.

In addition, numerous specific exemptions apply. These include a balanced portfolio exemption that is available for non-exempt FIF interests where their aggregate value is less than 5 per cent of the total value of FIF investments. A small investor exemption for individuals with aggregate interests of $50,000 or less also applies.

Alternative approaches, discussed below, could be used to identify offshore funds that are unlikely to be offshore accumulation entities. However, in general, portfolio investors will not have sufficient information to know whether offshore accumulation of passive income is occurring.

Alternatives based on the jurisdiction of entities

One alternative for identifying offshore entities that should be exempted from the FIF rules is to consider whether they are located in a comparably taxed country. Consistent with such an approach, the current FIF rules exempt particular classes of FIFs in the United States.

This alternative might deal with offshore accumulation entities located in tax havens or low-tax jurisdictions, but entities resident in comparable tax countries also can be used as offshore accumulation entities, or be involved in offshore accumulation of passive income. This can arise simply from the general design of a country's tax rules and interactions between the different rules of countries.

An effective offshore accumulation vehicle needs foreign income to be largely exempt from host country tax. For example, a United States entity that receives a flow-through tax treatment in the US can be a company for Australian tax purposes. Foreign source income could be accumulated in the entity without concurrent US taxation (as the United States considers it to be foreign source income flowing through to non-residents), and without Australian taxation (as no dividends are paid).

Furthermore, even a company that is generally subject to company tax in a comparable tax country can act as a conduit for investing in an offshore accumulation entity, unless that country also has robust FIF rules. For example, a New Zealand company is exempt from New Zealand CFC or FIF attribution to the extent that its shareholders are eligible non-residents. Accordingly, non-New Zealand residents could use these companies to hold interests in offshore accumulation entities.

For these reasons, the exemptions in the current FIF rules relating to US entities carefully target certain types of entities. The United States is a jurisdiction that also has robust FIF-type rules. Extending the treatment given to US entities to cover other jurisdictions would require an assessment of each country's FIF rules and that country's rules relating to various entities. Such an expansion also would require ongoing monitoring of each jurisdiction's laws.

Alternatives based on the features of offshore entities

FIF rules focus on offshore entities that are accumulation vehicles and do not regularly distribute income to investors. Therefore, a test could look at whether an entity annually distributes a significant proportion of its income.

However, an offshore accumulation fund could avoid a simple distribution test by interposing a company (with a formal distribution requirement) between itself and its investors. Investors also could find even a simple distribution test (let alone a test designed to deal with interposed entities) difficult to apply.

Investors also could find it impractical to apply any test of exemption based on whether a FIF has paid comparable foreign tax, since they probably would not have the necessary information available to them.

CHAPTER 5: IMPROVING AUSTRALIA'S TAX TREATMENT OF FOREIGN EXPATRIATES

In the global economy, skilled labour is becoming increasingly mobile, and countries are boosting their efforts to attract highly educated and skilled workers. To compete internationally, Australian businesses need to attract skilled workers to fill shortages and to access new ideas and skills. The influx of new ideas and skills produces benefits beyond the direct contributions of the foreign expatriates, improving the productivity and international competitiveness of Australian business.

The current taxation treatment of foreign expatriates who become temporarily resident in Australia discourages some multinational enterprises, particularly skill intensive business (including financial services), from locating in Australia or from bringing skilled people to Australia.

The Government has announced reforms to remove major tax disincentives to the employment of foreign expatriates. In many cases, the cost of these disincentives fall on Australian business. Often, Australian business either is unable to attract the required skilled staff, or must compensate them for the additional tax cost of working in Australia. Reforms include:

- a four-year foreign source investment income exemption for first-time temporary residents;
- an amendment to the exemption from the foreign investment fund (FIF) rules for exempt visitors;
- renegotiation of tax treaties to address concerns relating to the capital gains tax (CGT) treatment of departing residents; and
- relaxation of the superannuation preservation rules for eligible temporary residents when they permanently depart Australia.

These reforms significantly respond to the tax disincentives foreign expatriates face, and are consistent with approaches other countries take (Appendix 5.1). Outstanding issues affecting foreign expatriates include the treatment of employee share interests with a cross-border element, and better tax administrative support.

Improving Australia's tax treatment of foreign expatriates

Foreign source investment income exemption

The Government has announced that first-time temporary residents will receive a tax exemption for income derived from foreign assets and from interest withholding tax on interest payments for their foreign liabilities.

The exemption reduces the tax cost (which often falls on Australian business) for employers bringing skilled employees to Australia. Because of Australia's relatively high top personal tax rate, the foreign source income of temporary residents could otherwise be subject to a higher tax rate than if the temporary residents stayed in their home country.

Similarly, having to withhold tax on interest payments relating to foreign liabilities may push up the borrowing costs for temporary residents, if lenders are able to pass on the interest withholding tax cost.

