Removing Tax Barriers to International Growth

POSTIONING AUSTRALIA'S TAX SYSTEM TO MAXIMISE THE POTENTIAL GROWTH OPPORTUNITIES FROM INTERNATIONAL BUSINESS

Discussion paper prepared by

ANDERSEN

BUSINESS COUNCIL OF AUSTRALIA

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Positioning Australia's Tax system to maximise the potential growth opportunities from international business

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This Discussion Paper has been commissioned by the Business Council of Australia as part of its process for development of an agenda for change in the tax laws, to secure the removal of tax-related obstacles to the continuing development of Australia as a competitive base from which to conduct international business.

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Foreword

Over the past decade, Australia has been a medal winning economy. Through the 1990s, Australia was, with Ireland and the U.S., one of the three best performing economies in the world.

There are myriad reasons why Australia has done so well. As a nation, we are much better placed to compete in the world. A combination of low inflation, strong productivity growth and a competitive dollar has provided a stable and positive environment for investment.

Productivity has been driven by more flexible workplaces and much reduced industrial disputation. Again, in the past decade Australia's productivity growth has outstripped the US. Changes to wage fixing arrangements and an independent central bank have underpinned low inflation.

The outcome of all of this has been stronger economic growth. Put simply, a strong, growing economy is a prerequisite for a strong society. A strong, growing economy provides the foundation to begin to address the key challenges ahead. These include an ageing population, a dramatic call on our national education and training capacity, maintenance of the safety net in health, education and social security, positioning Australia as an attractive destination for the best and brightest, improving our infrastructure, and the profound impact of our greenhouse and environment obligations on jobs and regional development.

The design of the tax system remains central to the capacity of the economy to meet the lifestyle aspirations of all Australians.

While there is substantial room for improvement in tax administration, many of the deeper problems stem from the difficulties inherent in a fundamentally flawed tax structure. Comparisons with peer countries reveal a pattern of taxation in Australia that is particularly ill-equipped to deal with the challenges of globalisation.

While Australia's overall share of tax to GDP is not high by OECD standards, the share of company tax to GDP is the second highest of any developed county behind only Luxembourg. It is well above the average of all OECD countries and our relative emphasis on company taxation is very heavy – about 15 per cent of taxation revenue in Australia comes from corporations compared with about 9 per cent for the OECD average.

This is a critical point: with investment and business decisions becoming less confined by national boundaries, taxation differences between national jurisdictions are becoming more exposed. Subject to the constraints that can be put in place through international co-operation, tax competition in a globalising world will erode the extent to which the "mobile" tax base can be exploited without seriously undermining economic activity.

Concern about Australia's international tax regime, and its adverse impact on Australian companies, led the Business Council of Australia earlier this year to commission Andersen to identify the major impediments to making Australia an attractive location for international business.

Foreword *continued*

The result, *Removing Tax Barriers to International Growth*, is a major contribution to the debate about how Australia can best design and administer a tax system that maximises the potential growth opportunities from international business.

The Federal Government has announced its intention to review Australia's international tax arrangements, an initiative strongly endorsed by the Business Council of Australia.

The Council is presently considering the Andersen Paper, and will announce its priorities for the Federal Government review in the New Year.

By Dr John Schubert
President, Business Council of Australia

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BUSINESS COUNCIL OF AUSTRALIA

Preface

The Federal Treasurer noted in a recent speech "if a country wants to have Head Office and ancillary services its first priority should be to build a business environment that makes it attractive. This has been a large part of our thinking in reducing company tax, cutting capital gains tax, abolishing financial taxes and stamp duties. In addition, personal rates of income tax are relevant factors to decisions on where to base Headquarters and executives."[1]

In response to a question he noted that "if we were to sit around a table of the developed countries of the world and the British and the French and the Germans and the Japanese and us, you would find that most of those countries are seeking to reduce their company taxes, their capital taxes and to some degree their income taxes. ... I know which way the world is moving, it's moving that way. And if you want to be competitive you've got to move that way. If you want to be competitive and have decent social security, you've got to have a taxation base. ... we have moved and we're moving and I'm glad we've moved to the degree that we have. The pressures will continue to come in the future."

We concur with the key messages in these comments:

- Australia has moved towards reforming its taxation system especially addressing the imbalance between direct and indirect taxation,
- But the rest of the world is also reforming, with major countries aiming for internationally competitive taxation systems for international business,
- Australia must now re-calibrate its cross-border tax laws to be internationally competitive so as to retain and attract skills, talent and investment.

This White Paper is intended to contribute to Australia moving to an internationally competitive tax base.

This White Paper was prepared effective 1 September 2001 and was updated on 11 December 2001.

Acknowledgments

A work of this size involves many people, providing intellectual input and significant assistance. We would like to thank particularly our colleagues Tony Stolarek, and Anne Richardson for their involvement and energy. Tony's contribution was immense. We thank also Paul Ellis for his contribution on the human capital issues and Zorach Diskin for his input in the area of international tax policy.

Michael Wachtel and Alf Capito

December 2001

1 Address and response to questions by The Hon Peter Costello MP, Treasurer, to the Sydney Institute, "Challenges and Benefits of Globalisation", Wednesday, 25 July 2001 – sourced from the Treasurer's website, www.treasurer.gov.au

1. Executive Summary

At the request of the Business Council of Australia, Andersen partners Michael Wachtel and Alf Capito, and their team, commenced policy work and consultation with BCA members on this White Paper early in 2001 to identify the major impediments to making Australia an attractive location for international business. This White Paper was developed and has been discussed extensively with an editorial steering group of BCA members and major industry associations, in a series of meetings in Sydney and Melbourne. As well, it has been reviewed by two senior Australian tax academics.

This White Paper was released in draft form, and used for background briefings for, the Board of Taxation, the Howard Government and with the public service and the Federal Opposition. This White Paper was completed on 1 September 2001 and has been updated to 11 December 2001.

It was pleasing to see that the three major themes of this White Paper align with the views of the Federal Government in "Securing Australia's Prosperity", the Government's policy document released on 15 October 2001:

1. Fostering the **international growth of Australian based companies**, particularly as they raise equity and expand internationally. This requires a series of measures, discussed below,
2. Encouraging the establishment of **regional or segment headquarters in Australia for foreign-controlled groups**; and
3. Making Australia an **attractive location for talented people** which are needed to inject their technical and managerial skills into companies located in Australia. This reflects the fact that, if Australia is unattractive from a tax viewpoint as a location for basing people, the attractiveness of Australia as a whole is reduced.

That paper represents a major commitment by Government, potentially of strategic importance for Australia's direction, to realign Australia's tax laws to Australia's long-term objectives and desired position. This commitment should not be underestimated. With the focus of the Prime Minister and Federal Treasurer squarely on these issues, there is potential for major much-needed reform.

We applaud this initiative and comment below (Section 1.14) on the way forward.

These issues are not just "big end of town" issues. They affect the formation of new and emerging businesses in Australia, and whether these remain in Australia or whether their headquarters and commercial centres shift overseas to other commercial centres.

This White Paper's recommendations are focused on those which we consider urgent, necessary and achievable. As well, we identify some issues which deserve further study.

We expect that the recommendations in this White Paper, if adopted, will alter business behaviour noticeably. It is important that Government takes this behaviour into account in **assessing the revenue impact of these recommendations**.

We have been careful to make our recommendations responsibly, in forms which should be practical and achievable. We have sought also to prioritise the recommendations and in some cases to set out a sequence for actions.

1.1 How to use this White Paper

This Executive Summary includes a brief outline of all our recommendations, cross-referenced to the detailed discussion.

A concise summary of the need for action is in chapter 2, the Overview. It outlines why, if Australia does not take action, it risks significant damage to the relevance of Australian business in international activities.

1.2 The basic design approach and themes underpinning the recommendations

The central themes governing our proposed changes are as follows:

Recommendation 1: An internationally competitive holding company regime

The Australian Government should focus urgently on creating internationally attractive holding company tax regimes for:

- Parent holding companies – an environment to encourage the parent holding companies of Australian-based international businesses to remain centred in Australia; and
- Conduit holding companies – an environment to attract foreign-owned businesses to locate their regional headquarters and other activities in Australia. This issue needs to be recognised by the community as affecting emerging businesses and not simply being a "big end of town" issue. Emerging Australian high growth businesses are potentially more mobile than "big business".

Recommendation 2: Design Australia's tax system for flow-through of foreign source income and certain gains to foreign investors

In setting the policies for taxation of income flowing through Australian entities, Australia should consider an approach of encouraging the flow of foreign source income and certain gains and general foreign activity through Australian entities to foreign investors in a non-taxed manner. This is consistent with the principle of not taxing foreigners on foreign profits.

The Australian Government should focus urgently on creating internationally attractive holding company tax regimes for parent holding companies and conduit holding companies

To implement these core recommendations, we make more specific recommendations, which are summarised in the next section.

We comment also on the Government's election announcement of accelerated consultation concerning the tax changes required.

1.3 Summary of the Recommendations

An overview of our recommendations can be seen in the table on the next page:

Table 1.1 Overview of our recommendations

Principal Recommendations	Improving tax environment for: Australian-owned companies	Australian subsidiaries of foreign groups	Talented people in Australia	Rec No.	See Ch.
Internationally-competitive Holding Company Regime					2
to encourage Australian holding companies for Australian-owned businesses and foreign-owned international groups	✔	✔		1	
Allow flow-through of foreign income and certain gains to non-residents, consistent with original principles of our tax law	✔	✔		2	
Dividends					
• Dividend Imputation review and modernisation	✔			3	3
• Allowing dividends to foreign shareholders without disadvantaging Australian shareholders, by allowing streaming of imputation credits	✔			4, 6	
• Renegotiate Double Tax Agreements to reduce DWT, IWT		✔	✔	5, 7	
Capital Gains Tax reform for Conduit Holding Companies to enhance Australian holding companies in global groups,		✔		8	4
Review positions on capital gains and pre-CGT Double Tax Agreements		✔		9	4
CFC Rules modernised for modern business practices to allow appropriate use of foreign subsidiaries	✔	✔		11-15	5
Corporate Residency Rules modernised to enhance Australian management of foreign companies	✔			16	6
Outbound thin capitalisation "black-hole" remedied	✔			17	7
Intangibles					8
• Amortisation of intangible assets, and	✔	✔		19	
• Reduced withholding tax under Double Tax Agreements	✔	✔		19	
Foreign Investment Fund rules streamlined, as they now retard offshore investment by Australian businesses	✔		✔	20	9
Inpatriates' tax rules adjusted by					10 – 12
• Introduction of temporary resident status for some inpatriates	✔	✔	✔	21	
• Adjusted superannuation treatment	✔	✔	✔	22	
• Adjusted treatment of pre-residence assets and income from those assets	✔	✔	✔	23, 25	
• Adjusted treatment of pre-residence employee shares	✔	✔	✔	24	

1.4 Dividend imputation

We recommend that, in line with international trends, Australia review its dividend imputation policy to ensure that it remains the best model to facilitate the growth of Australian-based companies in international business. Dividend imputation has generated benefits for Australia, but several other countries have recognised that a dividend imputation system encourages domestic expansion not international development, and they have adjusted their imputation systems.

We recognise that this policy development will take time. We therefore make interim recommendations to deal with some of the biases inherent in the imputation approach to taxing companies and shareholders.

1.5 Remittance of dividends to overseas investors without adversely affecting Australian shareholders

Dividends paid by an Australian based group via a foreign subsidiary to foreign shareholders from foreign profits cause a **debit to the group's Australian franking account, reducing the group's capacity to pay franked dividends** to its Australian shareholders. This results in a loss of value to the Australian shareholders.

Australian individual and superannuation-fund shareholders pay tax on income which, although it has borne foreign tax, passes to them as an unfranked dividend. Effectively this results in double taxation of foreign income derived by Australian companies and their shareholders.

We believe it would be in Australia's interest to introduce a system that will allow foreign dividend income to flow through an Australian company to foreign shareholders without reducing the company's franking credits for Australian shareholders. This goes beyond the recommendation made by the RBT in relation to providing franking credits for foreign withholding tax.

It would be in Australia's interest to introduce a system that will allow foreign dividend income to be flowed through an Australian company to foreign shareholders without reducing the company's franking credits for Australian shareholders

Alternatively, and as a second preference to the streaming proposal, we recommend that the franking rules and FDA rules be amended so that FDA credits be reserved for dividends paid to non-residents and that franking credits be applied to the proportion of the dividend not subject to FDA declaration.

(These recommendations are outlined in Chapter 3).

We also recommend action in resolving the triangulation or exchange of imputation benefits between Australia and New Zealand.

1.6 Reducing barriers to remittance of foreign dividends to Australia

As a major initiative, we recommend that Australia pursue vigorously the process of renegotiating the DTAs which lead to inequitable results for foreign investments. It should be a national priority to reduce the DWT rates on non-portfolio dividends during these negotiations and for changes to be implemented as soon as possible. The DTA renegotiation process with major trading partners needs to be escalated to a significant economic and trade issue.[2]

2 The unilateral withdrawal of the exemption for franked dividends paid to residents of individual foreign countries should be considered to expedite the negotiation process. The position currently taken by the Australian Taxation Office, that Australia's DTAs do not protect foreign residents from Australia's capital gains tax, might need to be conceded in order to achieve the dividend withholding tax concessions

Australia's new protocol to the US/Australia Double Tax Agreement, announced on 27 September 2001, will commence to operate in 2003 in respect of dividends. This is very positive for Australia and implements some of the key issues recommended in this White Paper – at least in the context of the US/Australia Double Tax Agreement. Key developments from the new protocol will be, from the effective date:

- dividend withholding tax will be reduced to 5% where a resident of the other state holds at least 10% of the voting power in a subsidiary, and will be eliminated where a dividend is paid by subsidiaries owned at least 80% by certain publicly listed companies or other companies;
- interest withholding tax will remain at 10% generally but will be reduced to 0% for governments and banks;
- royalty withholdings will be reduced to 5%, and equipment leasing will now be subject to branch profits treatment.

As outlined in our recommendation, **the US/Australia Double Tax Agreement protocol could act as a model for similar initiatives** which now need to be undertaken in relation to DTAs with Australia's major trading partners (notably UK, Germany and Japan).

(These recommendations are outlined in Chapter 3).

1.7 Capital gains tax exemption for conduit holding companies in Australia

Australia should allow a CGT exemption for the disposal of certain overseas subsidiaries which hold active businesses, where these are sold by conduit holding companies ("CHCs"). CHCs could be defined to include unlisted companies that are incorporated in Australia, and are wholly owned by foreign investors. A lower level of foreign ownership might qualify also.

The exemption could be provided to all foreign investors or only to investors resident in countries with which Australia has a DTA. This concession could be extended to companies which are at least 50% controlled and owned by such foreign investors (ie joint venture holding companies). This recommendation would be consistent with a long-held Australian policy of not taxing non-residents on foreign source income. Australia should extend this principle to capital gains by not taxing non-residents investing through Australian subsidiaries on the capital gains they make via their foreign operations.

(These recommendations are outlined in Chapter 4).

1.8 Modernise Australia's CFC rules

Australia's attractiveness as a location for Australian companies expanding offshore is often adversely affected by the breadth and complexity of the CFC measures.

(a) Foreign services and intangibles are now more paramount than flows of goods in international business and the CFC rules would benefit from modernisation to accommodate current business practices.

(b) The CFC rules need to be redesigned to facilitate companies entering commercially motivated corporate reorganisations or joint venture arrangements by expanding the range of capital gains tax rollover concessions.

(c) The 1997 changes limiting the number of broad-listed exemption countries need to be reconsidered. At a minimum, the list needs to be reviewed to include OECD countries with comprehensive CFC and FIF regimes, and guidelines provided for the addition of further countries to the broad-exemption list based on meeting given criteria. Alternatively, we propose a more simple approach to dealing with concessionally taxed income in all jurisdictions together with better treatment for offshore services income.

(d) The requirement to calculate attributable income in a broad-exemption listed country should be removed in relation to CGT events where CGT rollovers are available under the relevant taxation law of the listed country.

(e) If the Tax Value Method "Option 2" methodology for the calculation of assessable income is implemented, we believe that there would be a fundamental escalation in the complexity of complying with the CFC measures. In our view, therefore, Option 2 should not be applied to the calculation of CFC income, as this would add another level of complexity to these rules.[3]

Foreign services and intangibles are now the "currency" of international business and the CFC rules would benefit from modernisation to accommodate current business practices

(These recommendations are outlined in Chapter 5)

1.9 Place of incorporation as the test for residence for corporate groups

Australia can tax foreign-incorporated companies under its far-reaching definition of residence for companies. This tends to be counter-productive, to establishing Australia as a regional headquarter location because it creates a powerful incentive to isolate Australian management from overseas affiliated companies.

It may be more beneficial for Australia to adjust its corporate residence test and align itself with the U.S. model of taxing, as resident companies, only those companies incorporated in Australia.

Australia will retain its taxing powers over international business activities using tax measures such as CGT, CFCs, FIFs and transfer pricing, so the old concept of "central management and control" is no longer necessary nor appropriate.

Alternatively, the application of the CM&C test to deem Australian residency for non-Australian incorporated companies needs to be legislatively limited, to reduce its negative impact on foreign operating or holding companies with Australian based management participation.

(These recommendations are outlined in Chapter 6).

1.10 Outbound thin capitalisation rules: adjusting the rules

Australia's new thin capitalisation rules require re-thinking in at least two respects.

We recommend that the safe-harbour thin capitalisation rules, which are currently based on Australian accounting standards, should expressly allow for market valuation of internally developed business goodwill. This will ensure that growth businesses are not disadvantaged in their international development.

3 In any case, under the TVM, CFC income will be treated as a special adjustment to taxable income and dealing with CFC income in the manner proposed above would not compromise the broad thrust of the TVM should it go ahead

As well, funding costs, which are disallowed in a year, should be recoverable in later years either when there is excess debt capacity in later years or on some phased-in basis.

(These recommendations are outlined in Chapter 7).

1.11 Encouraging the development and location of intangible business property in Australia

Australia's tax laws for amortisation of expenditure on intangible property are currently limited. The concessions are limitied to some categories of intangible property but do not allow amortisation of many costs when businesses are acquired.

We recommend a new tax regime for the amortisation of intangibles to enhance the scope for Australia to become a better base for the ownership, development and exploitation of intellectual property

Australia should also consider, subject to more detailed consideration, renegotiation of selected DTAs to reduce withholding tax on royalty payments. The approach adopted in the Australia/US DTA protocol, of tax withholdings on royalties to be reduced to 5%, could act as a model for DTA renegotiations with Australia's other major trading partners (notably UK, Germany and Japan).

(These recommendations are outlined in Chapter 8).

1.12 Adjustment of Foreign Investment Fund (FIF) rules

Australians might have investments in offshore companies or other entities which fall below the threshold for the CFC rules, but which therefore fall under the FIF measures. The FIF rules were designed to have exclusions for active income, ie. offshore business activities.

However the law does not reflect the original policy rationale. The FIF rules thus stifle investment by Australians and Australian businesses in overseas affiliated entities.

These rules need to be reformed, together with the Offshore Banking Unit (OBU rules) to better meet the needs of Australia's businesses and funds management industries.

Australia needs to remedy many of the disincentives for foreign inpatriates working in Australia.

1.13 Taxation of inpatriates

To attract and retain human capital, Australia needs to remedy the disincentives for foreign inpatriates[4] working in Australia. Our recommendations are summarised below.

In its October 15 election policy statement "Securing Australia's Prosperity" the governments stated that it would enhance the tax exemption for foreign source income of expatriates resident in Australia for less than four years, including removal of the automatic deemed disposal of non-Australian assets on termination of postings, to apply from 1 July 2002. As well the government will also address the current difficulties relating to capital gains tax applicable to expatriates in Australia on their non-Australian assets and issues relating to NZ expatriates in Australia.

In the summary below, and more detailed analysis in chapters 11 and 12, we identify our recommendations and whether these are covered by the election policy statement.

4 We use the term "inpatriate" to refer to non-residents who come to work in Australia on a temporary basis

1.13.1 Temporary resident status

Australia should adopt a 'temporary resident' status for executives in Australia for up to five years, with concessions similar to those offered by the UK and Japan, as detailed in Chapter 12. ("Securing Australia's Prosperity" refers to this issue in relation to inpatriates in Australia for under 4 years, in relation to certain assets).

1.13.2 Superannuation

Employees who are 'temporary residents' should be able to either remain in their home country superannuation system or make private arrangements in their home country without being required to make superannuation contributions in Australia. An alternative solution would be to remove the preservation requirements on their superannuation funds after they have left Australia.

In addition, employers should be allowed deductions for contributions to offshore funds on behalf of individuals who qualify for the temporary resident status.

("Securing Australia's Prosperity" does not refer to this issue).

1.13.3 Pre-residency income and assets

Investment income from temporary residents' overseas pre-posting assets should be exempt as outlined in the Ralph Report without a 'subject to tax' test. The exemption should be extended to cover capital gains and stock options granted before inpatriates commence Australian residency, and not granted as a condition of the Australian assignment. We think that there are grounds to extend the concession to temporary residents' complete foreign investment income, on the basis of simplicity. ("Securing Australia's Prosperity" refers to this issue in relation to inpatriates in Australia for under 4 years, in relation to certain assets).

1.13.4 Deemed disposal rules

The CGT deemed disposal rules create tax liabilities in relation to overseas and local assets for certain foreigners working in Australia. These rules are a penalty for working in Australia and imposed at the time of leaving. We recommend that they should be abolished.

("Securing Australia's Prosperity" refers to Australia resolving this issue by agreement in Double Tax Agreements along the lines of the recently-concluded US-0Australia DTA. This is attractive, but will take many years to resolve).

1.13.5 Internationally competitive scheme for employee shares

Australia's system for taxing employee share schemes is inconsistent with international practice and penalises employee share participation. We support the various other initiatives and reviews recommending reform of Australia's taxation of employee share schemes in view of its impact on our international attractiveness for employees (inpatriates and expatriates). ("Securing Australia's Prosperity" does not refer to this issue except implicitly in other statements. This issue will not be solved merely by addressing Australia's capital gains tax rules).

(These recommendations are outlined in Chapters 11 and 12).

1.14 Government's "Securing Australia's Prosperity" Policy

The Government issued an election policy statement "Securing Australia's Prosperity" on 15 October[5] stating that it would, on re-election:

- "As a matter of priority" consult widely to identify what features of the Australian tax arrangements affect the decisions of businesses to remain in Australia or to locate in Australia. The focus would be on whether Australia's international tax rules are an impediment to Australian companies in:
  - attracting equity,
  - expanding offshore, or
  - creation of holding companies and conduit holdings in Australia.
- Enhance the tax exemption for foreign source income of expatriates resident in Australia for less than four years, including removal of the automatic deemed disposal of non-Australian assets on termination of postings, to apply from 1 July 2002. As well the government will also address the current difficulties relating to capital gains tax applicable to expatriates in Australia on their non-Australian assets and issues relating to NZ expatriates in Australia.

This is a major Government commitment and program for the third Howard Government. It allows the Treasurer and Government to consider the Ralph RBT recommendations but also to look more widely at other measures required. It is an opportunity for far-reaching reform of Australia's international tax rules.

We welcome the Government's election commitment. The proposals dealing with expatriates do not address all of the issues discussed in this White Paper but expect that the unresolved issues can be considered in the broader consultation.

Critical issues for decision will include:

(a) The timetable for the review and for its early conclusion.

(b) The need to identify who will undertake the review.

(c) The timetable for adoption of the recommendations.

As recent experience has shown, the process for delivery of recommendations into the business taxation law can be a very lengthy process.

This review is a high priority initiative for business and is welcome.
This White Paper will provide a significant tool for that review.

1.15 Other potential tax reforms, not referred to in this White Paper

Australia could consider other potential tax reforms affecting international business, but which we do not discuss in detail in this paper as these are currently under review in other contexts. As well, the focus of this White Paper is on general barriers to international business in Australia, rather than on specific incentives which might be offered. Such potential reforms include:

(a) Adjustment of personal tax rates, from their current steeply-progressive scale. Australian individuals currently reach the top marginal tax rate at an income level which is quite low by international standards.

5 Summarised at Appendix E of this White Paper.

2. Why Australia Must Act – Overview

2.1 Approach of this White Paper

Business today operates internationally. This creates significant opportunities for the growth of the Australian economy and for Australian employment.

However, there are distortions in Australia's international tax system currently which inhibit Australian companies from competing on the world stage from an Australian base.

- As the proportions of foreign source income and foreign shareholders increase, Australian companies need to adopt new capital management strategies to continue to maximise shareholder value.
- Similarly, the taxation system tends to discourage foreign-owned companies from establishing regional or segment headquarters in Australia.

If Australia represents only 1% – 2% of the world's economic activity, then it follows that over 98% of the growth opportunities are overseas.

In this White Paper, we examine both the international tax arrangements that impact upon companies in Australia and the taxation of inpatriate[6] employees.

Tax is not the only driver of location decisions. Australia has had much foreign investment even before the recent tax reform process commenced. But a competitive tax system is important in relation to functions which are mobile, and where the people involved are mobile. As discussed below, these mobility factors apply to an increasing component of business activity.

Throughout this paper, we compare our tax system with those of other countries. At the same time, we recognise that we need a solution tailored uniquely to Australia's position in the world. This is important to enhance Australia's growth opportunities and Australia's business influence internationally.

- We put forward recommendations for discussion on the ways to foster the international growth of Australian based companies,
- to encourage the establishment of regional headquarters in Australia for foreign-controlled groups.
- We also present recommendations to make Australia an attractive location for the most talented people available to inject their technical and managerial skills into companies located in Australia.

These recommendations, summarised in Section 2 of this introduction, are set out in detail in Parts I and II of this paper. Our recommendations are focused on those which we consider urgent, necessary and achievable. As well, we identify some issues which deserve further study.

We expect that the recommendations in this White Paper, if adopted, will alter business behaviour favourably. It is important that Government takes this behaviour into account in assessing the revenue impact of these recommendations.

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6 We use the term "inpatriate" to refer to non-residents who come to work in Australia on a temporary basis

2.2 This White Paper does not contain the costings of the recommendations

Unlike the Reform of Business Taxation mandate afforded to the Ralph Committee of 1999, the recommendations in this paper are made without the hindrance of a goal of revenue neutrality. The recommendations in this White Paper are intended to have revenue costings developed by an independent economic forecasting firm, as part of the policy development process.

Rather, the intention is to identify recommendations and issues which need urgent attention, based on the experience of Australian corporations and businesses operating in Australia, and our practical experience in advising such businesses.

Thus, this White Paper is a report “from the coal face”. The ultimate calibration of the policy measures will affect the tax revenue outcomes.

We have been careful, however, to make our recommendations responsibly, in forms which should be acceptable to Australia’s Government. The recommendations have been devised so as to be practical and achievable, and we have refrained from making recommendations which are mere ambit claims or (although useful) would be difficult or impossible to achieve within the medium term.

We have sought also to prioritise the recommendations and in some cases to set out a sequence for actions.

2.3 Why this issue has become important now

Up to the 1980s, Australian business was largely focused on operations in Australia, with a limited role in the ownership or management of foreign subsidiaries or businesses. Today the position is different.

Australian businesses have increasingly taken advantage of the benefits of operating on an international scale. Australian businesses now export not only goods but also substantial services. They borrow funds and attract shareholders from all parts of the world. Many Australian businesses have active business units in other countries and Australia hosts the international and regional headquarters for many international businesses.

A strong Australian participation in international business at all levels is central to the development of our economy. Directly and indirectly, a large and growing proportion of our workforce provides goods and services to international markets. Such activities and related jobs are a major source of stability and growth in our economy.

As Australian businesses – whether emerging companies or large successful companies – grow, they increasingly deal with international tax structures of the Australian tax system:

- Australian businesses seek to raise funds in international capital markets and seek opportunities for expansion into those markets.
- Australian companies with world class products, ideas and management find that their best opportunities for growth are to expand their business activities internationally. If Australia represents only 1% – 2% of the world’s economic activity, then it follows that over 98% of the growth opportunities are overseas.
- Further, business processes increasingly include international ‘supply chains’ and networks, which involve exports and imports of partly completed products and services, integrating businesses and business units in a variety of countries.

The international debate has evolved defensively from how Australia can attract regional headquarters to how Australia can be saved from becoming a branch office economy. The fundamental issue remains – how to **sustain Australia's growth path by attracting and retaining high growth dynamic companies**. That growth is needed to create employment and economic development.

Many younger, emerging companies have a greater international focus than larger companies, and emerging companies are often more mobile than larger companies. **These issues are just as important for dynamic young companies as for large successful companies in Australia.**

All Australian businesses must compete with foreign competitors, some of whom are resident in more favourable tax jurisdictions, for scarce debt and equity funding. Australia must ensure that Australian businesses are positioned to efficiently access and use international capital to pursue the best opportunities for growth, and that international investors and overseas businesses look to Australia and Australian companies to invest their capital. These issues are essential to Australia's relevance and growth.

Businesses choose to locate in a particular country for many reasons and Australia is an attractive location on many fronts. However, Australia needs to work hard to ensure that it remains an attractive base for the headquarters of established and growing companies, and that it strengthens the flow of advantages to the Australian economy of being an international and regional business centre.

Currently, the Australian tax system still retains inherent biases against Australian based companies operating on an international scale. Notably:

- Australian businesses earning income abroad and/or with significant numbers of offshore shareholders confront tax-related barriers as they strive to increase shareholder value, while retaining a base in Australia.
- Additional barriers deter many offshore companies from locating their regional headquarters in Australia.
- There is a distinctly unfavourable tax treatment for temporary residents.

These issues combine to inhibit the development of Australia as an international and regional business centre.

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

… we need a solution tailored uniquely to Australia's position in the world

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

2.4 Making tax systems competitive for international business

International and regional business headquarters are increasingly more mobile than they were in the past. International businesses are dissecting their management activities into operational headquarters which may be scattered across various countries with different functions. The intellectual property and human capital essential to the function of corporate headquarters are particularly mobile.

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

Tax policy should now be developed to present Australia as an attractive location for these activities. Many other countries, including well developed nations, continue to amend their tax regime to achieve this goal. If Australia fails to do so, its prospects of retaining and increasing its involvement with international businesses will diminish.

The Australian taxation system … can be used to actively facilitate Australia as a place to locate … our international businesses as well as a location for the regional headquarters for offshore companies

Location decisions are not based solely on tax issues and no single factor will be uniquely responsible for the decision of a multinational group to locate in a particular country. However, with advances in information and communications technology creating **increasing freedom of movement** for all business headquarters and corporate domiciles, the relative importance of taxation in the location decision increases. This trend, coupled with the constant focus on increased shareholder value, means that companies are much more focused on capital management strategies to increase shareholder returns.

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

- The UK Government recently stated publicly that it wishes to make Britain "the best place in the world for multinationals to locate"[7].
- Sweden, often proposed as a successful peer of Australia, introduced in its annual Budget for 2001 a series of measures designed to make it a more attractive headquarters location.
- Germany has recently announced tax reform measures for similar purposes.

The Australian taxation system is controllable by Australia and can be used to actively facilitate Australia as a place to locate the headquarters of our international businesses as well as a location for the regional headquarters for offshore companies; and do so in a way which is of benefit to all Australians.

2.5 The human capital challenge

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

7 UK Pre-Budget Report dated 8 November 2000

The human capital challenge is closely linked with the attractiveness of Australia as an international and regional headquarters location. Just as our leading sportspeople seek out and thrive on the challenge of competing with the world's best, our highly skilled technical and managerial talent will continue to seek opportunities to work in the most challenging and equally rewarding business environments. Very frequently, this challenge is presented within the international and regional headquarters of international businesses. Unless we attract and retain these headquarters in Australia, our best technical and managerial talent will seek out these challenges in other countries, to our disadvantage.

Taxation may be a significant factor for an individual when asked to work in a location. For employees, the detrimental taxation of their personal investment income can be an essential factor in deciding whether to accept a position. For employers, the cost of having an inpatriate assignee can be two to three times as much as a domestic employee, with higher tax rates increasing this cost significantly.

In order to compete with other countries, Australia must offer a competitive tax system that both encourages international businesses to locate their management in Australia, and ensures that neither individuals nor companies face disincentives when considering Australia as a place to locate and work.

The complexity of the Australian taxation regime for inpatriate employees is a significant disincentive to locate in Australia.

Given the scarcity of talented individuals in many business specialties, businesses increasingly adopt tax equalisation strategies to compensate individuals for additional tax imposts in particular countries. Under such policies the additional Australian taxes imposed on the individuals' incomes add to business cost structures in Australia. So the tax disadvantages add costs to the employing Australian business, and hinder their competitiveness.

The complexity of the Australian taxation regime for inpatriate employees is a significant disincentive to locate in Australia. Australia's tax arrangements for inpatriates may discourage talented individuals from accepting or extending appointments in Australia.

2.6 The two strategic objectives

Australia needs to encourage the maintenance and further growth of Australian headquartered international companies and Australian subsidiaries of international business groups.

There are two **strategic objectives** that underpin this White Paper:

(a) To remove impediments, or provide attractions to, companies using Australia as a headquarter or holding company location for either their international or regional operations, in two categories:
- issues for Australian-controlled companies; and
- issues for foreign-controlled but Australian-based companies.

(b) To encourage (or avoid discouraging) the location of senior management in Australia – whether that management is of Australian or foreign nationality.

The rationale is as follows. Every tax inefficiency in Australia's taxation of international business is ultimately shifted to Australian businesses with an international orientation and ultimately adds to their cost structure. These costs create competitive disadvantages for the Australian businesses, and ultimately cause pressure for Australian businesses to leave Australia or relocate activities overseas, and cause foreign businesses to bypass Australia for key activities. This issue is developed in Section 1.7 below.

Every tax inefficiency in Australia's taxation of international business is ultimately shifted to Australian businesses with an international orientation and ultimately adds to their cost structure. These costs … cause pressure for Australian businesses to leave Australia or relocate activities overseas, and cause foreign businesses to bypass Australia for key activities

2.7 Distortions affect Australian businesses, leading to loss of investment and employment opportunities

The mobility of capital and the need for international involvement, alter the incidence of taxes and create additional costs for Australian businesses. For example:

- An Australian business operating internationally and with international shareholders finds that it is wasting tax attributes because it cannot stream franking credits to Australian investors, and correspondingly cannot fully stream foreign tax attributes to foreign investors. If the business does nothing, then Australian investors may prefer to switch to other investments which pay fully-franked dividends. Or foreign investors may prefer to switch to other businesses which have higher net after-tax yields. So the Australian company's share price might suffer as a result. Alternatively, the Australian business will need to increase its dividend or capital distributions, which will effectively increase its cost of capital by comparison with competitors.
- If an Australian business must borrow funds from overseas or licence technology from overseas, the interest and royalty payments to the foreign lenders or licensors are subject to Australian taxes. It might be thought that the payments are borne by the foreign parties. However, the foreign lenders or the foreign licensors will generally seek to have Australian taxes absorbed by the Australian borrower or licensee.
- If a foreign expatriate has a unique skill which is necessary in Australia (whether in an IT area, or to lead a company, or to develop an international activity) and the foreign individual is considered valuable, the foreign individual will seek additional compensation for the fact that Australia's personal tax rates and tax system for inpatriates are less competitive than that in other countries. The additional compensation costs may be borne in the main by the Australian business. Alternatively, the individual will find Australia's taxation system a barrier to entry. Either way, Australia is not viewed favourably in terms of inpatriate tax costs.

These few examples illustrate that, in a world of many choices for investment, of mobile capital and of mobile talent, the cost of additional taxes can ultimately be shifted away from the perceived taxpayer to the Australian business.

These few examples illustrate that, in a world of many choices for investment, of mobile capital and of mobile talent, the cost of additional taxes can ultimately be shifted away from the perceived taxpayer to the Australian business.

Our businesses will respond in various ways to the shifting of internationally non-competitive imposts. Some of the imposts will be accepted in the light of a business' geographical or other functional connection to Australia. But in many cases, businesses will respond in a manner unfavourable to Australia. For example:

- If the cost of capital through operating in an Australian corporation proves unacceptable over time, the Australian business might adopt various strategies adopted which will migrate the corporate headquarters to another jurisdiction allowing lower capital costs. Or the company might be taken over.
- The costs of licensing technology or borrowing funds which service export-oriented activities might ultimately be eliminated if the export-oriented activities are relocated to other countries which might have different withholding tax regimes.

- Foreign-owned international businesses which are looking for regional holding companies through which to own and manage regional groups of subsidiaries might examine Australia and note that the current capital gains tax rules, CFC rules, inpatriates rules and other rules make Australia a less attractive environment than in other countries. They might therefore relocate their Asia-Pacific headquarters activities to other countries perceived to be more attractive.

Tax is not the only factor, and is often not the dominant factor. However tax does form part of the overall matrix, and becomes increasingly significant in relation to more mobile activities such as headquarters locations, international coordination centres, technology development and utilisation centres. Tax is becoming a more significant factor in shaping the range of options for Australian businesses and their potential.

2.8 Executive summary of the specific problems

The existing Australian tax system contains many constraints on Australia being an internationally attractive place for the location of growing international companies and regional headquarters. We have identified several broad areas which we believe could benefit from redesign.

2.8.1 Ineffective allocation of franking and other tax attributes

Australia effectively double taxes the foreign income of Australian companies – by diluting the franking credits otherwise available to Australian shareholders on account of foreign income paid as dividends to foreign shareholders

Australia's imputation system tends to penalise any attempt by Australian companies to allocate foreign sourced income to foreign investors and franked Australian-source income to Australian investors. As a result, a successful Australian company with, for example, a strong United States investor presence and United States operations must pay dividends from the United States through the Australian parent company to US investors. This circular route results in the payment of US and potentially Australian withholding taxes and a wastage of Australian franking credits for Australian shareholders.

If dividends are paid from the United States subsidiary **direct** to US investors under a stapled-stock arrangement, the Australian parent company's franking credits are still wasted. As a result, dividends paid to Australian individual shareholders and superannuation funds are more heavily taxed as there will be less franking credits attached to the dividend.

Australia effectively double taxes the foreign income of Australian companies – by diluting the franking credits otherwise available to Australian shareholders on account of foreign income paid as dividends to foreign shareholders. The same inefficiencies apply to a company's Foreign Dividend Accounts ("FDAs"). FDA credits result from the receipt of foreign dividends from comparably taxed countries, and are used to ensure such foreign income can be paid out of Australia without non-resident withholding taxes arising for non-resident recipients. Under our current law, these FDA credits have to be notionally allocated to all shareholders and so the proportion of FDA credits referrable to the a company's resident shareholders is effectively wasted.

These are not inadvertent outcomes. They result from express Australian tax policy.

Australia is often considered a sub-optimal location for a parent holding company of an international group. Australia needs a system for more efficiently allocating franking and other attributes to relevant shareholders, or channelling foreign source income through Australian companies to foreign shareholders without actual and perceived wastage of attributes.

Impact:

The desire of internationally focused Australian companies to avoid tax attribute wastage and better utilise their franking accounts or FDAs leads them to look to alternative strategies. For instance, an Australian based international company might seek to use an offshore listed company for reasons which include using the overseas companies to issue shares to overseas investors to invest in the group's overseas operations. Ultimately, this could lead to a "hollowing out" of the Australian listed company.

2.8.2 Dividend withholding tax on dividends from foreign subsidiaries

Australia has a series of Double Tax Agreements ("DTAs") which often produce inequitable results for Australian companies with foreign subsidiaries. The DTAs typically allow foreign countries to levy withholding tax at the rate of 15% on dividends paid to Australian companies from foreign subsidiaries.

Australia effectively removed dividend withholding tax ("DWT") unilaterally on franked dividends paid to non-residents in 1987. Since then, no Australian DWT has been levied on fully franked dividends paid from Australian companies to overseas shareholders.

… Australia has not negotiated mutual provisions in DTAs with major investing countries (notably the United States and Europe) to require dividends paid by overseas subsidiaries from taxed profits to an Australian parent to be exempt from foreign DWT. As a result, Australia's DTAs are now uncompetitive …

However, Australia had not renegotiated mutual provisions in DTAs with major investing countries (notably the United States and Europe) to require dividends paid by overseas subsidiaries from taxed profits to an Australian parent to be exempt from **foreign** DWT. The notable exceptions are the US (where we applaud the recent protocol to the DTA commencing in 2003 to reduce or eliminate DWT in some cases) and the UK (which does not impose DWT).

As a result, Australia's DTAs are now uncompetitive, given a readiness on the part of countries negotiating DTAs to reduce DWT to zero or 5%. For example the foreign DWT paid on non-portfolio dividends in the following general circumstances:

Payer of Dividend	Recipient in	Rate
US	UK	0%
UK	US	0%
Any EU country	Another EU country	0%
US	Australia	15%

Impact:

Australian companies with successful subsidiaries in overseas jurisdictions can only remit dividends from those countries with the additional cost of foreign DWT. This reduces the company's reported earnings, which diminishes the company's published financial performance. As a result:

- foreign dividends tend not to be remitted to Australian parent companies and
- international businesses with significant foreign earnings find Australia to be an unattractive location for a parent holding company because of the DWT impact on their earnings.