In effect, the exemptions will create a new class of taxpayer, the 'temporary resident'. Temporary residents will be taxed on their Australian source income but temporarily exempt from tax on their foreign source income, other than foreign wage and salary income that relates to their period of Australian residency. This treatment reflects the lesser connection that a temporary resident has with Australia compared with a permanent resident.

Eligible temporary residents will include individuals from a range of occupations who are granted business (long stay) visas, with the greatest number of visas granted in 2000-01 being for computing professionals and programmers, managers, nurses and accountants.

Foreign workdays

Some countries, for example the United Kingdom and (in the future) Singapore, provide an ongoing tax exemption for income certain temporary residents earn from employment outside their country. If the income is not taxed by the country where employment occurs, then temporary residents receive this income tax free.

Australia's income tax law (section 23AG) currently exempts from tax an Australian resident's foreign earnings arising from at least 91 days of continuous employment in a foreign country. However, the need for continuity limits the applicability of the exemption, and it generally does not apply if the income is exempt from tax in the foreign country.

The foreign source investment income exemption does not provide for any further concessional treatment of foreign workdays, except it exempts foreign wage and salary income relating to foreign employment performed before becoming a temporary resident, but received while a temporary resident.

In removing disincentives to the temporary employment of skilled workers in Australia, the Government's tax treatment of the employment income of temporary residents is comparable to permanent residents. This avoids a tax bias favouring employing temporary residents.

Amendment to the foreign investment fund rules

The Government also has announced that it would extend the exemption from the FIF rules for temporary residents. This means taxpayers holding a temporary resident visa will be exempted from the FIF rules regardless of the period of the visa.

The previous exemption taxed temporary residents who were in Australia more than four years on the increase in their accumulated retirement benefits in non-employer sponsored superannuation funds in their home country. This meant that they were taxed on an increase in benefits that may not have been available to them until their retirement age, and if the home jurisdiction did not provide a credit for Australian tax paid on the accrued increase, double taxation would have occurred.

The extended FIF exemption is more generous than the four-year foreign source investment income exemption because accruals taxation of temporary residents' FIF income could produce potentially significant cash-flow difficulties and double taxation risks.

Tax treaties and the capital gains tax treatment of departing residents

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. The CGT liability relates to assets that do not have a necessary connection with Australia, principally foreign assets. Individuals can elect to defer CGT until disposal, but then they also face CGT on any post-departure gains.

An exception applies to an individual who has been resident in Australia for fewer than five out of the preceding ten years. These individuals are exempt from the deemed disposal rules for those assets they owned before becoming residents or those acquired because of someone's death.

This CGT treatment of departing residents raises the costs of employing skilled foreign workers in Australia, and often makes it difficult to retain foreign expatriates past five years. Expatriates staying more than five years in Australia may face double taxation on disposal of assets (as their home jurisdiction may not credit the Australian tax paid), inflated gains due to currency movements, and cash-flow difficulties from paying tax before assets are disposed.

The Government already has announced that it is moving to address these concerns, country by country, through renegotiating tax treaties. A treaty approach solves potential double taxation problems and takes account of the interaction between the tax rules of Australia and the relevant overseas jurisdiction. A tailored solution also avoids inappropriate 'no tax' outcomes and allows Australia to benefit if the other country also has exit taxes.

The Australia-United Kingdom treaty renegotiation is considering the CGT treatment of departing residents. The potential to trigger most favoured nation clauses provides scope for agreeing on protocols with a large number of current treaty partners to address the CGT treatment of departing residents (see Chapter 3).

The Review of Business Taxation Recommendation 22.20 proposed that if departing residents defer CGT until actual disposal of the assets, they should provide a security against payment of the future liability. However, such an approach would exacerbate the problems with the current CGT treatment, involve considerable compliance and administrative costs, and may be contrary to the Government's current approach.

Option 5.1 for consultation: to consider whether to proceed with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred CGT liability.

Superannuation arrangements for temporary residents

Australia's superannuation laws require all employers to make superannuation contributions to a complying superannuation fund on behalf of their eligible employees.

Foreign expatriates working temporarily in Australia, especially those near retirement age, may wish or be required to continue in their home-country retirement plan so as to maximise the return on their investment and retirement benefit.

Unless superannuation concessions are available to foreign expatriate workers, the requirement to make contributions to a complying superannuation fund could increase the cost to Australian employers of hiring those foreign skilled workers who wish or are required to remain in their home-country retirement plans.

Two main types of exemptions currently apply to foreign workers:

- general exemptions from the Superannuation Guarantee for certain senior executives; and

- exemptions where Australia has entered into a Superannuation Double Coverage (SDC) Agreement with another country.

The senior executive exemption is available to expatriate executive employees provided they hold a temporary resident visa and have been appointed by a company operating in Australia to be the national managing executive, deputy managing executive or a state manager. Holders of these visas also may be eligible for an exemption if their full-time positions carry substantial executive responsibility or they are establishing a business activity in Australia on behalf of their employer.