Australia's DTA policy in relation to dividends, and other income as discussed below, is not consistent with the interests of a capital exporting country. The DTA negotiating policy does not enhance the position of Australian companies as holding companies and owners of capital and intellectual property.

2.8.3 Tax on foreign assets of foreign-owned Australian companies

On various factors, Australia is an attractive location for the regional headquarters of overseas multinational businesses. However, Australia's CFC and CGT regimes provide many disincentives for an international group using Australia as its regional headquarters location.

In particular, if a foreign investor uses an Australian company to own overseas subsidiaries, Australia's CGT regime will tax gains made **on the disposal of overseas subsidiaries**, as well as the gain on disposals of Australian businesses.

Impact:

As a result, foreign-owned groups reposition their Australian subsidiaries to the lowest tier operational companies. Foreign groups generally ensure that their Australian subsidiaries own no other international subsidiaries. Australian subsidiaries are demoted in status, and are excluded from the regional ownership and often, as a result, the management chain. This reduces the potential for Australians to be significantly involved in the management of regional companies and reduces Australia's influence in the region.

… foreign-owned groups reposition their Australian subsidiaries to lowest tier operational companies. Foreign groups generally ensure that their Australian subsidiaries own no other international subsidiaries. Australian subsidiaries are demoted in status, and are excluded from the regional ownership often, as a result, the management chains

2.8.4 The design of Australia's CFC rules

Australia's Controlled Foreign Company ("CFC") rules are somewhat anachronistic in the current international business environment. The rules target, and tend to tax in Australia, those overseas affiliates and subsidiaries of Australian groups which derive "tainted income" from services, intellectual property and intangibles. But services and intangibles are now the value-added "currency" of international business and the CFC rules need to accommodate international business practices.

The rules have strategic difficulties:

- With the exception of only seven countries, all overseas countries are effectively treated as tax havens along with complex compliance burdens.
- International business is converging to international supply chains and networks – where the production of goods and services may involve subsidiaries in many countries providing intra-group services, production, financing support. The CFC rules treat intra-group services provided by overseas subsidiaries and other CFCs as being taxable in Australia. Related party services are an integral part of how international business is transacted and treating these transactions as "tainted" is increasingly inappropriate.
- **Australian companies are increasingly entering into joint ventures with overseas groups resulting in the incorporation of partly-owned overseas companies, which fall into the CFC net.**
- Finally, the rules are inconsistent as they **exempt gains** made on the sale of foreign active business **assets**, but they **tax gains** made on the full or partial sale of **shares** in active business entities. Moreover, the deliberate exclusion of the new scrip for scrip rollover in a CFC context is an unwarranted limitation on the ability to restructure the operations of a foreign group or enter into business alliances and joint ventures.

These are serious impediments in an international environment especially where companies are increasingly carrying on business through joint ventures. They provide a major disincentive to holding active business assets via Australian company.

We note that the Australian CFC rules were re-engineered in 1997. However, the changes not only imposed greater compliance obligations but are also contrary, in our view, to Australia's long-term interests. Another review is imperative.

Impact:

The over-reaching CFC rules are seen as a major disincentive to locating the parent or regional holding company of an internationally integrated group in Australia. As a result:

- international groups tend to avoid Australia as a location for their holding companies; and
- Australian companies tend to be less flexible and less able to enhance the growth and integration of their international activities.

2.8.5 Australia's residency rules for companies

Australian revenue law taxes an overseas company in Australia as a resident if its "central management and control" is in Australia.

The residency test causes Australian companies with foreign subsidiaries or joint venture companies to ensure that the subsidiary's management is out of Australia, and thereby **minimises Australian involvement**. To do otherwise would expose the foreign subsidiary's earnings (as well as actual or deemed capital gains) to tax in Australia.

The residency test causes Australian companies with foreign subsidiaries or joint venture companies to ensure that the subsidiary's management is out of Australia, and thereby minimises Australian involvement

By contrast, some other countries such as the USA **do not tax foreign incorporated companies** as residents simply on the basis of the key decision makers being located in the "home" country.

Impact:

The Australian tax system results in a tendency to minimise the Australian involvement in overseas subsidiaries, a reduced Australian involvement at board and executive level and a potential migration of headquarter functions out of Australia. This creates a loss of management related work opportunities for Australia.

If Australia adopted a single US style "incorporation" test for corporate residence, management functions could continue to be carried out from Australia without attracting dual resident company issues. We believe that the central management and control concept is outdated in light of Australia's CFC, capital gains tax and transfer pricing rules and works against Australia's interests. However we recommend that foreign-incorporated companies be permitted to adopt Australian corporate residence, at the election of the companies.

2.8.6 Outbound thin capitalisation rules: The new "black hole'

Australia has introduced thin capitalisation rules to regulate deductions for financing expenses for foreign-owned businesses in Australia, and for all Australian businesses operating internationally. The rules were adjusted as announced in the Federal Budget for 2001.

There is a need to question whether such rules were necessary for Australian based multinationals, especially since other countries such as the UK or the US do not limit interest deductions to resident companies in this way. Nonetheless, accepting their existence, two issues require immediate attention in our view.

The thin capitalisation rules require that asset values be based on Australian accounting standards. Australian accounting standards do not allow the recognition of internally generated goodwill. Australian businesses cannot, therefore, look to the value of internally developed business goodwill in their thin capitalisation safe harbour calculation, despite the fact that these assets are recognised by banks and lenders when the companies borrow. This is illogical and unfair to companies with long-standing business.

Additionally, the current proposals call for the permanent disallowance of funding costs. Funding costs disallowed cannot be carried forward and deducted when there is later conformity with the rules.

Impact:

These features of the outbound thin capitalisation rules will tend to disadvantage long-time owned Australian businesses with respect to their international growth strategies compared with other companies who may have recently acquired existing business and are able to recognise goodwill on their balance sheet. Moreover, the permanent disallowance of interest expense is a harsh outcome especially in circumstances where a carry-back of excess debt capacity is not available.

2.8.7 Australia's treatment of intangibles

Unlike many countries, Australia has limited provision for the amortisation of intangible assets.

Moreover, Australia has not taken action in its DTAs to reduce foreign-country withholding taxes on royalties paid to Australian residents. As a result, withholding taxes on royalties flowing both into and out of Australia are very high by global standards. (We recognise and support the recent US DTA protocol which will provide for withholding taxes on royalties to be reduced to 5% effective 2003).

Impact:

Australia is often by-passed as a location for the ownership and for the international licensing of intangibles. When a foreign company acquires an Australian business, the intangibles tend to be relocated into a overseas jurisdiction. Moreover, any Australian research and development activities are then conducted for the foreign intangibles-holding company.

Australia is often by-passed as a location for the ownership and for the international licensing of intangibles. When a foreign company acquires an Australian business, the intangibles tend to be relocated into a overseas jurisdiction. Moreover, any Australian research and development activities are then conducted for the foreign intangibles-holding company.

Australian companies competing for business acquisitions against international based rivals find that the international companies are often able to bid a higher price based on their ability to write-off the intangibles.

Finally, the high royalty withholding taxes on royalty flows make Australia less attractive as a global or regional intellectual property centre.

2.8.8 Foreign Investment Fund (FIF) rules

Australian investments in offshore companies or other entities might fall below the threshold for the CFC rules, but which therefore fall under the FIF measures. The FIF rules were intended to provide for taxation in Australia on, broadly, unrealised gains in values in relation to foreign passive investments.

The FIF rules were designed to have exclusions for active income, ie. offshore business activities. But the law does not reflect the original policy rationale. Similarly the Offshore Banking Unit (OBU) rules are drafted defensively and in a way which restricts the potential for Australia's funds management industry.

Impact:

The FIF rules retard investment by Australians and Australian businesses in many overseas affiliated entities which are **not** mere passive investment pools.

These rules, together with the Offshore Banking Unit (OBU rules), provide unnecessary restrictions on the ability of Australian businesses to engage in international business, and international funds management.

2.8.9 Taxation treatment of foreign inpatriates

The taxation treatment for foreign inpatriates may result in these individuals being subjected to Australian tax on non-Australian assets and cashflows arising out of a period before their Australian residency. This is a serious impediment in attracting the best talent in the world to contribute to the success of Australian companies in the international marketplace.

The Australian Government announced measures in its economic policy document "Securing Australia's Position" to institute specific reforms. These do not address all of the issues, but we welcome the announcement as a significant and long-awaited first step towards the necessary reforms.

Impact:

Foreign inpatriates (at all levels of a company) are costly to employ in Australia. They come to Australia for shorter periods and are more likely to have a short-term and limited commitment to Australia. This reduces the scope to capture the corporate or divisional headquarters functions for Australia for international businesses. Consequently, Australia loses the job growth opportunities to other countries and is denied the contributions of highly skilled personnel.

2.9 The need for active and focused attention

International tax competitiveness is important to:

- maintain Australia as a base for international businesses incorporating business functions such as headquarter, regional, finance and intellectual property activities;
- attract the brightest talent available to contribute to these corporate activities; and
- enhance the Australian tax revenue payable from these activities and from the services that support these activities.

In order to achieve these outcomes, Australia's international tax arrangements need to be modernised.

The Review of Business Taxation ("RBT"), led by Mr John Ralph AO, identified this issue in broad directional terms. A summary of the RBT's recommendations in relation to international taxation is set out in Appendix A.

In the Ralph Report released in 1999, the RBT listed the area of international tax reform as a separate necessary project for Australia.

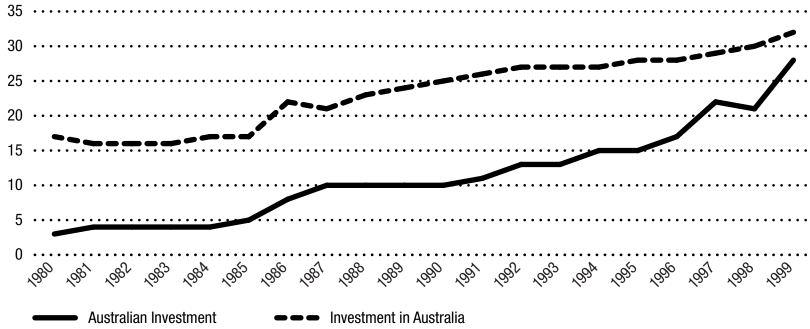
The RBT expressed clearly the need for Australia's international tax policies to reflect Australia's increasing maturity and international business. For instance (in the context of the need for a review of DTA policy the FBT no Fed):

> "current DTA policy places greater emphasis on source country taxing rights than does the OECD model convention … In the first half of the 1980's, Australian investment abroad was only 10 to 20% of the volume of foreign investment in Australia. Currently, Australian investment abroad is about 60% of the level of foreign investment in Australia.[8]

8 RBT, A Strong Foundation, 1999 – Table 2.3

We have updated the RBT statistics as follows:

Table 1.1 Australian direct investment abroad and foreign direct investment in Australia, as a percentage of GDP



The RBT clearly signalled that Australia's tax system for international business needs to progress beyond its historical approach, of a tax system built on the assumption that Australia was substantially a location for low-influence subsidiaries of foreign companies, with a focus on taxing the revenues perceived to be flowing out of Australia. The tax system now needs to recognise and encourage the development of Australia as a hub for international business.

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The review recommended by the RBT has not yet commenced. However the government, in its Federal election statement "Securing Australia's Prosperity" announced an intent to commence consultation.

If these issues are not addressed there will be significant risks for Australia:

(a) Emerging Australian companies will continue to be acquired by, or relocated to, overseas centres.

(b) Australian companies will be increasingly pressured by international capital markets to structure their affairs so that headquarters and listing structures will be out of Australia, leading over time to a reduction in the headquarter presence in Australia.

(c) Foreign companies will continue to structure their Australian subsidiaries as lowest-tier companies, exporting physical goods and services from Australia but having little role in the international management and international leadership of their groups.

(d) Many of Australia's best and brightest people, looking for the greatest exposure to international business, may leave Australia and few will arrive to replace them.

The debate is about maximising value for Australia. If Australian companies do not have international headquarters roles in Australian-owned or foreign-owned groups, the labour and capital in the Australian economy might still be fully employed. But in our view an Australian economy without strong companies taking international leadership roles would generate lower value. It would no longer have the benefits of a vibrant head office service sector and the intellectual property and entrepreneurial spirit typically associated with the activities of head offices. Australia would not be as well positioned to earn the income associated with intellectual property and entrepreneurship. Those residents who were formerly systems engineers might not be able to progress beyond computer programmers. The finance directors might now be financial accountants, and the marketing directors might be salesmen.

2.10 This is Not a Debate Just About the Branch Economy

Some might argue that the recent debate is an overstatement of the "branch economy syndrome" and "disappearing headquarters" issue, because:

(a) Australian companies which grow to a certain size might internationalise and their location or headquarters might move out of Australia in any event, by reason of non-tax factors.'

(b) Even if Australian companies are relocated or taken over, new Australian businesses develop to take their place.

(c) If Australian subsidiaries of international groups are excellent in research or manufacturing or management, they will develop their own influence so that Australia will be appropriately represented in global groups.

This White Paper is not driven by an over reaction to the branch office debate. We seek an internationally competitive tax environment to **maximise the potential of all Australian businesses** – both Australian-headquartered companies and local subsidiaries of international groups.

We seek an internationally competitive tax environment to maximise the potential of all Australian businesses – both Australian-headquartered companies and local subsidiaries of international groups.

Local subsidiaries of international companies are recognised in other countries, as they have been in Australia, as significant contributors to local economies, as discussed in Section 1.6. They can potentially develop over time in their roles[9] from a pure local sales operation with local scope, through stages involving:

- Local sales and manufacturing with local scope;
- Regional hubs with regional scope;
- World product mandates with global scope.

However, the development of a foreign-owned local subsidiary does require a competitive environment. If a local subsidiary is to bid for and develop to a regional hub or world mandate in an international group, a competitive tax environment is a relevant factor.

So the settings of Australia's tax system influence the Australian subsidiaries' ability to maximise their potential globally. And the Australian taxation of the researchers, scientists, managers and business people who are internationally marketable and who transfer in and out of Australia should be internationally competitive to allow Australia to attract and retain such people.

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

9 See Section 4.2 below.

2.11 International competitiveness is a strong theme globally

This White Paper's recommendations align with the trends in tax regimes adopted by leading OECD countries. We have deliberately steered away from tax incentives that could be categorised as unusual, aggressive or representing harmful international tax competition, so as to develop a package that can be adopted comfortably by Australia.

The pace of international tax change and competitiveness in overseas countries has continued to increase. Several major OECD countries such as the United Kingdom, Germany and Sweden have made significant changes to their tax systems, specifically to attract international business and the employment and other growth benefits it brings.

International tax reform requires a sense of alignment across political divides, which is being built in other countries. The Swedish Social Democrat Government noted this in its national Budget of 2000.

There is a need to modernise our international taxation arrangements if Australia is to benefit from a full participation in international business

> *"The amount of tax paid in Sweden is ultimately governed by the willingness of citizens to pay for welfare. However, the Swedish tax system has been confronted by considerable challenges as a result of the ongoing internationalisation where the markets for goods and services just as the labour and capital markets are increasingly integrated with the surrounding world. … The increased cross-border mobility means that the prerequisites for the tax system will change in the next few years … The Government … considers it important to maintain preparedness to take measures within the areas that are particularly sensitive for cross-border mobility."*[10]

This White Paper provides a potential catalyst towards creating this sense of national purpose in Australia. We believe there is a need to modernise our international taxation arrangements if Australia is to benefit from a full participation in international business.

To date, as evidenced by the Ralph Reform recommendations, our international tax system has been left on the back burner. Meanwhile, the world and Australian businesses are moving on. We appreciate that there are many pressing issues facing Government. However, we struggle to find one more relevant to the future of Australia's international business landscape than tax competitiveness.

10 The Fiscal Policy Statement. Various recommendations, made in 2001, are likely to be implemented with commencement dates from 1 January 2002

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Part I –

Locating International Companies, Headquarters and Intangibles in Australia

3. Taxation of Dividends

3.1 Introduction

Successful Australian companies expand internationally for many reasons:

- Over 98% of the world's markets are overseas, so the growth opportunities overseas are great.
- If listed companies do not grow, their relative stock price suffers and they are taken over by other companies.

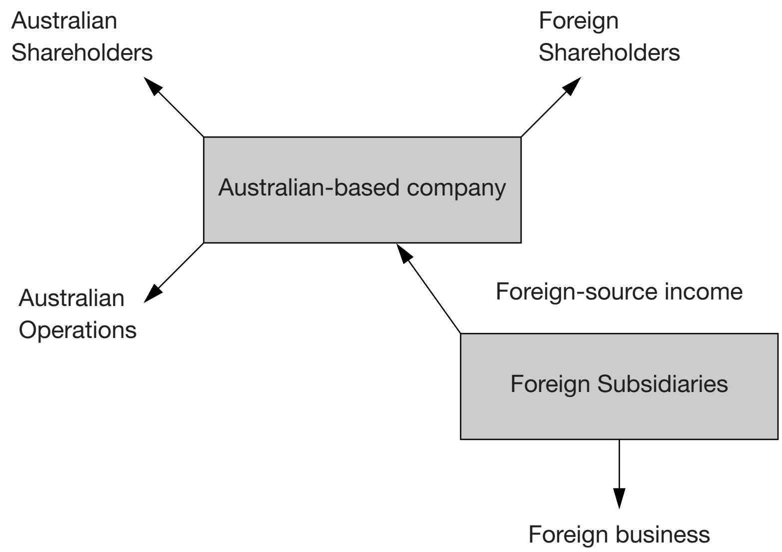
To finance their international growth Australian companies look to international shareholders as well as Australian investors, because Australia's capital markets are not as deep as overseas markets.

Australia's tax law contains inherent biases against foreign source income. This is creating significant risk that such companies will drift out of Australia, with resulting loss of Australian employment, Australian growth and Australian influence regionally and globally.

3.2 The problems with dividends for Australian-based international companies

Dividends which are paid to foreign shareholders from foreign activities cause a debit to the group's franking account. This creates a loss of franking capacity to pass to the Australian shareholders, a loss of value to the company and ultimately the shareholders

Australian-based international companies with foreign shareholders and foreign businesses typically develop a structure along the following lines.



The company faces two major distortions requiring remedy:

(a) Dividends paid by a foreign subsidiary of an Australian-based groups to foreign shareholders from foreign profits cause a debit to the group's Australian franking account. This creates a loss of franking capacity to pass to the Australian shareholders, a loss of value to the company and ultimately the shareholders.

(b) Dividends received by the Australian companies from the foreign subsidiaries from most countries attract relatively high foreign dividend withholding taxes, reducing reported earnings[11].

11 The UK is a notable exception, as UK does not impose Dividend Withholding Tax. The US does impose DWT, but the recently-announced protocol to the US/Australia DTA will ameliorate this when the protocol comes into force. This is discussed below.

To remedy these distortions, in this section we recommend:

- Changes to Australia's domestic tax law to resolve the franking distortion. Without this change, Australian listed companies will tend to drift or "hollow out" the Australian company structures. We believe that the RBT recommendation of a credit for foreign DWT is insufficient for this purpose, and was a second-best option only[12].
- Changes to Australia's DTA negotiating position to seek nil or 5% DWT rates on dividends from foreign subsidiaries to Australia, and vice versa, following international trends among developed countries. This needs to be built into the Australia/United States DTA currently being renegotiated. These changes are discussed in Section 3.11.

… the effect of the imputation system on the distribution of these profits and a comparatively inefficient set of tax treaties … distort the incentives for residents to invest offshore via Australian-based international businesses

If no action is taken along these lines, the risks are that Australian-based and Australian-listed companies, may move into various offshore structures described below, or else might be taken over by foreign companies.

A significant trend by foreign countries which adopted dividend imputation is now to alter their dividend imputation system, recognising that imputation systems hold back growth opportunities from international business (see 3.4 below). We think that our recommendations for fine-tuning the imputation system will resolve the immediate issue which threatens Australia's business infrastructure.

3.3 Receipt of dividends from foreign subsidiaries

Dividends paid by a foreign company to a resident of Australia are either exempt from Australian tax or taxed with a foreign tax credit available. For this purpose, foreign countries are divided into listed (comparable tax) and unlisted (low tax) countries. When the foreign company pays a dividend to the Australian company (after payment of foreign income taxes and dividend withholding taxes) the taxation treatment will be as follows:

(a) A dividend paid by a company resident in **a listed country** will be exempt from tax if the Australian resident company has at least 10% of the voting shares in the foreign company paying the dividend.

(b) A dividend paid by a company resident in an **unlisted country** will be taxed to an Australian company recipient at the ordinary company tax rate with foreign tax credits for any foreign taxes.

The key tax anomaly affecting the receipt of dividends into Australia is the imposition of foreign DWT on the dividend. Foreign DWT is typically 15% of the dividend from the foreign subsidiary and can be as high as 30%.

The foreign DWT cost is magnified by the effect of Australia's imputation system on the distribution of these profits to the shareholders of Australia's internationally focused companies.

Australia's franking laws require that, when a distribution is made, all shareholders must receive the same proportion of franked, FDA and unfranked dividends. Australia does not provide imputation credits for underlying corporate income tax paid in a foreign jurisdiction. Therefore, Australian individual and superannuation fund shareholders receive **no imputation benefits from dividends sourced from the overseas businesses of Australian companies**. The Australian shareholders are taxed at their personal marginal tax rates on dividends paid by Australian companies out of after-tax foreign-sourced income.

12 The RBT, at page 629 of **A Tax System Redesigned**, notes "either providing an imputation credit for foreign DWT or allowing streaming of unfranked dividends to foreign shareholders would address the potential disincentive for offshore investment relative to domestic investment. However, streaming is estimated to have a greater revenue cost than providing imputation credits for DWT of up to 15 per cent."

The dividends paid to foreign shareholders also include an averaged portion of franked, FDA and unfranked dividends. However, **most foreign shareholders derive no benefit from the franked dividend**, other than elimination of Australian DWT (which in many cases would have been creditable in their home country). Resident shareholders do not benefit from the franking credits wasted in this fashion.

Due to this wastage and the ever-lower percentage of franking payable by Australian multi-nationals with increasing foreign profits, the imputation system makes **it unattractive for Australian shareholders to invest in Australian companies which have international businesses. This is a dangerously non-neutral outcome of the tax system.** For similar reasons, the United Kingdom, Germany and Sweden have all recently taken action.

3.4 The need to consider other countries' changes to their imputation systems, recognising the domestic bias of imputation regimes

Imputation tax systems such as Australia's have a well-recognised bias to discourage foreign investment over domestic investment[13]. This was acceptable when economies had less international interaction in day-to-day business. Australia's imputation system, introduced from 1987, has done much to encourage investment in domestic companies, and was an appropriate tax policy for its time.

However the business environment is now different. With the internationalisation of business and capital markets, it is no longer appropriate to have a core design feature of business taxation which discourages international activity. As a result **countries which had imputation systems have adjusted their imputation systems in order to make them more internationally competitive**. Most notably these include the United Kingdom and Germany.

… the German Government commented that "The imputation system works well in closed economies. It is not very well suited for international business. It discriminates against foreign shareholders"

The UK Government has revised the particular features of its imputation system that may have resulted in the double taxation of a company's overseas profits. With effect from 6 April 1999, **the system of Advanced Corporation Tax ("ACT") was abolished** and all dividends paid, now have an associated non-refundable credit of 1/9 of the relevant dividend paid regardless of the source of the profits or where those profits were subject to tax. These measures, together with changes in the personal income tax rates applied to dividends, ensured a consistency of treatment for UK resident individuals for dividends received both before and after 6 April 1999. In 'fixing' the system, the UK Government did not completely abandon the imputation system but introduced modifications to ensure that the **system was neutral in terms of where the profits of a UK company group were sourced and taxed**.

13 See for example the RBT Report, page 627

The German Government has implemented changes from 2002 onwards, where the full imputation system will be replaced by the so-called "half-income" system assessing shareholders on only half the dividend received. When announcing these changes the German Government commented that, *"The imputation system works well in closed economies. It is not very well suited for international business. It discriminates against foreign shareholders"*[14]. Under the half-income system, only half of the dividend will be included in the German resident shareholder's personal income tax base, and there will be no credit for the corporation tax paid by the company against the shareholder's income tax.

Australia needs to consider a modernization and redesign of the imputation system, as an important part of making Australia an internationally competitive environment for business which is developing its international orientation.

We recognise that this policy needs to be carefully considered, and this will take time. The imputation system affects the position of investors, particularly individuals and superannuation funds, so adjustment of the imputation system would need to consider the impact on national savings.

As a result we make interim recommendations[15] to deal with the most significant and immediate problems pending the core reassessment of the imputation system.

Australia should modify the current system in order to remove the well-documented distortions …

Other approaches could be adopted to deal with these distortions but we identify those which would be effective and could be implemented relatively easily.

Recommendation 3: Review of the imputation system

At a conceptual level, Australia should reconsider whether in respect of foreign income an imputation system is the most efficient way to encourage and facilitate the growth of Australian companies in overseas markets. A complete review of the imputation system is outside the scope of this Paper, although this should be addressed on the basis of the powerful international trend described in the Paper.

However, **irrespective of the potential for future debate and redesign, Australia should immediately modify the current system to remove the well-documented distortions as set out in Recommendations 4, 6 and 7 below.**

3.5 Australia's inefficient treatment of dividends from foreign subsidiaries of Australian-based companies

Companies that do not generated fully franked dividends … may not be as attractive to Australian resident investors, and as a result their cost of capital is often higher

To take advantage of international opportunities, it is necessary for Australian multinationals to attract foreign source debt and equity funding. Australia's capital markets are not large enough to sustain the capital and growth funding needs of Australian-based international companies.

While generating significant value for Australian resident shareholders and companies, the adoption of the imputation system in 1987 **introduced a well recognised bias towards domestic as opposed to foreign investment**. Companies that do not generate fully franked dividends may not be as attractive to Australian resident investors. So their cost of capital is often higher.

14 Bundesministerium der Finanzen Referat Presse und Information, Page 16, "Steuerreform 2000 Steuern senken – Wachstum staerken – Arbeitslosigkeit bekaempfen", Berlin 21.12.1999

15 Recommendations 4, 6 and 7 below

The Australian imputation regime for foreign source dividends provides a taxation barrier to an Australian company's international competitiveness.

Put simply, Australian-based companies with significant foreign sourced income and foreign shareholders find that their capacity to pay franked dividends to Australian shareholders is diminished.

Moreover, Australia's anti-dividend streaming arrangements require the spreading of franking credits across all dividends, without the ability to allocate dividend attributes to shareholders who will value the attributes[16]. This creates a distortion that results in an effective double taxation of profits (illustrated in Section 3.6).

As a result, Australian companies in this situation may find their increased cost of equity capital places them at a disadvantage in the competitive international market.

It is the fast growing Australian companies with both foreign activities and foreign shareholders who are most at risk. Australia must ensure that there is no taxation impediment to their growth potential from an Australian base.

The retention of the imputation system is a real issue and other countries using an imputation system have begun to address these issues with the objective of creating a favourable international holding company regime.

In particular, the United Kingdom has revised the features of its imputation system that affected a UK resident company's international competitiveness and influenced its investment decisions. At the time of abolishing Advanced Corporation Tax ("ACT") the UK Government announced that: *"Advanced Corporation Tax (ACT) currently distorts the tax system because, for some companies, surplus ACT results in double taxation of their overseas profits"*[17].

The UK now has no ACT on dividends by its companies, and the UK has no Dividend Withholding Tax on dividends to non-resident shareholders. Appendix B of this White Paper outlines some of the rationale for the UK reforms introduced in 2000.

Australia has continuously protected the inefficiencies of the dividend imputation system to generate tax revenues. The RBT and Treasury have written openly about the wastage of dividend franking credits to non-residents and the resulting revenue gains[18]. We consider that it is now appropriate for Australia to reconsider the policy of dividend imputation and to carefully monitor the impact its removal may have in Germany and the United Kingdom.

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16 There are a number of provisions in the *Income Tax Assessment Act 1936* ("ITAA") that influence the treatment of dividends paid to resident and non-resident investors, which include the anti-dividend streaming and FDA rules.

Under Section 160AQCB, where an unfranked dividend is paid to one set of shareholders in substitution for a franked dividend, then the franking account of the company paying the franked dividend will be debited as though the unfranked dividend was actually franked.

Section 177EA is a general anti-avoidance provision which targets franking credit trading and dividend streaming schemes where one of the purposes (other than an incidental purpose) of the scheme is to obtain a franking credit benefit. Where the Commissioner determines that there is a franking credit scheme the Commissioner may debit the company's franking account or deny the franking credit benefit to the recipient of the dividend or distribution.

Under Paragraph 128B(3)(gaa), non-resident shareholders in an Australian company are able, under certain conditions, to receive dividends free of withholding tax where the dividends are paid out of amounts of income derived from certain sources outside of Australia. The amount that can be paid in this way is determined by the surplus in the Foreign Dividend Account ("FDA") and this is required to be allocated to all shareholders evenly although only non-resident shareholders can benefit from the FDAs.

17 Section 3.56 UK Pre Budget Report dated 25 November 1997

18 See for example RBT Report, page 629

3.6 Australia's foreign dividend account does not remedy the distortion

The principle of allowing comparably taxed foreign income to be streamed to foreign shareholders of an Australian company has been adopted in a limited sense, under the FDA regime. **However, we believe that at a conceptual level, there should be no barrier to foreign sourced equity funding being used to finance the international operations and for that funding to be serviced by the results of that investment – without the restrictions of the FDA mechanism.**

There should be no barrier to foreign sourced equity funding being used to finance the international operations and for that funding to be serviced by the results of that investment – without the restrictions of the FDA

The FDA provisions provide a partial relief from the multiple layers of taxation that can arise where income is earned in a foreign jurisdiction, but fall well short of the mark because:

(a) The FDA rules assist only where the dividend would otherwise have been unfranked. An Australian international company is **required to frank the dividends paid to foreign shareholders to the limit of its franking capacity**, notwithstanding that the dividends are foreign sourced and have passed through the FDA; and

(b) The FDA dividend that can be paid to foreign shareholders is limited to the proportion of the foreign ownership interest in the company. That is, **the FDA is averaged across Australian shareholders (who cannot benefit from the FDAs), diluting the benefit of the FDA**.

The current FDA rules together with the franking rules entrench these distortions. These rules have the effect of allocating franking credits to dividends paid to foreign shareholders and to waste FDA credits on dividends paid to Australian shareholders.

Australia's tax regime effectively double taxes foreign income received by an Australian company which pays dividends to foreign shareholders

Australia's tax regime effectively double taxes foreign income received by an Australian company which pays dividends to foreign shareholders. The foreign income is taxed once overseas in the country of source and may also be subject to DWT. On distribution of the profits to the Australian parent, the dividend will either be exempt or taxable with foreign tax credits available in Australia.

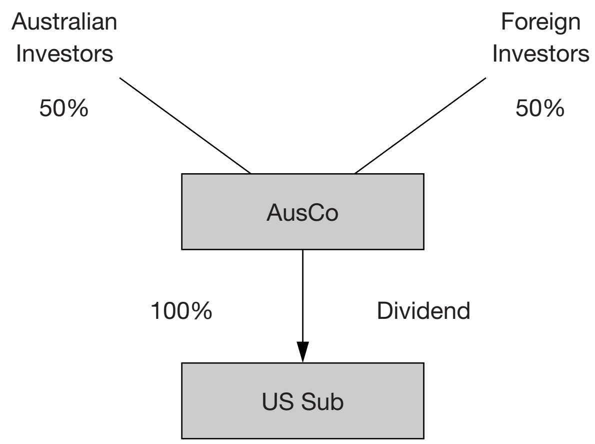
When the Australian parent pays a dividend, any franking credits must be allocated proportionally to residents and non-residents alike. This adds a new cost being the dilution in the franking credits available to other Australian shareholders.

If the company has no other franking credits then the FDA credits are diluted because they must be allocated across all shareholders including resident shareholders who derive no benefit from them. All this results in a loss of value for the company and may increase its cost of capital.

The RBT examined this issue in light of the terms of reference imposed on it for revenue neutrality, and recommended that the anti-dividend streaming rules be retained. The RBT did recommend some modifications to provide partial relief from the distortions in its Foreign Income Account proposal which has been deferred until 2002. However, these measures do not address a major part of the problem.

Example 3.1

An Australian listed company, AusCo, has a 100% owned US subsidiary, US Sub. AusCo is owned equally by Australian and foreign resident investors as shown in the following diagram.



The US Sub generates $1,200 of pre-tax profits. The profits of US Sub are subject to an effective tax rate assumed to be 39% in the United States[19] and the remaining profits are distributed to AusCo by way of dividend and are subject to 15% US dividend withholding tax ("DWT") applied to the dividend paid as follows:

US Profits	*1,200*
US Corporation tax at 39%	*(468)*
Distributable profits	*732*
US Dividend withholding tax at 15%	*(110)*
Net dividend received in Australia	*622*

* *Total US tax is $578 on profits of $1,200, with an effective US tax rate of 48.2%.*

AusCo generates $1,000 of Australian sourced income that is subject to tax at a 30% rate, whilst the net dividend received from US Sub is exempt from further corporate income tax in AusCo:

Australian sourced profits	*1,000*
Dividend from US Sub (exempt)	*Nil*
	1,000
Australian Corporation tax at 30%	*(300)*
Distributable profits	
– Australian sourced	*700*
– US sourced	*622*
Total distributable profits	*1,322*

19 Comprised of the US federal company tax rate plus the state tax rate, which is dependent on the particular states in which the operations are carried on

Example 3.1 (continued)

The net amount of the repatriated profits from USSub, together with the post tax Australian profits, is distributed to the shareholders. The United States source profits are eligible to pass through the FDA and therefore paid without the imposition of Australian DWT. However, to qualify for FDA treatment, a dividend paid must first be debited against the company's franking account. This results in the following position in respect of the dividends paid by AusCo:

Recipient	***Franked***	***FDA***	***Total***
Australian shareholders (50%)	*350*	*311*	*661*
Foreign shareholders (50%)	*350*	*311*	*661*
Total	*700*	*622*	*1,322*

In this scenario, the Australian resident shareholders will currently receive a dividend that is only 53% franked*, because franking credits will be restricted to Australian income and need to be allocated across both resident and non-resident shareholders. In effect, the dividend paid to the foreign investors will have consumed some of AusCo's franking account balance tax even though the foreign investors could have simply been allocated the FDA credits generated from the foreign earnings. The requirement to pay franked dividends pro rata to both resident and non-resident shareholders has resulted in an adverse position for the Australian resident shareholders. Simultaneously, FDA credits are wasted by being allocated to Australian resident shareholders.*

The requirement to pay franked dividends pro rata to both resident and non-resident shareholders has resulted in an adverse position for the Australian resident shareholders. Simultaneously, FDA credits are wasted by being allocated to Australian resident shareholders

3.7 Franking benefits may be of little value to foreign shareholders

The Australian imputation credits associated with franked dividends paid out of **Australian taxed** income may be of little or no value to foreign shareholders. Dividends paid to non-residents are exempt from Australian DWT to the extent they are franked. However, where the overseas shareholders can obtain a credit for Australian DWT, the exemption from Australian DWT will not result in any reduction in their global taxation costs. For those shareholders, the exemption from Australian DWT will be only a timing benefit of no enduring consequence.

Where Australian companies fund foreign expansion from foreign sourced capital, the anti-streaming rules effectively prevent the servicing of the capital from the **foreign returns** generated by the foreign investment without suffering **negative Australian franking consequences**.

Example 3.1 (continued)

In example 3.1, the element of AusCo's dividend that related to the United States sourced earnings could have been paid out of the excess in the FDA and therefore would not be subject to Australian DWT in any event. However, the current law effectively provides a franking penalty for this.

The net effect of the current system is that the United States sourced earnings paid as a dividend from AusCo will have:

(a) suffered US taxes of 48.2%; and

(b) deprived Australian shareholders of franking credits because of the Australian tax law's design, effectively with an Australian tax cost of 30%.

3.8 Current distortions encourage companies to relocate their listings

For many Australian companies seeking growth, it is inevitable that significant expansion will occur in offshore markets. Australian companies must consider how to take their expertise and expand into new markets overseas. In A Tax System Redesigned ("ATSR") at page 627, the RBT recognised that a growing number of companies in Australia derive an increasing proportion of their income from overseas.

As Australian companies … attract foreign investment, the ability to deliver both franked dividends to Australian shareholders and attractive growth prospects to foreign shareholders becomes increasingly difficult … Australian international businesses are being forced to consider alternative strategies

As Australian companies become more involved in foreign markets and seek to attract foreign investment, the ability to deliver both franked dividends to Australian shareholders and attractive growth prospects to foreign shareholders becomes increasingly difficult. Due to the multiple layers of taxation on foreign sourced income, the rate of tax paid by Australian shareholders also increases.

As a result, Australian international businesses are being forced to consider alternative strategies. The most likely strategies involve one of the following:

(a) Relocation of the listed company out of Australia, including its tax domicile or residency;

(b) Setting up a dual listed stapled structure whereby non-resident shareholders hold shares in a foreign listed company which is "stapled to" or linked with the Australian listed vehicle;

(c) Setting up of a dual company non-stapled structure whereby non-resident shareholders hold shares in a foreign listed company, which is independent from the Australian listed vehicle.

All three of the above alternative strategies considered by companies may have less than optimal outcomes for Australia.

The first option could involve a relocation of the company's headquarters out of Australia.

The second and third options risk a similar disadvantage to Australia. As the foreign operations became more significant, the offshore listed vehicle would likely assume greater importance within the group, causing control or influence over the group to drift out of Australia.

Example 3.2

Continuing Example 3.1, assume that AusCo restructured to create a ***dual-company stapled structure****. The United States shareholders could hold shares in the Australian company but would also hold shares in the US company and directly in the US profits. Similarly, the Australian shareholders could hold shares in AusCo and participate in the Australian profits.*

Under a ***dual company stapled structure****, the dividend declared by the United States company would still* ***erode AusCo's franking account, because of Australia's anti-franking-streaming rules****.*

Example 3.2 (continued)

*To overcome this problem a **dual company non-stapled structure** could be used. The United States shareholders would not be involved in the Australian company and the anti-franking-streaming rules would not apply. The United States company would be able to declare a dividend out of US profits equal to half the group's total distributable profits of $1,432 (the aggregate of Australian and US sourced distributable profits of $700 and $732, respectively) without any Australian income tax implications. The balance of the US profits is repatriated to AusCo in order to support the dividend to the Australian resident investors, and therefore, AusCo could pay a virtually fully franked dividend.*

Recipient	***Franked***	***Unfranked***	***Total***
Australian shareholders (50%)	*700*	*16*	*716*
Foreign shareholders (50%)	*N/A*	*N/A*	*716*
Total	*700*	*16*	*1,430*

Eliminating US DWT on the profits repatriated to Australia would boost the total dividend by more than $100 [20].

… protecting … the "wasted" imputation and FDA credits may deprive Australia of far more substantial economic benefits. It repels capital and international economic activity from Australia, and creates a risk of client or branch status for Australian international businesses

Australia needs to retain the benefit of any value accretion that may result from its international companies when considering the economic outcomes of the measures to allow dividend streaming. The value for Australia is not in the short-term revenue benefit of franking credits being wasted. Other factors to be considered are:

(a) Employment opportunities in direct employment in Australian headquarters;

(b) Economic growth in Australia's business infrastructure of the financial, service and support industries which they generate; and

(c) Enhancement of Australian influence regionally and globally.

So the approach of protecting the revenue by forcing "wasted" imputation and FDA credits, may deprive Australia of far more substantial economic benefits. It creates capital market inefficiencies which are not positive for Australia.

Leading countries have seen the risks of adverse outcomes and have taken action eg. the United Kingdom, Germany and Sweden. This issue cannot be discounted as one that affects only growing or developing countries. It affects Australia and should be addressed.

20 The difference in the total dividend paid to foreign and Australian resident investors is due to the US DWT on the US profits repatriated to Australia

3.9 RBT proposal of imputation credits for foreign DWT is insufficient

It appears that for revenue reasons the RBT recommended that Australian companies not be allowed to direct foreign sourced dividends to foreign shareholders and Australian sourced dividends to Australian shareholders (Recommendation 20.2). However, the RBT did recommend that imputation credits of up to 15 per cent of the repatriated dividends be allowed for foreign withholding taxes paid on such dividends (Recommendation 20.1).

The RBT's proposal was designed to put an Australian investor in an Australian company with foreign subsidiaries, in the same position as if the investor had invested directly in the foreign subsidiary. The measure, which was incorporated in the now deferred simplified imputation system[21], appears to partly reduce the bias against foreign investment and is an improvement to the current rules.

There is, however, serious doubt whether it will have any material effect on investor and corporate behaviour.

… the RBT did recommend that imputation credits … be allowed for foreign withholding taxes paid on such dividends … There is serious doubt whether it will have any material effect on investor and corporate behaviour

As noted by the RBT[22], an imputation credit provided for foreign withholding taxes would only partially convert unfranked dividends out of foreign sourced income into franked dividends (because some franked dividends would still be "wasted" on non-resident shareholders).