Australia has SDC agreements with three countries (the United States, the Netherlands and Portugal) as part of broader social security agreements. Negotiations are continuing with other countries, including Belgium, Chile, Croatia, Finland, Norway and Switzerland. The Government continues to examine opportunities for further SDC agreements.

SDC agreements ensure that Australians working temporarily overseas or non-residents working temporarily in Australia contribute to only one pension or superannuation scheme if contributory social security schemes operate in their home country. They make the cost of doing business in Australia cheaper. SDC agreements also reduce the costs to Australian employers who send employees to work in countries that have agreements with Australia.

The Government recently introduced an exception to the superannuation preservation rules. Individuals who hold, or have held, an eligible temporary residence visa and have permanently departed Australia can access their superannuation benefits before reaching preservation age. The exception is subject to withholding tax arrangements that aim to recoup the superannuation tax concessions that were provided on the benefits because they were to be used for retirement income purposes.

The exception benefits many temporary residents, including those who already have permanently departed Australia.

In addition, the Government has announced that it is prepared to negotiate reciprocal arrangements with other governments to allow non-residents to transfer superannuation monies to a pension fund in their home country, provided the country has corresponding preservation arrangements.

Removing double taxation of employee share options

Foreign expatriates may be subject to double taxation on the benefits arising from employee share options. An example is where an employee is issued share options offshore that are conditional on a certain period of service with the employer, part of which occurs offshore and part in Australia. Alternatively, the employee may be issued share options in Australia that are similarly conditional.

In these circumstances, double taxation could arise because countries have different approaches to taxing the benefits arising from these options. Some countries tax the benefit at the time the option is granted, or when the option vests, or when the option is exercised, or when the shares acquired under the option are sold. Some countries may not tax the benefit from the share option separately, but catch it under their capital gains tax provisions. Australia generally treats the benefit or discount on an employee share option as assessable income at the time the option is acquired, although assessment may be deferred for certain 'qualifying' options.

Because of the wide range of approaches that countries have adopted and the need for reciprocity to effectively remove double taxation, it is appropriate to address the double taxation of benefits arising from employee share options on a country-by-country basis through bilateral tax treaty negotiations.

One approach that could be adopted in treaty negotiations is the one the OECD promotes. The OECD approach allocates full residence taxation to the treaty partner in which the share options are exercised. The other treaty partner's taxing right is limited to that proportion of the income or gain on the option which relates to the period(s) between the grant and the exercise of the option during which the individual has worked in the partner country.

This approach is able to deal with residence-source issues where share options are subject to tax in more than one country. However, it does not always appropriately deal with situations where share options are taxed in three or more countries on a residence and source basis. The OECD noted that a solution would be for the competent authorities of each country to agree that each should provide relief on the residence-based tax that the other country levied on that part of the benefit relating to employment exercised while the employee was a resident of the partner country.

In addition to the treaty approach, changes to Australia's domestic tax law treatment of employee share options might also be needed.

Option 5.2 for consultation: to consider addressing the double taxation of employee share options through bilateral tax treaty negotiations and possible consequential changes to Australia's domestic tax law treatment.

Under the current domestic tax law (Division 13A), tax on a discount given to an employee for 'qualifying' shares or rights acquired under an employee share scheme may be deferred for up to ten years unless a 'cessation time' event occurs. The Review of Business Taxation Recommendation 22.19(a) proposed treating a resident's departure from Australia as a cessation event.

However, if ending Australian residency (where the individual has not left the current employer) constituted such a cessation event, the holder of such interests could face similar cash flow and currency valuation issues that taxpayers face with the deemed disposal CGT rules. Treating the ending of Australian residency as a cessation event also could be contrary to the Government's general policy direction in taxing foreign expatriates and departing residents.

Option 5.3 for consultation: to consider whether to proceed with the Review of Business Taxation recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A.

Providing administrative support for foreign expatriates and employers

Foreign expatriates working in Australia generally have tax affairs involving a wide range of domestic and international tax issues. The need to deal with a second, unfamiliar tax system may increase compliance costs, or be a disincentive to working in Australia.

Establishment of a specialist cell within the Australian Taxation Office could alleviate this concern. The cell could provide a single contact point for foreign expatriates to obtain advice and assistance on how tax law operates in Australia.

The specialist cell also could work closely with employers to address the tax concerns of their foreign expatriate employees.

Option 5.4 for consultation: to consider the Australian Taxation Office establishing a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.

Appendix 5.1: Some overseas expatriate tax regimes

Several countries, the United Kingdom, the Netherlands and Singapore in particular, have established favourable expatriate taxation regimes to attract mobile skilled labour.

United Kingdom

The United Kingdom's regime is fairly complex. The tax treatment of expatriates depends on the nature of their residency in the United Kingdom.