More importantly, in order to provide shareholder benefits from the imputation credit, a company must first incur the expense of the foreign DWT. Companies will be very reluctant to do this because of the impact on reported after tax earnings and because the shareholder group will not value the imputation credit eventually received at its full face value, whilst the company incurs the full cost of the foreign DWT.

The RBT appears to have preferred this proposal in part because allowing imputation credits for foreign withholding taxes appeared to benefit a wider range of entities. The RBT has also recognised that streaming would be less beneficial for Australian companies with few foreign shareholders.

However, we believe that these arguments are not very persuasive since:

(a) Most listed public companies in Australia with foreign subsidiaries have both resident and non-resident shareholders.

(b) The proportion of non-resident shareholders is increasing as Australian companies invest into offshore markets, often funded by the offshore equity providers.

21 The Government stated that it accepted the RBT proposals which grant a franking credit for foreign DWT, thereby aligning the tax treatment of investing directly into overseas companies or through an Australian company. This proposal was included in the Entity Tax Exposure Draft legislation and was due to have effect from 1 July 2001, but has subsequently been withdrawn on 27 February 2001. The Government has proposed that this measure will now become effective from 1 July 2002.

22 ATSR at page 629.

… imputation credits for foreign withholding taxes will not remove the adverse profit and loss impact of foreign withholding taxes and we believe that this measure will not thereby encourage companies to repatriate foreign earnings

Example 3.3

Continuing Example 3.1, Assume that AusCo was entitled to a franking credit in respect of the US DWT suffered on the dividend from USSub and all profits are distributed. This would mean that the $700 of franked profits would be increased by $256 to take account if the franking credits on the $110 of DWT suffered when the dividend was paid from USSub to AusCo. This results in the following position in respect of the dividends paid by AusCo:

Recipient	***Franked***	***FDA***	***Total***
Australian shareholders (50%)	*478*	*183*	*661*
Foreign shareholders (50%)	*478*	*183*	*661*
Total	*956*	*366*	*1,322*

In this scenario, the Australian resident shareholders would receive a dividend that is only 72% franked. The overall corporate profit will have also fallen by over $100 as a result of the need to pay the US withholding tax charge.

This outcome would be significantly less attractive than a streaming or unstapled-foreign-listed strategy as outlined in Example 3.2.

The overall effect of this proposal is that overseas investors lose the benefit of FDAs and/or foreign tax credits while the franking credits available to Australian shareholders are diluted.

The RBT also rejected the allocation of dividends and tax credits due to its potential revenue cost. The RBT estimated that the cost of this measure would amount to between $180m to $260m per year. In making this estimate, we understand the RBT based its analysis upon ATO data in respect of:

- non-portfolio dividends received by Australian companies; and
- the level of franking by such companies.

The cost to revenue was then calculated by comparing the foreign sourced dividends received and the unfranked dividends paid. It appears that the RBT analysis assumed that all foreign sourced dividends received have been subject to 15 per cent withholding tax.

In our experience, the vast majority of dividends repatriated to Australia by multinationals are structured to attract little or no foreign withholding tax. Most multinationals are concerned with the profit and loss statement impact of withholding tax costs and therefore tend not to repatriate dividends from countries with high withholding tax rates.

As a result, the RBT proposal to allow imputation credits for foreign DWT will not encourage companies to remit foreign dividends to Australia, because the proposal **will not remove the adverse profit and loss impact of foreign withholding taxes**, and we consider that this measure will not thereby encourage companies to repatriate foreign earnings.

So while the imputation credit for foreign DWT is welcome, we think it is significant to deal fully with the problem.

3.10 Treatment of dividends is non-neutral and the tax policy requires review

Recommendation 4: Allowing foreign source dividends to be paid without adverse franking impact

We recommend changes to the taxation treatment of dividends when paid out of foreign sourced income of an Australian company to its foreign shareholders. Australian companies should be able to pay unfranked dividends out of foreign income to foreign shareholders without the imposition of Australian DWT and adverse franking account consequences.

This will involve the extension of the current FDA and future FIA regime, and will make Australia a more attractive international parent or holding company location.

This recommendation is insufficient without further action to deal with the additional cost of foreign DWT, as recommended below.

A major objective is to provide a set of signals to business which are as neutral as possible. Thus, the initial revenue cost should not be taken as a crucial economic test for whether a dividend and tax credit allocation arrangement is defensible. As noted by the RBT for the proposed Taxpayer Charter[23]:

> *"In raising revenue for the Government, the business tax system should interfere to the least possible extent with, and indeed should promote, the best use of existing national resources, efficient allocation of risk, and long-term economic growth. Ideally, the business tax system should be neutral in its impacts and thus not be a consideration in business decision-making. Poorly designed tax systems can inhibit economic growth by distorting business decisions. In cases where existing market forces and institutional structures do not produce an optimal outcome, the tax system may sometimes be the best instrument to correct the deficiency. In all such cases it must be established that changes to the tax system will be likely to increase economic growth."*

Australia should pursue vigorously the process of renegotiating tax treaties … to reduce the DWT rates on non-portfolio dividends … Otherwise Australian companies will continue to suffer restrictions on cross border capital flows …

For the reasons outlined above, the RBT's proposed foreign withholding tax franking credit measure is unlikely to provide substantial benefits to Australian companies and is clearly "second best" to the tax credit allocation and stapled stock arrangements discussed above.

Accordingly, the rationale for allowing the directing of offshore profits to foreign shareholders while retaining the benefit of Australian franking credits for Australian shareholders appears to be strong. This dividend allocation arrangement would improve the competitiveness of Australian based companies in foreign markets and hence lead to greater integration of Australian companies into the international economy.

The precise mechanism for calculating the proportions of dividends to foreign shareholders and foreign income needs to be very efficient, not complex. New Zealand has an effective mechanism for setting the ratios.

23 ATSR, page 105

3.11 Action required in double tax agreements to eliminate dividend withholding taxes

As noted above, the repatriation of foreign profits to Australia, or through Australia, may give rise to a significant foreign DWT cost.

Australia has entered into a series of now largely inefficient DTAs with foreign countries which were negotiated at a time when there was general agreement within the OECD that a 15 per cent DWT tax rate on dividends was an acceptable balance between free capital flows and source country taxing rights. Since then, the international norm has been to negotiate markedly lower DWT rates in DTAs.

Australia exempts from DWT those dividends which are franked dividends or which have FDA status. Consequently, Australia has to a large extent unilaterally removed DWT. This was not accompanied by the renegotiation of the DTAs with Australia's major trading partners.

Under the current rules, if an Australian subsidiary of a US parent remits a dividend to the US parent, there is no Australian DWT to the extent that it is fully franked or paid from the FDA. However, if a US subsidiary of an Australian company remits a dividend to the Australian company, the US subsidiary will incur a 15 per cent US DWT tax on profits fully taxed in the United States. The income is taxed in the foreign country at a comparable tax rate, and may be subject to further Australian income tax or withholding tax when distributed to the shareholder. **There is a clear disincentive for foreign investors to invest in an Australian company in order to enjoy the profits derived from non-Australian operations if Australia continues to take no action on the reduction of foreign DWT on dividends paid to Australia.**

At the time of granting the unilateral DWT exemption, Australia could have actively sought to renegotiate more competitive DTAs, to enable Australian companies to remain tax competitive. One problem with the DTA system is that the negotiation process is not transparent. At present, it is often difficult to determine what efforts, diplomatic or otherwise, have been employed in seeking to renegotiate key DTAs.

Recommendation 5: DTAs need to be renegotiated to remove dividend withholding taxes

As a major initiative, we recommend that Australia should pursue vigorously the process of renegotiating tax treaties which lead to inequitable results for foreign investors. It should be a national priority to reduce the DWT rates on non-portfolio dividends during these negotiations and for changes to be implemented as soon as possible. Otherwise, Australian companies will continue to suffer restrictions on cross border capital flows, adversely impacting profits and investment decisions.

We applaud the action of the Australian Government in agreeing to the protocol to the United States/Australia DTA. This can be a model for renegotiation of other DTAs, such that foreign dividend withholding taxes on income flowing to Australia are reduced to zero, with a corresponding reduction of Australian dividend withholding taxes on unfranked dividends to foreign investors.

The RBT made a range of recommendations in respect of Australia's DTAs that are consistent with this view[24].

24 Notably ATSR Recommendation 22.21

3.12 An interim solution: Stapled stock measures

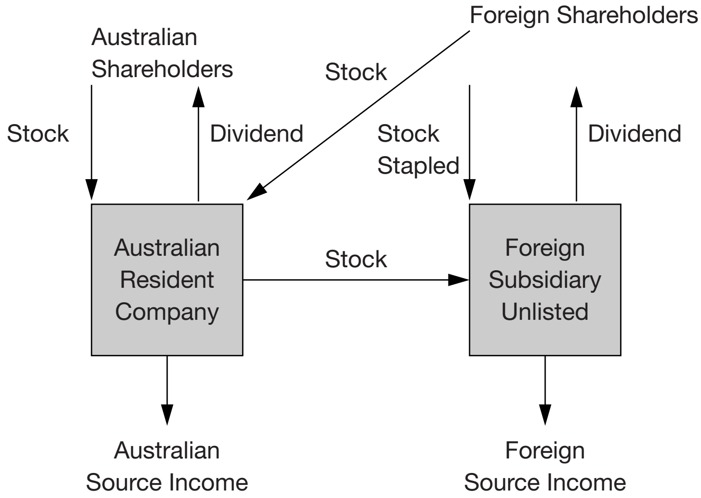
Until Australia's DTAs are negotiated to eliminate foreign DWT, one way of alienating the problem is for companies to stream dividends from foreign subsidiaries to shareholders in the same country as the subsidiaries.

Stapled-stock arrangements provide benefits to Australian companies and indirectly to shareholders by eliminating foreign DWT on the repatriation of profits to Australia.

However, the current anti-dividend streaming rules result in a diminution of the company's franking account. We recommend alteration of these rules.

Stapled-stock arrangements provide benefits to Australian companies and indirectly to shareholders by eliminating foreign DWT … However, the current anti-dividend streaming rules result in a diminution of the company's franking account

The proposed model for allowing stapled-stock arrangements is illustrated in the following diagram.



Foreign shareholders who hold shares in an Australian multinational company could also hold another share in a foreign subsidiary of the Australian company, with the second share being stapled to the share in the Australian company. The foreign shareholders could then receive dividends through the stapled stock rather than through the share held in the Australian company. If either pool of income were insufficient to meet the dividend requirements of each set of shareholders, then other arrangements would need to be made. For example, the non-resident shareholders could receive top-up dividend payments from the Australian resident company.

This arrangement has been used in the past but was rendered ineffective by the enforced "anti-streaming" franking debits under Australia's imputation rules, which should be removed.

Recommendation 6: Stapled-stock arrangements without adverse impact on franking account

Australia's tax law should allow foreign shareholders to receive dividends directly from foreign subsidiaries which are resident in listed comparably taxed countries using a stapled-stock arrangement, without creating franking debits to an Australian company's franking account.

Not only would this structure provide advantages to Australian shareholders by enabling them to derive maximum benefit from imputation credits, it could also provide benefits to non-resident shareholders by eliminating foreign DWT on the repatriation of profits to Australia. The foreign shareholders would also be taxed according to the laws of their own countries and this may have the additional benefit of providing access to local imputation credits.

Australia's tax law should allow foreign shareholders to receive dividends directly from foreign subsidiaries which are resident in listed comparably taxed countries using a stapled-stock arrangement, without creating franking debits to an Australian company's franking account.

The essential thrust of this model is that Australian shareholders are in the main regarded as providing the equity necessary to earn Australian sourced income, while non-resident shareholders are regarded as providing the equity to earn foreign sourced income.

3.13 Australia must resolve triangulation of taxation with New Zealand

An issue outstanding for many years has been the potential harmonisation of the dividend imputation systems of Australia and New Zealand to enhance the scope for international business between companies resident in both countries.

In summary, New Zealand has an imputation system not unlike Australia's. New Zealand companies operating in Australia pay Australian company tax, but are currently unable to pass franking benefits to their New Zealand shareholders.

Conversely, Australian companies operating in New Zealand pay New Zealand tax, but are unable to pass Australian franking benefits to their Australian shareholders.

This issue has generated difficulties for several years, and we understand that a resolution has been sought by New Zealand.

Arising out of recommendations of the RBT[25], Australian and New Zealand Treasury officials have been instructed to develop a workable model for recognition of imputation credits in triangular cases and assess the costs and benefits of applying such a model.

The officials have been instructed to report back soon. It would be unfortunate if this report was shelved or otherwise not acted on promptly.

Recommendation 7: Triangulation of imputation credits for NZ

Australia should proceed to achieve triangular imputation credits in Australia and New Zealand in respect of company tax paid by companies in the other jurisdiction.

We understand from a recent speech by NZ Finance Minister[26] that the initial thinking tends to an "averaging" of franking attributes – that is, that NZ and Australian franking attributes would be averaged across all dividends paid, so that NZ shareholders would benefit from the NZ-franked portion of dividends while Australian investors would benefit from the Australian-franked portion.

This is the strategy which underpins the current approach to Australian franking and FDA credits, which we recommend should be varied.

If the indications by the NZ Finance Minister are correct, this development would be useful but would be insufficient to deal effectively with the issue, for the reasons discussed above.

25 Recommendation 20.6

26. Treasurer Mr McCullen, 20 June 2001 speech at Parkroyal Hotel, Wellington.

We would prefer to see a full franking credit in each country for the other country's tax paid. We recognise that this recommendation might be considered inconsistent with the earlier recommendations favouring retention of tax attributes on income flowing to shareholders. However, we believe that the case for triangulation of Australian and New Zealand taxation systems warrants being treated as an exception to the general rule, in the same way as the RBT treated its Trans-Tasman harmonisation recommendation differently to the general rule for foreign-sourced dividends.

3.14 Addressing Possible Reservations about Dividend Streaming

3.14.1 Issues raised by RBT

We recognise that some commentators will have reservations about a more effective dividend streaming system.

… some commentators will have reservations about a more effective dividend streaming system.

The RBT, in the commentary to its recommendation 20.2 rejecting streaming for foreign dividends[27], made a number of observations which we broadly summarise as follows:

1. "(E)ither providing an imputation credit for foreign DWT or allowing streaming of unfranked dividends to foreign shareholders would address the potential disincentive for offshore investment relative to domestic investment. However, streaming is estimated to have a greater revenue cost"
2. "(P)roviding an imputation credit will benefit a wider range of entities – not only those with some franked income and some foreign shareholders. All entities will have an equal incentive to expand offshore into profitable ventures. If only streaming were allowed, entities with no foreign shareholders or franked income would receive no incentive.
3. "Allowing streaming of foreign dividends to foreign shareholders would not improve the returns to foreign shareholders. This is because Australian tax is not currently levied on most foreign source dividends paid to foreign shareholders (through the effect of the foreign dividend account arrangements)."
4. "Allowing streaming would provide an incentive to match the proportion of Australian shareholders to the proportion of franked dividends … If the proportion of unfranked dividends increased (reflecting further expansion offshore), there would be pressure to reduce the proportion of Australian shareholders relative to foreign shareholders … if the proportion of foreign source income and the level of foreign shareholding in an Australian entity increased markedly over time such that resident shareholders are in the minority, the Australian entity could face pressure from the foreign shareholder majority to re-locate offshore (to improve the foreign shareholders' after-tax return on income sourced in their home country)."

We suggest that some of these propositions do not in fact support the RBT conclusion. Our comments are as follows.

The first extract confirms the benefits of streaming but notes the higher revenue cost, which was a substantial influencing factor in the RBT recommendation (driven, as it was, by terms of reference which sought revenue neutrality).

27 "A Tax System Redesigned", page 629 ff

The second RBT proposition was that imputation credits for foreign DWT provide an equal incentive to all entities to expand offshore. We have outlined at Section 3.9 that an imputation credit for foreign DWT:

(a) assumes that an Australian business will accept the foreign DWT, and the adverse impact on its reported earnings, to bring back the relevant dividend. Our view is that this is not likely to occur.

(b) will not provide a significant boost to the franking percentage of many Australian companies, in relation to dividends paid to Australian investors (see example 3.3). So the impact of the imputation credit would be muted.

(c) would not be of any benefit to foreign investors, because a flow-through to foreign investors potentially would benefit under the foreign dividend account or foreign investment account concessions in any event.

(d) assumes that foreign DWT will continue at high levels. Given our recommendation for Australia to join the international trend to reduce DWT[28] in its double tax agreements , every DTA with reduced foreign DWT will reduce the advantage of the imputation credit for foreign DWT.

Therefore, while welcome, the proposal would not alter business behaviour in relation to their capital market structuring and location decision.

The third proposition is that streaming would not benefit foreign shareholders because Australian tax is not currently levied on most foreign source dividends paid to foreign shareholders (because of the Foreign Dividend Account). We agree that the streaming proposal is ultimately focused on **maximising benefits for Australian domestic shareholders** arising from the imputation credits. It is precisely designed to ensure that Australian shareholders' tax outcome from the company's Australian operations is not diluted by the foreign income generated by the company.

The RBT proposition assumes that the FDA measures operate efficiently, but they have an inefficient structure. Australia's current rules provide that where a company has a mixture of domestic taxed income and foreign income, that the dividends paid to investors are averaged so that every dividend has a mixture of franked and FDA characteristics. This has the result the benefit of the FDA is diluted, in the same way as the forced averaging of imputation credits involves a dilution and wastage of franking credits (Section 3.6, above).

The fourth proposition was that (notwithstanding the availability of streaming) Australian companies "could face pressure from" any foreign shareholder majority to relocate offshore to maximise the foreign shareholders' tax profile. We believe our approach deals with this issue.

… the allowance of foreign "stapled" entities without adverse impact on franking accounts is designed precisely to allow foreign shareholders to achieve optimal foreign tax outcomes without adversely affecting Australian shareholders.

Our Recommendation 6, for the allowance of foreign "stapled" entities without adverse impact on franking accounts, is designed precisely **to allow foreign shareholders to achieve optimal foreign tax outcomes without adversely affecting Australian shareholders**. It would allow any Australian company to implement a structure whereby foreign shareholders' dividends were sourced in a major foreign country, to allow an efficient channelling of foreign income to foreign shareholders in that same country. Such arrangements operated in the past in relation to Australian banks with stapled UK shares for their UK shareholders. In our view, streaming (together with stapling) should not result in the pressure foreshadowed to relocate Australian companies or to unduly reduce Australian shareholdings relative to foreign shareholders.

28 Section 3.11, supra

The dividend imputation system already provides a powerful tax challenge to domestic companies expanding offshore, by reason of the adverse impact on their franking position. This has been recognised internationally and other countries have taken action[29]. Our streaming recommendation is designed to mitigate this trend, by preserving some franking benefits for domestic shareholders, which are otherwise diluted under the imputation law whenever foreign income increases relatively.

3.14.2 Are Dual Listed Companies sufficient to resolve the issue?

Some might suggest that the dual listed company ("DLC") concept resolves the issues around imputation and DWT, and that no action is required by Australia.

In the Australian context, an Australian company might partner in a DLC with a substantial foreign company, as discussed at Appendix 3A.

We think the DLC concept is appropriate for certain Australian companies with significant scale, whose commercial requirements lend themselves to the DLC structure. However, DLCs carry risks which make them inappropriate as a generic solution for all international Australian businesses:

(a) The foreign company in a DLC may require a headquarters location in its foreign jurisdiction, usually as a condition of the foreign listing. The combination of the two headquarters locations creates a risk that, over time, the foreign company will become dominant, and that the Australian influence in the DLC group will reduce.

For this reason Australia has required guarantees of continued head office presence as a condition of allowing approval for major Australian companies entering some DLC structures.

… the DLC structure, which is very effective in a particular set of commercial circumstances, should not be seen as the cure-all or panacea to cover the gaps in the policy outcomes of Australia's imputation system.

(b) A DLC is appropriate where Australian groups need a greater size in overseas jurisdictions for capital-markets purposes and the foreign listing is necessary. However, the DLC might be unnecessary where an Australian company has sufficient scale in its own regard, and wishes only to provide a more efficient structure for channelling foreign-sourced income to foreign shareholders.

In such a case, the Australian company could achieve its desired outcome by creating a stapled subsidiary, as discussed in Section 3.12, to achieve the capital neutrality requirements, **without seeking to find a peer company with which to enter a DLC relationship**. Alternatively, an Australian company **might take over a significant foreign-listed company**, in a way which retains the overseas listing of the foreign company and retains unambiguous control in Australia.

So, the DLC structure, which is very effective in a particular set of circumstances, should not be seen as the cure-all or panacea to cover the gaps in the policy outcomes of Australia's imputation system.

3.14.3 Is Dividend Streaming sufficient to resolve the issue?

Our Recommendation 3 is that Australia needs to review the imputation system[30] in the medium term.