The employment income of individuals who are *resident but not ordinarily resident* is not taxed, if this income relates to duties performed outside the United Kingdom and is not remitted there.

The foreign investment income of individuals who are *resident but not domiciled* in the United Kingdom also is not taxed in the United Kingdom, if it is not remitted there. The capital gains income from non-United Kingdom assets is not taxed, unless it is remitted as foreign investment income.

Temporary residents in the United Kingdom can benefit from all three exemptions (foreign employment, foreign investment and foreign capital gains).

The Netherlands

The Netherlands has a specific tax concession to help Dutch employers attract skilled foreign specialists. The concession allows an employer to pay eligible expatriate employees up to 30 per cent of their salary free of tax.

The concession applies to expatriate employees who have skills which are in short supply in the Netherlands or who are assigned within a company group as part of an international job rotation, so long as the employees have been employed in that group for at least two and a half years.

The concession can apply for up to ten years, but is subject to periodic review to determine whether the individual's specific skills are still in short supply.

Singapore

Singapore's general tax rules are expatriate friendly. Singapore does not tax the foreign source income of resident individuals if such income is not remitted to Singapore. Individuals who migrate to Singapore are not taxed on their foreign source income where this income is remitted to Singapore after they take up residence there and was earned before they migrated. Singapore also does not have a capital gains tax.

Singapore plans to introduce, effective from the 2003 assessment year, a new class of taxpayer called 'not ordinarily resident' (NOR). To qualify as NOR, a taxpayer must satisfy two conditions. The taxpayer must not have been tax resident in Singapore for at least three years. Secondly, the taxpayer must have international responsibilities entailing at least 90 days of business travel outside Singapore each year. Individuals qualifying under the NOR scheme will be taxed only on income attributable to Singapore workdays. Employer contributions to the NOR taxpayers' home country pension schemes also will be tax exempt. The NOR status expires after five years of residence.

Attachment A: Overview of Australia's international tax arrangements

Australia's international tax arrangements

Australia's international tax arrangements revolve around the basic concepts of residence of the taxpayer and source of the income (Figure A.1). This structure is common to the income tax systems of most countries and is embodied in Australia's bilateral tax treaty network.

Balancing residence and source taxation

Residents of Australia in general are taxed on their worldwide income, from both labour and capital. Residence taxation often is justified on the basis of an individual's capacity to pay and enjoyment of public services provided by the country of residence. Non-residents are only taxed on income considered to have an Australian source. Source taxation often is justified on the basis that Australia provides the infrastructure, markets and economic resources for generating the income.

Figure A.1: Australian residency and source taxation

	Resident	Non-resident
Australian source income	Taxable.	Taxable subject to tax treaties.
Foreign source income	Taxable subject to tax treaties.	Not taxable, except conduit income.

Conduit income is foreign source income non-residents earn through an Australian entity. The presence of the Australian entity may give rise to Australian income tax liabilities.

For individuals, taxation of worldwide income is important in achieving the principles of vertical equity (the higher an individual's income, the higher the average rate of tax) and horizontal equity (individuals on the same income pay the same amount of tax). The latter principle is also important for economic efficiency in minimising distortions in commercial choices.

Changes in trade patterns, the increasing importance of services and intangibles in economic activity, more sophisticated tax planning and use of tax havens, improved communications technology and electronic commerce all pose challenges to the application of current residence and source rules. How to deal with these challenges is the subject of multilateral discussions, in which Australia actively participates, through the OECD and other international forums.

Other international tax arrangements

Currently, Australia has 41 *bilateral tax treaties* (or double tax agreements) governing the division of resident and source taxing rights between two countries to avoid double taxation. Tax treaties also provide for the exchange of information between tax authorities, effectively enforcing residence and source taxing rights. As a net importer of capital and technology from non-residents, Australia has sought to protect its revenue share by emphasising source taxing rights. Australia's domestic tax law supports the non-double taxation goals of tax treaties by giving credit for foreign tax paid or exempting income that is judged likely to have been comparably taxed offshore.

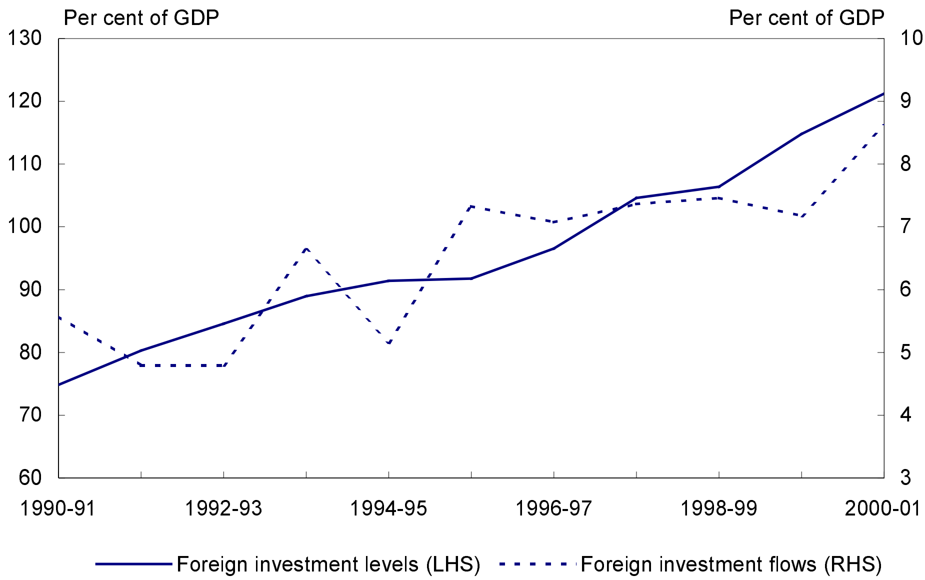
The *controlled foreign company* (CFC), *foreign investment fund* (FIF) and *transferor trust* rules seek to ensure the income of Australian residents does not escape current taxation through the interposition of a non-resident legal entity. These rules generally only apply in cases where the foreign source income is less likely to face comparable tax offshore or does not relate to the earning of active business income.

Transfer pricing rules seek to ensure Australian source income is not shifted to related parties offshore through non-arm's length pricing (for example, by overcharging for goods or services purchased from overseas or undercharging for goods or services supplied overseas). *Thin capitalisation rules*, and to some extent, interest and royalty withholding taxes and aspects of the CFC rules, similarly seek to ensure profit is not shifted out of Australia.

Taxing inbound investment — source taxation of capital income

Australia is a net capital importer, and inbound investment grew significantly over the last decade (Chart A.1). The stock of foreign investment into Australia reached around $800 billion at 30 June 2001.

Chart A.1: Inbound investment into Australia

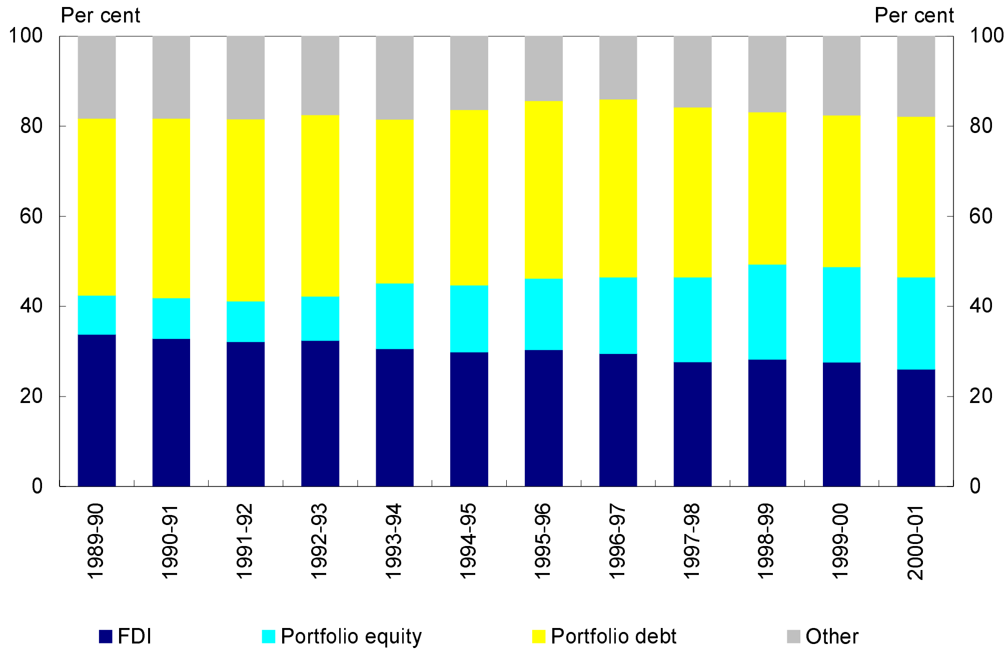


Source: ABS Cat. No. 5302.0.

Inbound investment includes direct investment through establishing branches or non-portfolio interests in Australian companies, portfolio debt or equity, and direct loans from financial institutions.

In Australia, inbound investment has grown primarily due to a significant increase in portfolio equity and debt, up from 50 per cent of the total stock of inbound capital to 60 per cent over the decade to 30 June 2001 (Chart A.2).

Chart A.2: Composition of the stock of aggregate inbound investment into Australia



Source: ABS Cat. No. 5302.0.

The income from these different forms of capital can attract different tax treatments, with Australia exercising its source taxing rights predominately over income from equity inflows, whether foreign direct investment or portfolio investments.