29 Section 3.4, supra

30 Sections 3.1 – 3.3, above

The imputation system was attractive for Australia when introduced … However, countries which were leading adopters of imputation (notably the UK and Germany) have moved beyond imputation

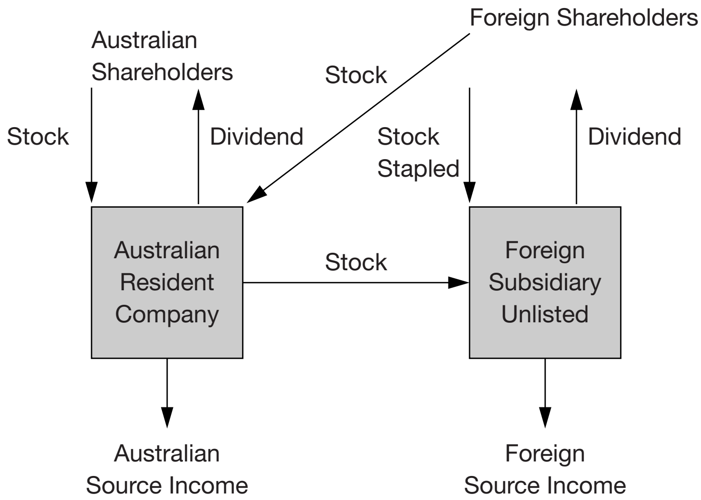
The imputation system was attractive for Australia when introduced in 1987 and its success in increasing Australian investors' participation in the securities markets must be recognised. However, countries which were leading adopters of imputation (notably the UK and Germany) have moved beyond imputation, recognising that imputation is no longer appropriate for international business environment of business that is strongly international, operating across borders, with capital markets driven by the needs of superannuation and pension fund investors, representing the savings of workers globally, which are broadly tax-free in most countries.

So our dividend streaming recommendations are designed as interim solutions pending the more comprehensive review of the dividend imputation system.

Appendix 3A: How Australia’s current law encourages companies’ headquarters to drift out of Australia

1. Stapled structures

After imputation was introduced, Australian companies originally considered stapled stock arrangements as illustrated in the following diagram.



However, the imputation law was adjusted to limit the use of such structures.

There are problems under the current law with a structure along the above lines as follows:

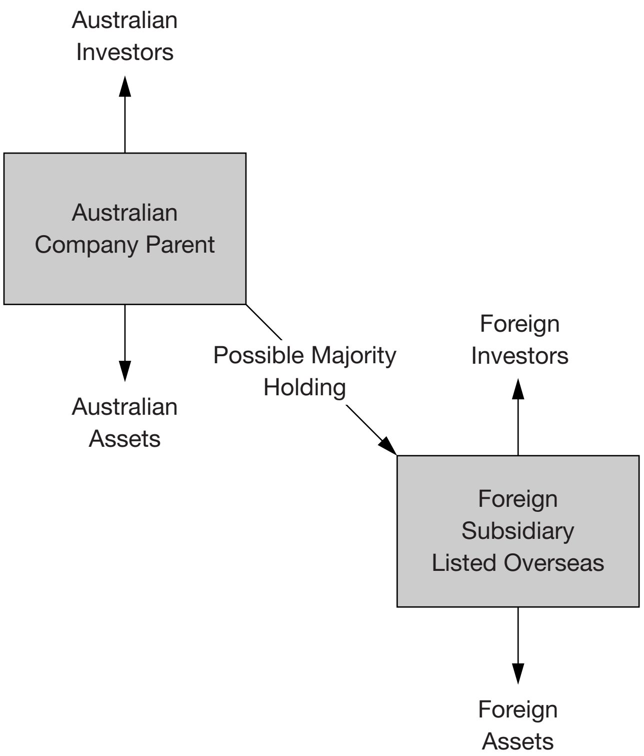
(a) The erosion of the Australian franking account, under Australia’s anti-stapled-stock rules in the imputation law.

(b) The foreign company must have its own Board and the involvement of Australians in the activities of the foreign company must be limited to manage the risks of it becoming an Australian resident or being subject to Australia’s tax laws generally as a result of our “central management and control” residency concept.

(c) In any event, Australia’s CFC laws would apply to this structure, causing foreign source income and capital gains in the foreign subsidiary to be subject to Australia’s CFC rules.

Because of the difficulties outlined above, an Australian group might be attracted to the following structure which “un-staples” an overseas subsidiary which is readied for listing overseas.

2. Partial spin-off

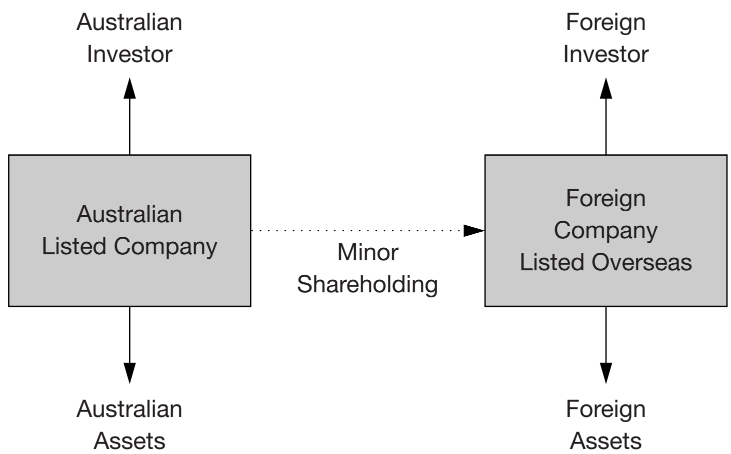


This structure solves the franking account management issues, by having overseas income flows passing to a foreign company, which declares dividends independently of dividends declared by the Australian company. It is, commercially, a partial spin-off.

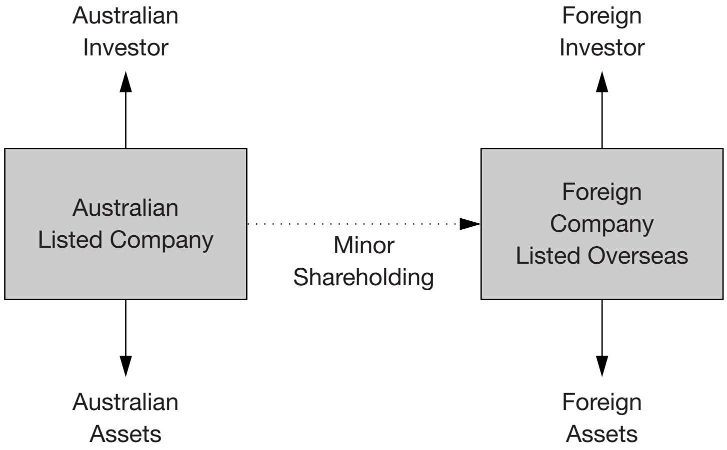
However, this structure requires that the foreign company must have its own Board and that the involvement of Australians in the activities of the foreign company must be limited, to manage the risks of it becoming an Australian resident or being subject to Australia's tax laws generally. In any event, Australia's CFC or FIF laws would apply to this structure.

The long term risk to Australia is that the functions performed overseas and the foreign investments made overseas will grow to take precedence over Australian functions and investments, with the risk that the Australian company's interest in the foreign company will shrink over time.

This could see a structure arising, sooner or later, along the following lines:



or the Australian company might decide to restructure to become a foreign listed company



with the primary income flow from overseas operations being directed to the foreign listing.

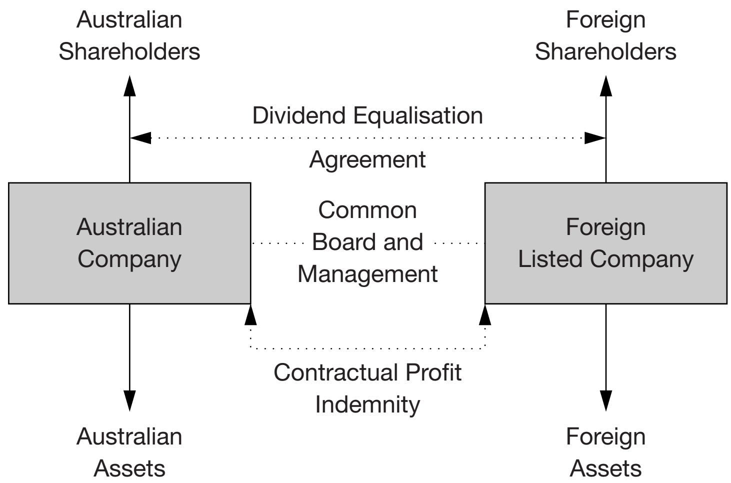
3. "Dual" joint listed companies

Dual Listed Company (DLC) structures were developed in Europe, and are used for example by Royal Dutch/Shell, Unilever and Reed/Elsevier (all three are dual listed on the UK and Dutch exchanges). DLCs are extremely useful as a technique to bring together two companies in a commercial arrangement which operates much like a merged company, but retains the separate companies. This eliminates the major tax and commercial problems which would arise if there was a takeover of one by the other, or a merger.

An Australian group might seek, for commercial reasons, to align with a foreign company to create a DLC structure. Both companies will retain their existence and their listings, but agree to align their dividend and capital policy and their management.

DLCs are usually driven by commercial factors involving two major groups, such as retaining dual entry points into capital markets, or eliminating the capital gains tax costs that would come from a formal merger or takeover. But they do allow, also, some prospect of optimising dividend flows, and we would see some groups in the future being attracted to DLCs for this reason.

The DLC structure is summarised below.



Again, this structure requires that the foreign company have its own Board and that the involvement of Australians in the activities of the foreign company must be limited, to manage the risks of the foreign company becoming an Australian resident or being subject to Australia's tax laws generally.

As before, the long-term risk to Australia is that the functions performed overseas and the investments made in foreign countries by the foreign listed entity will grow to take precedence over the Australian functions and investments, with the risk that the Australian business over time will be wound down.

4. Refining Australia's Capital Gains Tax to Encourage Holding Companies in Australia

… we propose a conduit holding company regime (CHC) regime to allow the foreign income and gains of regional holding companies to flow through to their foreign shareholders free from the imposition of Australian tax.

4.1 Capital gains tax discourages use of Australia as a location for regional holding companies for international groups

On many indicators, Australia is an attractive location for the regional headquarters of overseas multinational businesses. Australia possesses a highly skilled workforce, a stable democratic political system and a well-regulated business environment. However, Australia's tax regime provides a significant disincentive for an international group using Australia as its regional headquarters location, especially if the international group wants to achieve **structural integration** of the Australian company with other foreign subsidiaries.

Where an inbound investor uses an Australian company to own regional subsidiaries, the Capital Gains Tax (CGT) introduced in 1985 will tax gains made on the Australian operations as well as gains made on the disposal of overseas subsidiaries.

As a result, foreign owned groups now typically structure their groups so that:

(a) Their other foreign subsidiaries are **not owned by and bypass** their Australian subsidiaries; and

(b) When they take over Australian groups they seek to ensure that the acquired foreign subsidiaries of any Australian company are transferred to overseas holding companies.

This reduces the potential for Australians to be significantly involved in the ownership or management of regional companies.

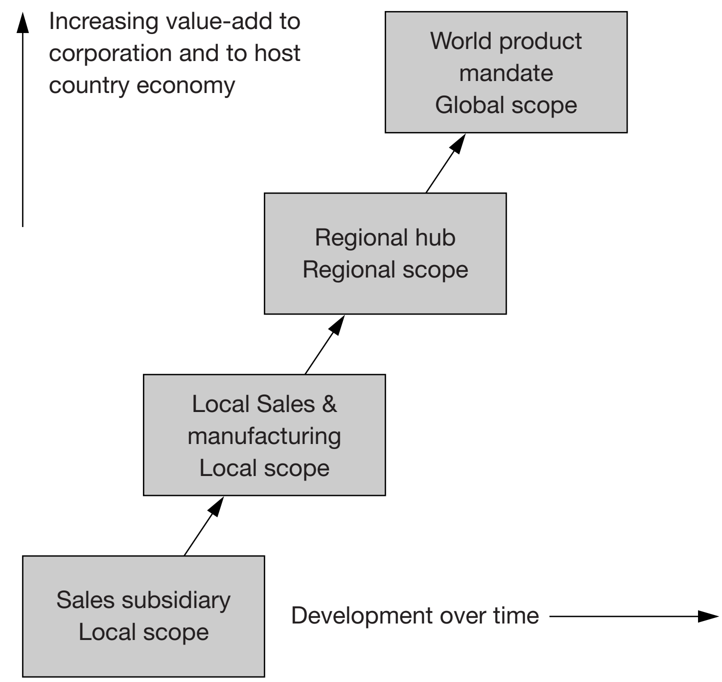
Other countries with similar structures have moved, in a strong emerging trend (discussed below), to introduce CGT concessions, targeted to overcome this adverse feature in their tax systems.

Australia needs to update its CGT policy for non-residents to meet the requirement for an internationally competitive holding taxation regime.

4.2 Local subsidiaries can achieve more significant roles in global groups, creating growth for Australia

With the increased international opportunities in businesses, local subsidiaries of international groups can achieve significant growth by identifying opportunities and winning mandates within their groups. Local subsidiaries can achieve international success and growth, using their natural advantages and the drive of their local management. One helpful way of seeing the stages in development of a local subsidiary of an international group is as follows[31].

Table 4.1 How local subsidiaries of international groups can develop



A local subsidiary can over time take on regional and even global roles within an international group, depending on the subsidiary and the international group.

The outcome will be affected by many factors, including the talent of the Australian workforce and management, economic and other comparative advantages and the networking ability and entrepreneurship of the Australian managers. In our view, the international company looking to enhance an Australian subsidiary's role will consider the Australian tax environment as a factor in agreeing to or shaping the local subsidiary's role.

A major Australian tax constraint on maximising the role of a local subsidiary is the Australian capital gains tax system and its effect discussed above. In this chapter we recommend that this impediment be resolved, in Recommendation 8.

31 J. Birkinshaw and N. Hood (eds), *The Multinational Corporate Evolution and Subsidiary Development*. Macmillan, London, 1998, and the work done for the Invest in Sweden Authority, eg "I huvudet på ett företag: *om huvudkontorets roll och lokalisering*", (*loosely translated by us as* "In the mind of a company – the headquarters (head office) role and location".) Pontus Braunerhielm, Julian Birkinshaw, Mats Forsgren, Ulf Holm, Invest in Sweden Agency, 1999. A useful literature review of recent thinking about strategies and structures of multinational corporations is "From M-Form to N-Form: The Structure of Multinational Corporations, Bjorn Alarik, Goteborg University, 2000.

There are other Australian tax constraints, which also require action:

- Australia's unhelpful CFC rules which make it inappropriate to have foreign subsidiaries owned by an Australian subsidiary (see chapter 5) especially if the Australian subsidiary is to have a significant management role (see chapter 6);
- the lack of amortisation for many intangible assets, and the Australian Double Tax Agreements which allow foreign countries to tax dividends, interest and royalties paid to Australia at excessive withholding tax rates (compared with payments to subsidiaries located in other countries) (see chapter 8);
- an unhelpful environment for the short-term transfer of foreign executives and researchers, from a tax viewpoint (see chapters 10-12).

4.3 Conduit holding company and CGT reform

To overcome the CGT disincentives, we propose a conduit holding company (CHC) regime to allow the foreign income (including capital gains) of certain regional holding companies to flow through to their foreign shareholders free from the imposition of Australian tax. The purpose of a CHC regime is to promote the international status of Australian subsidiaries of international groups in their corporate groups and regionally. This will enable the subsidiaries to grow in size and in finance, increasing their scale and Australia's service sector – particularly the growth of management, financial, advisory and other headquarter support industries which flow from a headquarter location.

We also consider the position taken by Australia in relation to CGT and DTAs.

4.4 Consistent with existing taxation concepts

Put simply, Australia has never taxed the foreign source income of non-residents. We believe the same policy principle should apply to **foreign capital gains of Australian companies owned by foreign investors**. Many other countries recognise this principle also and are currently refining their taxation systems along these lines.

We have discussed at Chapter 3 and Appendix 3A, the policy justification for foreign source income to be distributed to non-residents without the imposition of Australian income tax. The Australian taxation law already recognises the policy that foreign source income derived by non-residents should be exempt from Australian tax[32]. This principle should be extended to accommodate the flow through of capital gains on foreign active assets, made by non-resident shareholders of Australian holding companies. From an administrative perspective, the treatment of conduit income could operate through an extension of the current FDA concept.[33]

Conceptually, where non-resident shareholders have funded investments in **non-Australian assets**, there should be no incidence of Australian tax simply because they have chosen to own the assets through an Australian company. To do so would be to provide and perpetuate the disincentive that currently exists to use Australia as a holding country for regional investors.

The trend emerging strongly from Europe is the exemption from CGT on the sale of both foreign and domestic subsidiaries

This measure should be revenue positive, as it will encourage greater Australian employment and involvement in the management of international activities.

32 Section 23(r) of the ITAA 1936

33 It is noted that RBT proposed to replace this with a broader foreign income account concept

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4.5 International comparisons

CGT reform is a trend emerging strongly from Europe, going so far as providing an exemption from CGT on the sale by companies of both foreign and domestic subsidiaries.

4.5.1 Concessions for all corporate restructures

Various European countries have introduced schemes for participation exemptions. A participation exemption is a special purpose capital gains tax concession, predicated on the following policy principles:

(a) Businesses in a particular country will often create business structures such as subsidiary companies in other jurisdictions, or alternatively foreign investors will create or acquire subsidiaries in a particular country.

(b) Where the investments are significant (as distinct from mere portfolio investments), if there is a reorganisation, or if the investment is sold, the gain is free from capital gains tax. This generally recognises that the relevant gain either belongs to a non-resident and is foreign sourced, or will be taxed at the time when it is distributed to shareholders.

(c) The CGT concession is carefully structured, so that ordinary portfolio investments continue to attract capital gains tax.

A full participation exemption has existed for many years in the Netherlands and Luxembourg, and has been introduced recently in Germany and Spain.

The UK has decided, following consultation in July 2001[34], to introduce a "substantial shareholdings capital gains exemption". Draft legislation has been published for exempting capital gains and losses realised by companies on the sale of substantial shareholdings in trading companies:

- Effective for disposals on or after 1 April 2002.
- For 'substantial' holdings (for holdings of at 20% or more at time of writing).
- Extending to transactions with overseas group companies which should therefore facilitate group reorganisations.
- With rollovers (ie capital gains deferral) of certain deemed disposals on the occasion of a company leaving a group on or after April 2002.

Germany has introduced a tax exemption for capital gains generated by a German company as a result of the disposal of shares in German companies commencing from 1 January 2002. German companies had enjoyed a tax exemption for capital gains on the disposal of shares in foreign corporations, subject to a 10% minimum shareholding requirement. That minimum shareholding requirement was removed effective from 1 January 2001. A full CGT exemption system has applied in Spain since 25 July 2000.

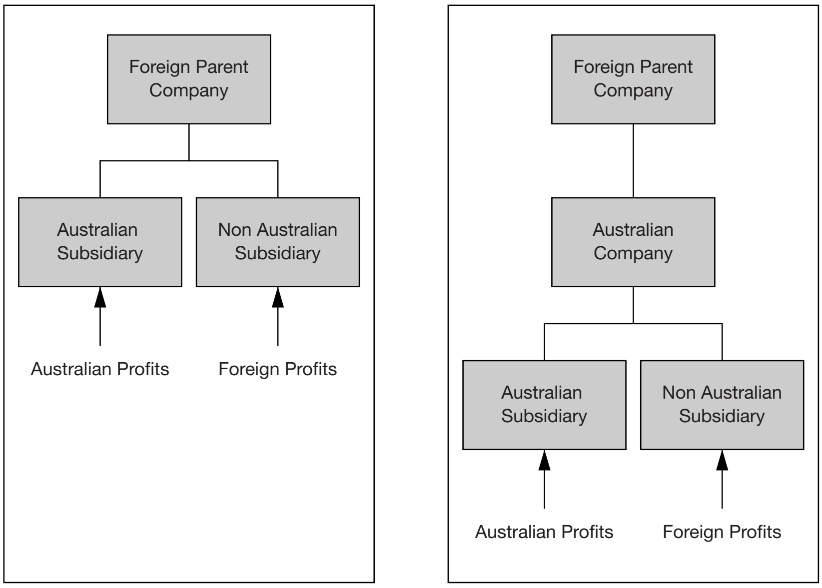
4.5.2 Concessions for conduit groups

We note further that many countries have developed specific concessions for regional headquarters, which are tailored to attract international businesses to locate in those countries. We have summarised a sample of these concessions at Appendix B of this Report.