Australia taxes foreign equity investment income mainly through company tax. Total company tax collections in 2001-02 are estimated at around $27.1 billion on a cash basis. The taxation of income generated from inbound equity capital is one of the two primary functions for Australia's company tax; the other is to act as a withholding or accruals tax on income residents earn through and retain in a company.

To a much lesser extent, foreign equity investment income also is subject to dividend withholding tax (on dividends paid to non-residents out of tax-preferred Australian source income and some foreign profits, largely conduit income, not subject to Australian company tax) and to capital gains tax primarily for disposals of non-portfolio investments. Interest and royalty withholding taxes also tax returns on equity investments, if they are disguised as interest or royalty payments.

For small capital importing countries, taxes on income from inbound investment can affect the cost of domestic capital, with the final tax burden falling domestically on less mobile factors (such as labour) rather than non-residents. This is more likely where capital is highly mobile and domestic tax does not benefit from foreign tax credits provided by the home country of a non-resident investor.

Consequently, Australia limits the application of its source taxing rights on interest and dividends paid to non-resident tax exempt pension funds (as they do not benefit from tax credits in their home countries) and generally on portfolio debt. Taxing portfolio debt — which is highly mobile and often not offset by tax credits overseas — could increase the cost of capital for Australian business. Hence, issues of publicly offered corporate bonds generally are exempt from Australian interest withholding tax.

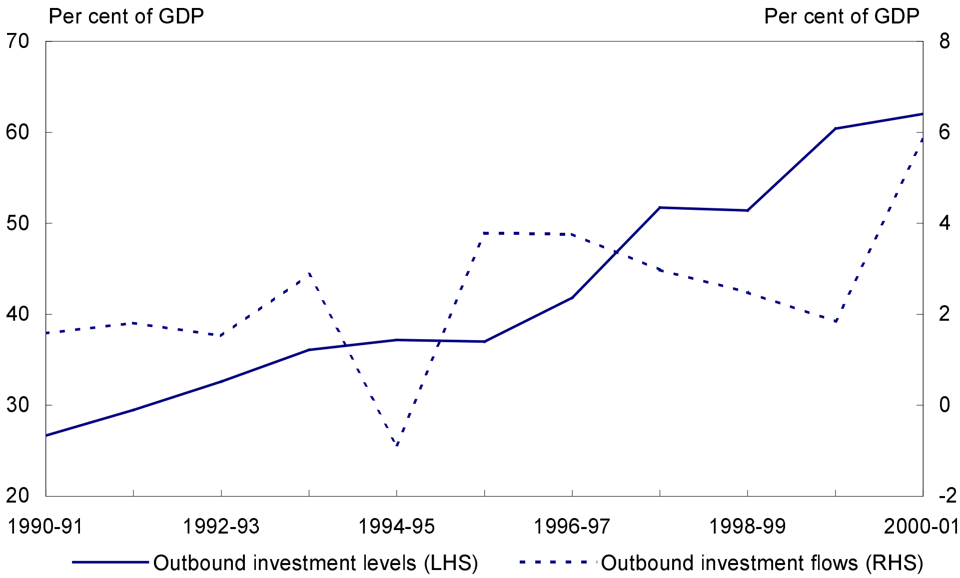
Similarly, the Government has moved to reduce Australian tax on inbound venture capital and extend the interest withholding tax free treatment of portfolio debt to other arm's-length debt obtained by Australian business from US financial institutions.

Total withholding tax collections on payments of dividends, interest and royalties to non-residents were approximately $1.2 billion in 2000-01.

Taxing outbound investment — residence taxation of capital income

While Australia remains a net capital importer, outbound investment has grown significantly over the last decade, from 26.7 per cent of GDP in 1990-91 to 62 per cent in 2000-01 (Chart A.3). At 30 June 2001, outbound investment reached around $420 billion.

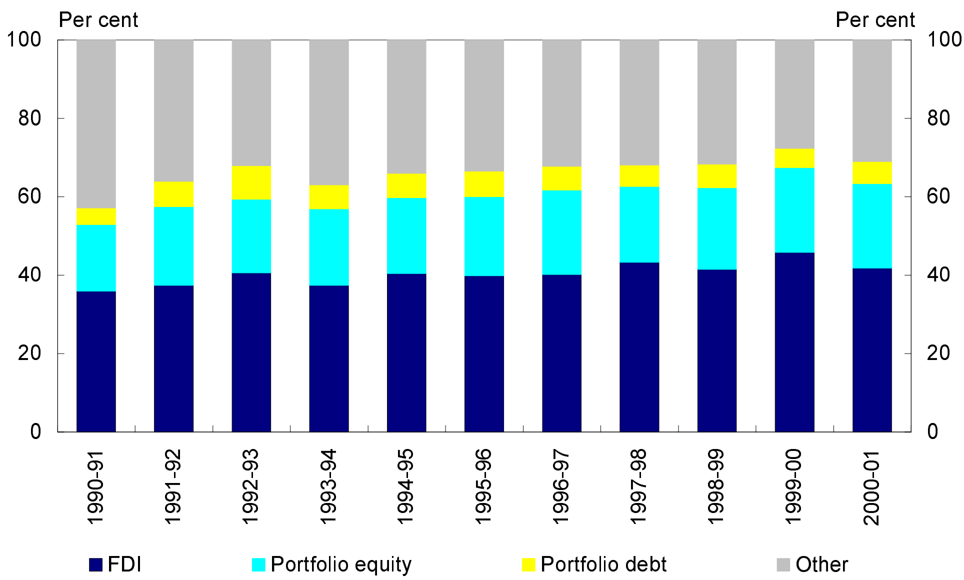
Chart A.3: Outbound investment from Australia



Source: ABS Cat. No. 5302.0.

Outbound investment from Australia takes various forms (Chart A.4).

Chart A.4: Composition of the stock of aggregate outbound investment from Australia



Source: ABS Cat. No. 5302.0.

Offshore direct investment by Australians has grown significantly, almost matching direct investment into Australia (Chart A.5). Australian direct investment into the United States now exceeds US direct investment into Australia (Chart A.6).

Chart A.5: Aggregate inbound and outbound direct investment

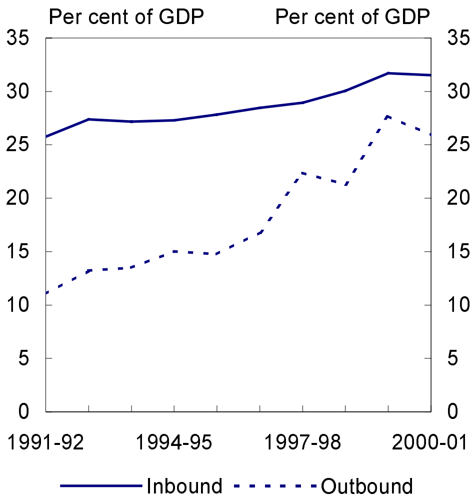
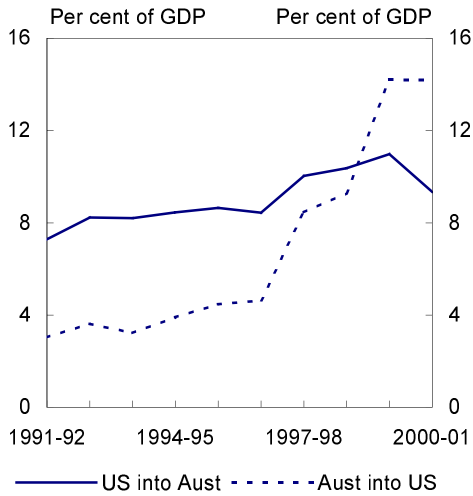


Chart A.6: Direct investment between Australia and US



Source: ABS Cat. Nos. 5302.0 and 5352.0.

The income arising from the various forms of Australian outbound investment attracts different tax treatments.

Offshore portfolio equity and debt income generally is earned directly by individuals or through resident unit trusts. The gross income is taxable with a credit for foreign withholding tax paid. The same treatment applies in general to other forms of foreign source income resident individuals earn.

Direct investment offshore is primarily by Australian resident companies. Non-portfolio dividends Australian companies receive from their offshore direct investments are exempt — if paid from one of 63 listed countries — or assessable with credit for foreign dividend withholding tax and underlying company tax paid.

The 63 listed countries are intended to have tax systems broadly comparable to Australia's. Around 95 per cent of non-portfolio dividends received by Australian companies are from listed countries and hence exempt. Exemption reduces compliance costs as Australian resident companies do not need to determine available foreign tax credits that would, in any case, largely offset any domestic tax liability.

However, exemptions or foreign tax credits are only of benefit while the Australian company retains the foreign income. It is taxable without credit or exemption when it is distributed to resident shareholders. Dividend imputation does not apply to outbound investment; it is effectively subject to a classical company tax treatment.

Attributed foreign source income

In certain cases, foreign source income is attributed to resident taxpayers even though this income is not distributed.

A primary function of Australian company tax is to act as an accruals or withholding tax on residents' income earned through and retained in a resident company. For resident trusts, a combination of entity and flow-through taxation prevents deferral.

The foreign source income attribution rules — CFC, FIF, transferor trust and deemed present entitlement rules — have a similar purpose of accruals taxation of income accumulating in *non-resident* entities. Non-resident entities are not subject to Australian tax at the entity level, except for branches in Australia. Instead, income retained in an offshore entity generally is attributed to a domestic taxpayer where it is less likely to have faced comparable tax offshore or does not relate to the earning of active business income.