So, we consider that Australia should allow for the creation of a tax rule which means that a foreign group with foreign and Australian companies (left hand side of Table 4.2) should have no disadvantage from creating an eligible Australian holding company (right hand side of Table 4.2).

34 Large Business Taxation: The Government's strategy and corporate tax reforms. A consultation document, HM Treasury, Inland Revenue, July 2001

Table 4.2 Australia needs to align Australian tax outcomes in the two situations below



With no Australian company — With Australian Holding Company

Australia currently collects minimal tax revenue from foreign owned groups disposing of overseas subsidiaries, because Australia's CGT system is a disincentive to foreign company groups from making any such investments through Australia …

4.6 A Conduit Holding Company regime

Recommendation 8: Conduit Holding Company ("CHC") regime

A CHC regime should be introduced which will provide a CGT exemption for gains realised on **non-Australian assets** held by CHCs where those gains flow through to non-resident shareholders.

The concession may be available to all non-resident shareholders or restricted to residents in Treaty countries. If the concession was to be restricted to companies owned by treaty-resident investors then the concession should apply to disposals of subsidiaries wherever they were resident. If the concession applied to Australian companies controlled by foreign investors in any country, then there might be scope to restrict the concession.

CHCs should be defined to include companies that are incorporated in Australia, with a prescribed level of foreign ownership.

The exemption should apply where the Australian company is a wholly owned subsidiary of a foreign group. A lower level of foreign ownership might also qualify; for example at least 50% controlled or owned by non-residents. The eligibility criteria might be aligned with the definition of foreign-owned entities for purposes of the thin capitalisation rules.

A CHC would continue to be subject to Australian tax on the disposal of any Australian assets.

Recommendation 8: Conduit Holding Company ("CHC") regime (continued)

A CHC would attract additional Australian tax concessions in two circumstances, being an extension of the current law and policy that capital gains realised on the disposal of **active businesses** owned by CFCs of an Australian company are not taxed. No Australian tax would be imposed on:

(a) Capital gains realised on disposal of **shares in CFCs** of the CHC where there is an underlying active business.

(b) A proportion of **capital gains realised by the non-resident investors** on disposal of shares in the CHC, corresponding to the unrealised gains on non-Australian assets held by the CHC.

To be eligible a CHC would require a substantial presence in Australia with, among other possible criteria, employment of a given number of employees in the CHC or associated Australian companies. Registration as a CHC would be required.

The CHC regime could apply only on a prospective basis eg for assets acquired after the date of commencement of the concession.

CHCs should be defined as a minimum to include companies that are incorporated in Australia, which are 100% foreign owned. A less-than-100% foreign ownership might also qualify; for example at least 50% controlled or owned by non-residents (the eligibility criteria might be aligned with the definition of foreign-owned entities for purposes of the thin capitalisation rules).

This would cater for joint venture investments into Australia especially where a foreign "partner" is involved. It is typically the foreign "partner" of an incorporated joint venture, which is disadvantaged by Australia's tax regime and generally demands that the holding entity and headquarters be located outside Australia.

… this measure should be revenue positive in encouraging greater Australian employment and involvement in the management of international activities

A CHC would continue to be subject to Australian tax on the disposal of any Australian assets.

A CHC would attract additional Australian tax concessions in two circumstances. This policy is an extension of the current law and policy that capital gains realised by CFCs on disposal of **active businesses** owned by CFCs are not taxed to an Australian company.

The concession should provide that no Australian tax would be imposed on:

(a) Capital gains realised on disposal of **shares in CFCs** of the CHC where there is an underlying active business.

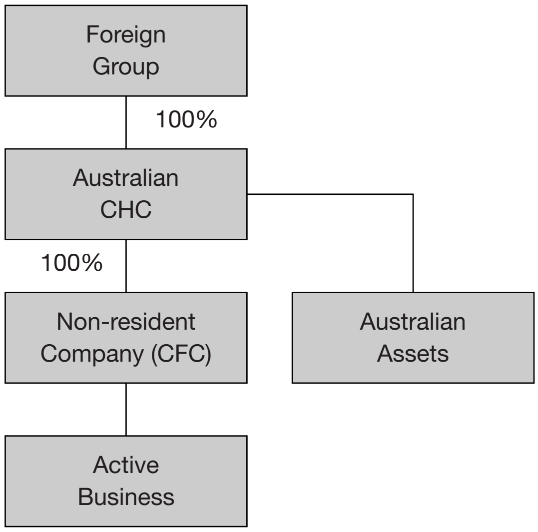
(b) A proportion of **capital gains realised by the non-resident investors** when they disposed of their shares in the CHC, corresponding to the unrealised gains on non-Australian assets held by the CHC.

For example, if a non-resident disposed of an interest in a CHC and the gain was attributable 60% to overseas subsidiaries, then 60% of the gain would not be taxed in Australia and 40% of the gain would be taxed by Australia.

This extension of the principle to flow through tax **exemption of unrealised gains is vital**. Otherwise, a disposal by a non-resident of its interest in the CHC (for example, in the context of a major international restructure, perhaps following a takeover) would create a tax trap in Australia. If the proportionate flow-through treatment were not available, the concession would be undermined and would be ineffective.

Example 4.1

Assume that a foreign group owns 100% of an Australian company to be designated as a CHC. The Australian company has Australian assets which are valued on 1 May 2001 at $60 million, and acquires a new subsidiary in Asia Pacific on 1 May 2001 for $A80m. Assume that over four years the activities grow and in 2005 the Asia Pacific subsidiary is sold for $A100m. Under the CHC concession, the gain of $20m (being $100m minus the $80m cost price) would be free of Australian tax, whether or not it was distributed to the foreign investor.



If the gain were re-invested in Australia to generate future growth then that future growth would be taxed in Australia.

Alternatively, assume that in 2005, the foreign group sells the Australian subsidiary, complete with its Asia Pacific and Australian businesses to a new foreign owner. Assume that the sale price of the Australian subsidiary reflects an increased value of $A20m attributable to the foreign subsidiary, and a further increased value of $25m on the Australian business. In this situation the CHC concession would allow the foreign vendor a tax-free gain of $20m (representing the gain attributable to the foreign subsidiary). The $25m gain attributable to the Australian assets would attract Australian tax.

This principle is consistent with Australia's long-term tax policy, since if the foreign investor held the foreign subsidiary directly Australia would impose no tax on the gain.

As noted, we recommend that this concession would apply prospectively only to new foreign subsidiaries. Various rules would be designed to prevent "freshening up" of the status of foreign subsidiaries and we expect that the need for such rules would be minimal given that most foreign companies have bypassed Australia as a regional holding company location for the last 16 years since the introduction of CGT.

The implications of this proposal are as follows.

4.6.1 Where an active foreign business is sold

Where a non-resident subsidiary of an Australian resident disposes of an active business, an exemption is currently provided under the CFC rules to ensure that the gain is not attributed to the Australian resident. Under the existing CFC rules, where the CFC distributes the gain to the Australian company, the distribution will not be taxable to the Australian company where it has been paid from a non-resident in a listed country. Where it is paid from a company in a non-listed country it will be taxable with a foreign tax credit.

Where the capital gain is subsequently paid to a foreign shareholder the dividend will be exempt from dividend withholding tax to the extent of any franking credit or FDA credits. So, under current law, the gain on the active business may flow through the Australian CHC with no Australian tax (if from a listed country) or with some top up tax where subject to a foreign tax credit.

The CHC proposal is an extension of this treatment to all other gains referable to foreign assets, as follows.

4.6.2 Where a CFC holding a foreign active business is sold

The disposal of shares in a CFC should attract the same concession under the CHC proposals to the extent of underlying active assets of the CFC.

4.6.3 Where a foreign owner sells their shares in the CHC

Where the disposal of shares in the CHC results in a gain, an extension of the CHC approach is to exempt that part of the gain referable to the gain in the underlying foreign assets.

This is consistent with the FDA and FIA treatment of foreign income flowing to foreign shareholders.

4.7 Anti-abuse provision: substantial presence

In order to ensure that the CHC achieves its desired outcome of increasing “headquarter” industries and employment in Australia, the concession could be offered only where the CHC has a substantial presence in Australia. Requirements could include:

(a) The CHC must establish an Australian business in the CHC or an associated company;

(b) The employment of a given number of employees; and

(c) Registration requirements similar to those that apply to management investment companies or foreign venture capital investors.

In order to ensure that the CHC achieves its desired outcome of increasing “headquarter” industries and employment in Australia, the concession could be offered only where the CHC has a substantial presence in Australia.

Such transparency and business substance should be consistent with any OECD trends.

Further, the CHC regime should apply only on a prospective basis to cover only assets acquired after the date of commencement of the regime.

4.8 Revenue costs

We see the revenue costs of this measure as small. In fact the measure may be revenue positive in encouraging greater Australian employment and involvement in the management of international activities.

Australia currently collects minimal tax revenue from foreign-owned groups disposing of overseas subsidiaries, because Australia’s CGT system is a disincentive to foreign company groups from making any such investments through Australia.

4.9 Australia's position on CGT exemptions and DTAs, particularly for DTAs negotiated before Australia introduced CGT

Foreign investors will generally be subject to CGT on all real estate, share investments and assets associated with a branch in Australia. Some exceptions exist for non-residents for portfolio investments in shares, for example where their holding is less than 10% and the shares are in a publicly listed company. There are other variations for non-resident investors, but in broad terms, there is marginal difference between non-residents and residents when it comes to the taxation of capital gains.

Australia has concluded DTAs with various foreign countries which are designed to avoid double taxation and regulate the sharing of taxing rights over affected income. Typically, the DTAs concluded by Australia since the introduction of CGT in 1985 have Articles setting out the circumstances in which the residents of the other treaty country will be free from Australian CGT, and vice versa, the circumstances in which Australian residents will be free from foreign CGT.

For DTAs concluded before the commencement of Australia's CGT, the ATO is currently taking the position that various DTAs do not give the non-residents any protection from Australian CGT.

The ATO has issued a Draft Taxation Ruling TR 2000/D12 (some 15 years after the introduction of the CGT) asserting Australia's power to impose tax on capital gains generated by non-residents from the disposal of Australian assets notwithstanding the apparent effect of Australia's various DTAs.

The ATO has issued a Draft Taxation Ruling TR 2000/D12 (some 15 years after the introduction of the CGT) asserting Australia's power to impose tax on capital gains generated by non-residents from the disposal of Australian assets notwithstanding the apparent effect of Australia's various DTAs

This means that residents of the relevant treaty countries, who acquired assets after the commencement of CGT, or who undertake transactions which fall within the CGT net, will be exposed to Australian CGT without the benefit of DTA protection.

The Draft Ruling states that the ATO position is based on a holistic view of the contextual matrix of pre-CGT treaties. It does not rest on any particular point, but a number of factors that collectively indicate that capital gains were not covered in pre-CGT treaties (except Austria) and distributive rules in these treaties did not limit taxing rights over capital gains[35]. Many commentators and advisors have noted that the basis for the interpretation taken by the Commissioner in the Draft Ruling is questionable.

Treaties are designed to remove the barriers to the free flow of capital across international borders. The interpretation suggested by the Commissioner in the Draft Ruling at the very least conveys a message of fiscal uncertainty to non-resident investors, many of who believed that they were afforded relief under the DTAs.

35 The Draft Ruling relates to the construction of the following treaties and whether or not they have coverage to capital gains generated by entities where those gains are subject to income tax under the capital gains tax ("CGT")) rules introduced by Australia in 1985 to:

– the treaties referred to as the "pre-OECD" treaties, that is, the treaties entered into before Australia became a member of the OECD and signatory to the model treaty – the treaties involving: 'pre-CGT treaties': United Kingdom (1967); Japan (1969); Singapore (1969); Germany (1972); New Zealand (1972);

– The "post-OECD" and pre-CGT treaties, that is those entered into with France (1976); Netherlands (1976); Belgium (1977); Philippines (1979); Canada (1980); Switzerland (1980); Malaysia (1981); Sweden (1981); Denmark (1981); Italy (1982); Korea (1982); Norway (1982); USA (1983); Ireland (1983); Malta (1984); Finland (1984); and Austria (1986 – negotiated and agreed before the Australian CGT although assented to in Australia after the CGT).

The line taken is that "dealing with capital gains in the pre-CGT treaties … CGT was a contentious domestic issue. Further, (as Australia's post-CGT treaty practice clearly shows) Australia's economic interests were not perceived to align with allocation of taxing rights under the OECD Model's *Capital Gains* Article. By not dealing with capital gains in pre-CGT treaties, Australia avoided referring to this contentious domestic issue while preserving its freedom of action to subsequently negotiate appropriate taxing rights over capital gains if a CGT was introduced."

Recommendation 9: Australian CGT and pre-CGT DTAs

We recommend that Australia consider the international impact of the position taken by the Commissioner, in Draft Ruling TR2000/D12. This requires:

- urgent action to resolve the issue in negotiations with the relevant DTA treaty partners; and
- potential trade-off of this ATO position for negotiated concessions from treaty partners, notably in their elimination or reduction of DWT in relation to dividends paid by companies resident in those countries to Australia.

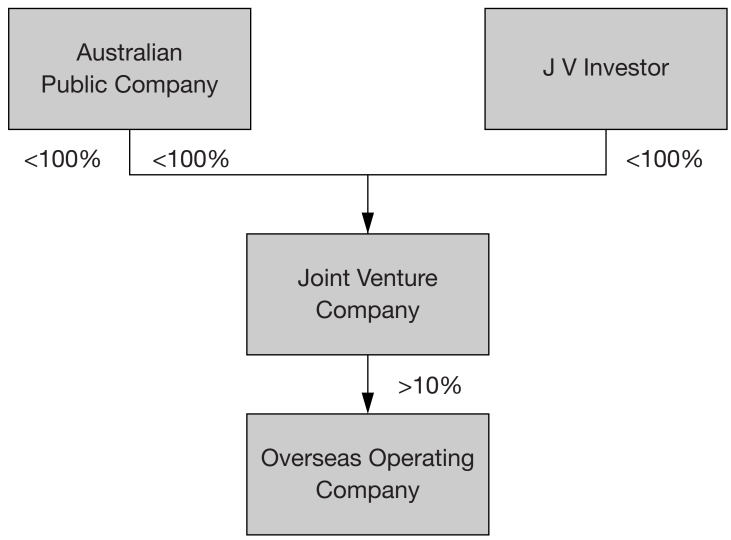
4.10 Extension of the CHC principles to Australian companies

It is clear that some adjustments are required to recently introduced Australian taxation laws which now prevent dividend rebates for unfranked dividends from non-wholly owned companies, where foreign investments are concerned.

This feature of Australia's tax law, introduced in the recent tax reform process, has the (probably inadvertent) effect of forcing joint venture management companies, with significant offshore operations, out of Australia.

Take for example the following structure for an investment in a joint venture.

Table 4.3 Australian investment in Joint Venture



In this situation an Australian company and another investor have created a joint venture company to invest, inter alia, in an overseas location. The flow of distributions of foreign taxed income from the jointly held Joint Venture Company to the Australian Public Company, as illustrated in the above diagram, is materially affected by the removal of the intercompany dividend rebate. **The Australian public company will now be fully taxable in respect of any unfranked dividend which it receives from the Joint Venture Company if the Joint Venture company is an Australian resident company.**

This is a worse position than if the Australian public company had invested directly into the Overseas Operating Company. In such a case, provided a 10% or more voting interest was held, the foreign dividend would be exempt (if paid from a listed country) or receive the benefit of any underlying foreign tax credits.

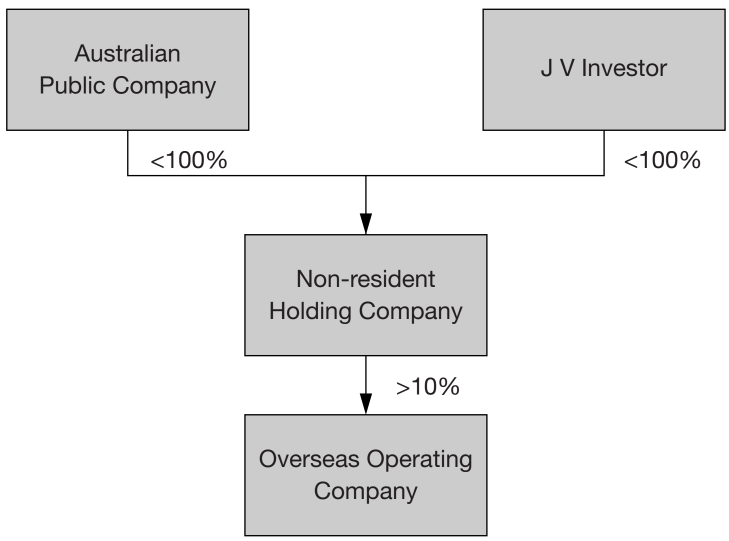
Under this structure, the Australian public company will enjoy either a tax exemption or full relief for its share of the foreign tax paid by the overseas companies when dividends are received via the Non-Resident Holding Company.

This distinction places Australian multinationals at a significant disadvantage compared to foreign counterparts in analysing and undertaking such overseas investments. In addition, it invites difficulties for joint venture relationships in settling a common distribution policy of the jointly owned entity.

Importantly, it discourages the establishment of joint venture centres as Australian based companies.

The potential solution is to **create a foreign joint venture holding company**, which is counterproductive for Australia.

Table 4.4 Tax-driven structure which bypasses Australia



Recommendation 10: Adjust Australian dividend rebate rules to allow for rebates from holding companies that hold foreign subsidiaries

Australia's dividend rebate laws should be adjusted to allow intercompany dividend rebates to be preserved for dividends from jointly owned Australian companies which own foreign subsidiaries, to the extent the dividend is attributable to income from foreign subsidiaries.

4.11 Consistency with OECD trends

This White Paper assembles a series of recommendations, which ought to be achievable in a short time in Australia. We have deliberately not sought to introduce concessions such as those which have been utilised by highly successful emerging countries to grow their economies quickly. Accordingly, we do not suggest concessions such as those offered by Singapore, Ireland or Israel. Also, the recommendations in this White Paper should not cause difficulty with the OECD "harmful tax competition" initiative.

The OECD has in recent years been increasing its focus on Harmful Tax Competition. It is clear that the OECD initiatives[36] allow tax competition. The OECD initiative is against preferential tax regimes designed "specifically to attract those economic activities which can be most easily shifted in response to tax differentials, generally financial and other service activities and from passive investment rather than income from active investment."

The OECD does not prevent tax competition or the achievement of efficiency in Australia's tax system. It has not prevented significant change being implemented in the last two years in United Kingdom, Germany and Sweden.

Four key factors assist in identifying harmful preferential tax regimes:

(a) a low or zero effective tax rate on the relevant income;

(b) the regime is "ring-fenced";

(c) non-transparent tax laws;

(d) little or no exchange of information with other countries, and

with further criteria including whether the regime generates significant new activity and the presence and level of activities in the host country.

The recommendations outlined in this White Paper are designed to generate economic activity in Australia, real substance and not "brass plate" companies. We consider that these would not fall into the category of harmful tax competition.

Indeed, the recommendations in this White Paper have been carefully chosen so as to align themselves to recent international developments.

The removal of manifest inefficiencies in Australia's tax system hardly represents harmful tax competition on an international scale.

We note also that the United States has dissociated itself from this initiative and that after significant business input, the OECD has recognised that its aims are NOT to set minimum levels of taxation, nor to endanger commercially useful structures or cross-border investment flows.

36 "Harmful Tax Competition; an Emerging Global Issue" – OECD 1998

5. Controlled Foreign Company Measures Need Reform

The foreign source income of Australian-based multinational companies is taxed under the CFC rules, the Foreign Investment Fund ("FIF") rules and foreign tax credit rules.

The CFC rules impose tax on an accruals basis, on certain income and gains which are generated by "controlled foreign companies" (CFCs) which income is passive in nature, or transacted between related parties, and not subject to "comparable" tax in the foreign country.

Passive income for this purpose includes the CFC's royalty income, interest income, service fees charged to associated companies and sales of goods to associated Australian companies.

5.1 The changes needed

In summary, we believe the CFC measures require significant reform in three principal areas.

In summary, we believe the CFC measures could benefit from significant reform in three principal areas

(a) The 1997 changes to the CFC provisions had the effect of increasing the compliance costs for Australian companies with overseas subsidiaries, by reducing the number of "listed countries" from sixty to seven "broad-exemption" listed countries. These changes were possibly somewhat misconceived and require review.

(b) Capital gains tax rollover relief needs to be introduced for Australian companies with CFCs. Reorganisations of CFC groups should benefit from CGT relief similar to that available for Australian-based subsidiaries. An attractive option would be a "participation" exemption for the sale of shares where the underlying assets are active assets, similar to that available in many European countries (see 5.3). Similarly, where a CFC in a "broad-exemption listed country qualifies for local CGT relief, there should be no requirement for attribution.