As discussed in Chapters 3 and 4, attribution rules help maintain the integrity of the income tax system. The amount directly included in the assessable incomes of taxpayers is low ($670 million in 1999-2000); however, more importantly, the provisions deter taxpayers from undertaking such investments and hence protect the revenue base. However, the current attribution rules are very complex and in some cases may be poorly targeted, adversely affecting offshore investments that are not tax driven.

Taxing conduit income

Conduit income is foreign source income non-residents earn via an interposed Australian entity. It can arise when non-resident portfolio investment occurs in a listed Australian company (for example, multinationals derive foreign source income); when a non-resident company sets up an Australian subsidiary which in turn invests offshore (regional holding companies); or when a non-resident invests in an Australian unit trust that invests, for example, in international securities or equities (for example, managed funds).

Conduit income may be subject to Australian tax at either the entity level, on the disposal of interests in the Australian entity, or on a withholding basis. The general policy, subject to two main caveats, should be to avoid taxing conduit income as arguments supporting residence or source taxing rights do not generally apply, and conduit income (particularly for managed funds and regional holding companies) is likely to be highly tax sensitive.

The first caveat is to maintain tax system integrity while avoiding unnecessary complexity in the tax law, particularly when the entity has both resident and non-resident investors and/or domestic and foreign source income. In these cases, full conduit relief may be difficult to achieve without benefiting resident taxpayers or reducing tax on the Australian source income of the non-resident investor.

The second caveat is to avoid unduly degrading other countries' ability to tax their own residents on their (low-taxed) foreign source income. This avoids retaliatory action by other countries (for example, a country's residents investing in Australian entities being taxed on an attribution basis) which may deter those countries' residents from investing in Australia.

Currently, Australian managed funds and companies are not taxed on certain conduit income. Non-residents investing in managed funds — unit trusts — in general have no Australian tax withheld on their share of the fund's foreign source income. Non-residents making portfolio or non-portfolio investments in Australian companies generally are exempt from tax on income from offshore subsidiaries and branches of the Australian company. A dividend withholding tax exemption also applies to certain conduit income. The Government has deferred introducing a more general exemption (through establishing 'foreign income accounts') pending the outcome of this review.

The offshore banking unit and offshore investment trust regimes provide for a more thorough conduit regime. They also provide for a low 10 per cent rate of tax on the income earned from managing those conduit entities.

Improving economic efficiency and international competitiveness

Economic neutrality benchmarks can be used to analyse the optimal taxation treatment of inbound, outbound and conduit income. Neutrality benchmarks aim to minimise tax distortions affecting individuals' choices and business' choices to improve the economic efficiency of the national or global economy.

While benchmarks provide a useful conceptual framework for examining issues, they point to conflicting policy directions and cannot give definitive policy guidance. Practical considerations of compliance and administration, Australia's national interest in protecting its share of taxing rights, and international obligations and consensus (to the extent it exists) constrain the adoption of any one benchmark.

Furthermore, ensuring the international competitiveness of locally based companies and managed funds is an important government policy goal.

Commonly used neutrality benchmarks are:

> *Capital export neutrality,* which aims for neutrality in international investment decisions, with pre-tax rates of return on investments equal between countries. To achieve this benchmark, an investor would need to face the same effective tax rate on an investment regardless of the country of investment.
>
> *Capital import neutrality,* which aims for neutrality in international savings decisions, with the after-tax rate of return on an investment in any particular country the same for all investors both domestic and foreign. To achieve this benchmark, the effective rate of tax on an investment would need to be the same regardless of investors' place of residence.
>
> *National neutrality*, which aims for neutrality in residents' investment decisions on the gross return to their country of residence, with the pre-tax return on domestic investments matching the post-foreign tax return on foreign investments. To achieve this benchmark, the foreign investment income of a resident investor would need to be taxed without deferral at the same domestic tax rate as domestic income and with foreign tax treated as a deductible expense.

A country acting alone cannot always achieve these benchmarks. Interactions between the tax systems of the domestic country, the country of the source of the income or residence of the investor, and third countries (in relation to conduit cases) affect success.

Many economists favour capital export neutrality on the basis that it maximises global welfare. It also fits well with horizontal and vertical equity benchmarks for individual taxpayers under a progressive tax system. However, optimal international tax arrangements are hotly debated, even at a theoretical level. For example, economic models supporting capital export neutrality assume the residence of taxpayers is fixed; ignore the dynamic benefits exposure to overseas markets may bring to domestic business; and assume the amount of company tax payable in a country is independent of the economic infrastructure provided by that country.

Australia's current international tax arrangements reflect all three benchmarks. The non-provision of franking credits for foreign tax paid by Australian companies and their offshore subsidiaries is consistent with a national neutrality benchmark. The income tax exemption for non-portfolio dividends (or branch income) an Australian company receives from a listed country, and the non-taxation of active business income retained offshore is consistent with a capital import neutrality benchmark. The foreign tax credit provisions and tax treaty obligations to provide credits for foreign tax are more consistent with a capital export neutrality approach.