(c) With Australia's strong transfer pricing regime introduced in recent years, the CFC rules dealing with cross-border services income now needs to be reconsidered and significantly reduced in scope.

The CFC rules were introduced at a time when Australian businesses generally were not active in the international supply of services. Since then, Australian companies have grown internationally in line with the expansion in service industries globally. This exacerbates the inappropriate treatment of services in the original CFC rules.

Companies in the business of the provision of services (e.g. media, telecommunications, professional services) are particularly adversely impacted by these rules because such companies may fail the active income test despite being active businesses.

5.2 Background to the CFC measures: a 1990 solution

Before the introduction of the CFC measures, from 1987 to 1990, Australia taxed foreign income under a general foreign tax credit system. The CFC rules were introduced in 1990[37] having been foreshadowed in a Consultative Document on 25 May 1988.

While complex, the original CFC laws were relevant to the times and followed significant consultation and business input.

Under the CFC rules, Australian companies became liable to pay tax on income earned by many CFCs in which they have a relevant controlling interest, notwithstanding that the income was yet to be derived or remitted to the Australian taxpayer. The CFC rules did not apply, however, to companies which were resident in the listed countries (approximately 60), except for certain designated income.[38]

5.3 Key design and policy features of the CFC rules

The CFC measures were introduced for reasons including:

Australian business participates in strategic joint ventures internationally. Joint venture companies are likely to be subject to the CFC rules, which … means that Australian companies' participation restricts the business activities of international joint venture companies.

- The foreign tax credit system provided a disincentive to remit income from overseas companies back to Australia. This was especially the case where the Australian tax rate was higher than in the country where the income was sourced.[39]
- The administrative and compliance burden associated with claiming the foreign tax credits was great compared with the revenue generated.

The CFC rules were therefore primarily aimed at the generation of income and gains which supposedly belonged in Australia but which were able to be located in an offshore jurisdiction with a lower tax rate.

The CFC measures were introduced when Australia had a relatively undeveloped administration of Australia's transfer pricing rules.
This is no longer the case[40].

The original 1990 design of the CFC rules was influenced by a need to keep the compliance costs associated with the measures reasonably under control.

For this reason, the jurisdictional limitations of the measures were put in place using a list of comparably taxed countries.

The CFC measures were introduced when Australia had a relatively undeveloped administration of Australia's transfer pricing rules. This is no longer the case.

As discussed below, Australian-based international businesses now operate in a different environment. The CFC measures need to change too.

37 in the *Taxation Laws Amendment (Foreign Income) Act 1990*

38 Eligible Designated Concession Income (broadly, some items of income which was subject to low or minimal tax in the listed countries) remained subject to attribution

39 Under the foreign tax credit system, income could be accumulated in an offshore location until remitted back to Australia. This problem was particularly acute where the income was sourced in a tax haven and could be lent back to the parent company without taxation implications. Furthermore, there was no legislative provision that could deem loans from the offshore subsidiary to the parent company to be dividends. This issue was magnified by Australia's high corporate tax rates at the time – 1987/88 – 49%, 1988/89 – 39%

40 The Australian Taxation Office significantly enhanced its administration, policing and information-gathering of transfer-pricing issues in the 1990s, including the development of new forms in business income tax returns, major rulings, significantly enhanced auditing and policing activity and an emphasis on taxpayer agreements with the ATO on transfer pricing policies

5.4 CFC rules – changed policy environment

With Australia's dividend imputation system, many resident corporate groups look for ways to generate profits in Australia rather than in a foreign country since they would prefer to substitute Australian tax for foreign tax.

The reform of the CFC rules needs to be considered in the context of:

(a) Australia's lower and more internationally competitive company tax rate. Australia's tax rate is now as low, or lower, than most comparable countries.

(b) A more favourable treatment of capital gains both internationally and in Australia.

(c) Australian business participation in strategic joint ventures internationally. Joint venture companies are likely to be subject to the CFC rules, which increases the likelihood of transactions that lead to attribution, and means that Australian companies' involvement restricts the business activities of international joint venture companies.

Many businesses have adopted **international supply chain processes that now involve many more intragroup transactions and relationships**. The CFC rules therefore have a greater reach and adverse impact now than in 1990.

The CFC rules impact adversely on the greater use of shared service centres and regional headquarters in offshore subsidiaries of Australian companies. These centres provide services to overseas business units in the corporate group, and are taxed inappropriately by the CFC rules, to the extent that the offshore subsidiaries' service income is attributed to and taxed in Australia.

Australia's transfer pricing laws have been strengthened in the last 10 years. Consequently, Australian companies providing services to their offshore subsidiaries are now required to properly apply transfer pricing methodologies to intercompany charges. CFCs themselves also require transfer pricing policies relating to their intercompany charges. Therefore, the relative importance of the CFC rules from a revenue raising perspective should be less of a concern, in the context of services and sales transacted between related parties.

The rationale for the 1997 restriction of the number of comparably taxed countries was very weak. Treasury and the ATO considered that they could not monitor tax deferral opportunities in the tax systems of so many countries. This has completely undermined the rationale for the listing approach.

We consider that any revenue concern about related party services and intercompany trade in goods should be dealt with by the use of transfer pricing measures. This approach is preferable to a blanket measure such as the CFC rules, which cover all services and trading companies and seek to attribute the offshore subsidiaries' income to the Australian parent.

All of these developments point to the need for a more favourable approach to the treatment of the policy underpinning CFC taxation.

5.5 CFC rules – 1997 changes poorly developed

Until 1 July 1997, the "listed" countries specified in the Regulations comprised approximately 60 countries that had a tax rate and tax system roughly comparable to Australia's. Where a CFC was resident in a listed country, the presumption was that the income earned by a CFC had been fully taxed and should not be subject to tax again in Australia by way of attribution.

From 1 July 1997, the "listed" countries, for the purpose of the CFC regime, were reduced seven "broad-exemption listed countries" and the remaining previously "listed" countries became "limited-exemption listed countries". These changes effectively reduced the size of the comparably taxed countries from around 60 to seven[41]. This reduction excluded 22 current OECD countries from being treated as comparably taxed.

The rationale for the 1997 restriction of the number of comparably taxed countries was very weak. Both Treasury and the ATO considered they could not monitor tax deferral opportunities in the tax systems of so many countries. This has completely undermined the rationale for the listing approach and deserves revisiting for this reason alone.

We believe that the administrative requirement for the ATO to consider each country's regime should be dealt with in a different way, focused on the perceived problems.

As a minimum, we would recommend the following:

(a) It would be possible for the government and ATO to generally designate any tainted income that is subject to a reduction of tax in a "limited-exemption" listed country.

(b) Alternatively, the list of seven "broad-exemption" listed countries should be reviewed periodically for the inclusion of other countries with, for example, comprehensive CFC and FIF regimes.

(c) Guidelines should be considered outlining the criteria for listing of other countries in the future.

The rollovers currently allowed under the CFC measures are extremely restrictive and restrict Australian multinationals operating offshore whenever they reorganise their operations

The 1997 policy change has increased compliance costs for business. It has the effect of now imposing Australian tax on passive income even if it is subject to comparable rates of tax in limited-exemption listed countries. The rules tax the income derived by a foreign company as part of the conduct of an **active business**, in circumstances where the Australian tax base is not at risk. Minimal Australian tax is collected, because the income from limited-exemption listed countries typically carries foreign tax credits, which offset or exceed Australian taxes. Therefore, the 1997 changes add cost and complexity with little economic advantage for Australia or Australian business.

The interaction of the listing approach and the treatment of passive income have never worked well. The measures have always worked to tax more income in comparably taxed countries than was the original intention. There has been a significant increase in the compliance work involved in assessing attributable income where passive income is earned in comparably taxed countries.

Recommendation 11: 1997 changes to the CFC regime were misconceived and need to be reviewed

The 1997 changes to the CFC measures restricting the number of countries falling within the "broad-exemption listed" countries were misconceived and not the subject of properly considered consultation with Australian outbound investors.

The CFC measures must be independently reviewed as a matter of priority to ensure that, consistent with their original broad policy intent, they are only applicable to cases of potential avoidance and do not impede genuine business operations. The reduced list of countries is inappropriate and should be expanded to include most of the countries with which Australia has a Double Tax Agreement and, in particular, Australia's major trading partners in the Asian region.

41 Those seven countries are the United Kingdom, the United States of America, New Zealand, Japan, Canada, France and Germany

Companies are afforded rollover relief where … companies amalgamate or merge … the relevant sections of the UK legislation are not restricted by reference to a country of incorporation or by reference to the residence of the acquiring company

5.6 Reorganisations of CFCs raise many Australian tax problems

The RBT did not have time to perform an exhaustive review of the CFC rules, but recommended that such a review be performed in the future.

One area where we believe that immediate reform is required is the availability of Capital Gains Tax (CGT) rollover relief in the CFC context. Put simply, Australian taxpayers face major international tax impediments in reorganising their CFC groups.

The rollovers currently allowed under the CFC measures are extremely narrow and restrict Australian multinationals operating offshore whenever they reorganise their operations. At present, unless the asset in question has the necessary connection with Australia, an asset owned by an Australian company may not be transferred to a CFC and gain the benefit of rollover relief.

This severely restricts the ability of Australian multinational companies to rearrange their offshore holding structures in the most commercial and tax efficient manner. This may impose legal structures on company groups that are not consistent with their management structure. It may also increase foreign taxes on the remittance of funds from CFCs to Australia.

The current capital gains tax rollover relief provisions need to be extended to ensure that Australian businesses can enter joint ventures, or undertake group reorganisations using a scrip takeover or on an asset-for-scrip basis without suffering major tax imposts.

Australia's capital gains tax regime is extended by the operation of the CFC rules. Specifically, if a capital gain is realised by a CFC that is not taxed in the CFC's country of residence, the gain will generally be attributed back to the Australian parent and taxed in Australia.

Example 5.1

Assume an Australian company group has a subsidiary in New Zealand and it disposes of its shares in a related entity for a profit. The profit would be subject to Australian tax by virtue of the combination of Australia's capital gains tax rules and CFC rules, simply because New Zealand does not tax capital gains.

The same analysis would apply to a "notional" gain as well as to an actual gain. This notional gain would arise from the application of deemed market value disposal rules in Australia's capital gains tax regime combined with the CFC rules. This would apply if the shares in the New Zealand subsidiary, in the above example, were disposed of for a nominal or book value consideration where the market value was significantly greater.

Therefore, a simple reorganisation of the affairs of (say) a New Zealand subsidiary, or a 50% joint venture interest at nominal or book value would give rise to this problem – although no real gain has been realised.

This problem restricts the ability of Australian corporate groups to reorganise to deal with excessive cross-border taxes on funds flows.

Competitors in those jurisdictions can periodically restructure and enter commercial mergers and joint ventures without the same limitations as are placed on subsidiaries or affiliates of Australian companies. In the absence of this rollover, Australian companies may be forced to forego commercial opportunities that are available to foreign competitors.

Example 5.2

Assume an Australian company has an interest in several CFCs located in various countries[42] and that the remittance of funds from each of those CFCs would create unacceptable cross-border foreign withholding taxes. However, an alternative structure (say, reorganising the entities under a UK holding company) would allow a more efficient flow of capital.

The resulting structure would reduce foreign withholding tax and allow for the free-flow of capital both within the offshore corporate group and to Australia. However, the potential Australian capital gains tax exposure makes this structure unattractive.

There seems little reason why this restructure should create a capital gains tax impost since, by the application of the CFC measures, the assets remain wholly within the Australian tax net.

The RBT recommended that scrip for scrip rollovers should be allowed in the domestic context and this CGT rollover relief has been implemented. There is no logical reason why such rollovers and any further relief allowed for mergers in the domestic context should not be extended to the CFC regime.

Scrip for scrip rollover relief is a feature of the taxation regime in many other jurisdictions, including the United States, Canada and the United Kingdom.

In our view, the system in the United Kingdom is an appropriate starting point for a review of our rollover relief, given that the system is relatively simple and has a reasonable degree of flexibility. UK companies are afforded rollover relief where (amongst other things) companies amalgamate or merge; or where companies enter a scheme of reconstruction of reorganisation. Importantly, the UK concessions are not restricted by reference to a country of incorporation or by the residence of the acquiring company.

Recommendation 12: Scrip for scrip rollover in the CFC context

Australian rollover relief should be considered in the following circumstances:

- to allow for tax deferred rollover of assets between CFCs that are members of the same wholly owned group, irrespective of the countries of residence of the CFCs;
- for a CFC resident in a broad-exemption listed country where that relief is consistent with relief provided by the broad-exemption listed country; and
- for transactions in scrip for scrip transactions not involving wholly owned corporate groups, and
- no attribution should arise under the CFC rules for transactions involving foreign rollovers in comparable-tax countries.

The impact of this recommendation is as follows.

42 For example, United Kingdom, Germany and the Netherlands

5.6.1 CFC transfers shares in a non-CFC to a CFC

Where a CFC swaps scrip in a non-controlled foreign company for scrip in a new entity under a takeover, it is reasonable to allow a deferral of the capital gains tax liability. The transaction is merely the exchange of one economic interest for a similar economic interest, and the values of the interests are no different. This will have no detrimental effect, since the new shares received by the CFC will still be within the Australian tax net by the application of the CFC measures to the disposal of the newly issued scrip. In addition, by appropriate carry over of the cost base of the original shares to the new shares, the accrued gain on the shares exchanged will be fully reflected in the gain (if any) on disposal of the new shares.

5.6.2 CFC transfers shares in a CFC to a non-CFC

Where the CFC exchanges scrip in a second level CFC for scrip in another company, the same policy as for the transfer of shares in a non-CFC should also apply. In either case, there will be no ultimate detrimental effect on the revenue.

The new shares received will still be within the Australian tax net notwithstanding that the new holding company may not be a CFC or the subsidiary may, as a result of the transaction, cease to be a CFC.

The cost base of the new shares would be derived from that of the old shares.

5.6.3 Transfer of shares by a CFC to a partly owned CFC

In addition to considering scrip for scrip rollover, the simple transfer of shares to a partly owned subsidiary that is a CFC should be the subject of a separate rollover. A limited rollover already exists for assets transferred between group companies. However, the transfer of existing shares in a CFC for shares in another CFC, where those CFCs are not part of a wholly owned group, will not allow either the original shares or the replacement shares to escape the Australian tax net.

This rollover is commonly available in other countries. Competitors in those jurisdictions can periodically restructure and enter commercial mergers and joint ventures without the same limitations as are placed on Australian subsidiaries. In the absence of this rollover, Australian companies may be forced to forego commercial venturing opportunities that are available to foreign competitors.

This transaction would give rise to some issues that do not arise in respect of the scrip for scrip rollover. The most significant issue is that the original company could dispose of the interposed CFC without attribution under the CFC measures since the original company would have a full cost base in the interposed company's shares. They would require some protective measures to be drafted.

5.6.4 Non-attribution of some rolled-over CGT gains for CFCs

Where a **CFC in a broad-exemption listed country undertakes a CGT event where there is rollover relief** in the relevant domestic jurisdiction but not under Australian CGT rules, there should be no attribution of a capital gain. This would reduce significantly the amount of compliance costs for taxpayers and ensure economic gains are not taxed until realised.

5.7 Transfer pricing changes make CFC attribution less relevant

The combination of the transfer pricing regime with the CFC rules imposes difficult and costly compliance processes.

In the late 1980s, when the CFC measures were being designed … trading companies and service providers received harsh treatment under the definitions of tainted income … The rapid advances and changing nature of services in business now create a different environment.

Australian resident groups operating on an international basis must apply transfer pricing rules to transactions between Australian entities and foreign related parties. They must equally apply these rules to arrangements that exist between their related foreign CFCs.

Example 5.3

For example, an Australian group with a Singapore service entity providing services to a 100% affiliated entity in Malaysia needs to apply Australia's transfer pricing rules to those services and to ensure that an arm's length charge is being levied. This is despite the fact that neither the Singaporean, nor indeed, the Malaysian taxation authorities may be interested in the transfer pricing issue.

A further example is where one CFC in a particular country has lent funds (interest free) to a CFC of another country. Australia's transfer pricing rules would be applied to deem a notional interest return. The CFC rules would then have to be applied to determine whether interest income ought to be attributed back to Australia and taxed.

Recommendation 13: Given the transfer pricing provisions, reduce application of CFC rules to cross-country transactions

Given the increased level of focus and expertise of the ATO on transfer pricing, the interaction of the CFC regime and the transfer pricing provisions needs to be reconsidered.

Since the CFC measures were being designed, the expertise of both taxpayers and the revenue authorities has increased dramatically in this area and transfer pricing is now a key focus of revenue authorities around the world. Wherever the potential for profit shifting embodies a transfer pricing issue, the transfer pricing provisions should be used to address the problem and not the CFC measures.

5.8 CFC rules need to allow for offshore companies in service industries and providing services which are owned wholly or partially by Australian businesses

One of the concepts underlying the treatment of tainted income in the CFC measures was that of so called "footloose industries" with activities that can readily be shifted from one jurisdiction to another. The more mobile the industry, the more readily income can be shifted between jurisdictions.

However, the original policy approach was heavy handed and a number of changes have occurred since then that justify revisiting the policy.

In particular, the concept of 'footloose industries' was put into practice in a way that reflected an 'old economy' view of the world. In the late 1980s, when the CFC measures were being designed, manufacturing was regarded as relatively immobile and hence received treatment that is more favourable. Both trading companies and service providers received treatment under the definitions of tainted income in Sections 447 and 448 of the Income Tax Assessment Act. The rapid advances and changing nature of services in business now create a different environment.

This is highlighted in capital intensive industries such as telecommunications. For example, telecommunications services income of a CFC is treated as tainted where the services are provided to an associate or to Australian residents, notwithstanding the active nature of the services themselves and the capital intensive nature of the infrastructure, which can not easily be shifted from location to location.

Cross-country services are more significant among international subsidiaries of international groups.

The Australian tax environment is hostile to offshore service income received by CFCs' affiliated companies, except where the CFCs are located in the seven broad-exemption countries.

The Australian rules operate as follows:

- All service income received by a CFC from an affiliated company or Australian residents is treated as passive income.
- If the passive income received by a CFC exceeds more than 5% of its turnover, then that passive income is attributable back to Australia, suffers Australian tax and achieves a credit for any foreign taxes paid.

This has severe consequences where Australian-based international companies have networks of companies and establish a centralised or shared service location in one company …

This has severe consequences where Australian-based international companies have networks of companies, say in the Asia Pacific sphere, and establish a centralised or shared service location in one company rather than having the services wastefully duplicated in each of the operating entities. Having such a centralised services subsidiary in a CFC generates problems, because the charging by the CFC of service fees to the other operating companies creates passive income which is then taxed in Australia.

This problem is also particularly severe for companies operating active businesses that happen to be service-related rather than manufacturers of goods.

This problem is also particularly severe for companies operating active businesses that happen to be service related rather than manufacturers of goods. To the extent that an international group is in the services business, it is quite natural that some of those services will be provided to other companies within the group, to its shareholders, or to Australian customers.

It may be argued that such a tax cost is merely part of the cost which must be borne by Australian companies. But the problem restricts the ability of Australian companies to participate meaningfully in international business activity without causing distortions to the economic outcome.

If an Australian company is a significant joint venture shareholder in an offshore corporate group, the foreign company will be treated potentially as a CFC of Australia.

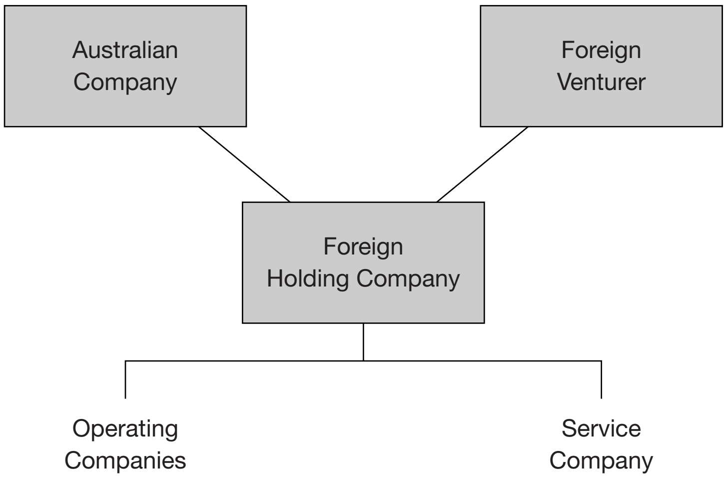
In particular, **if an Australian company is a significant joint venture shareholder in an offshore corporate group, the foreign company will be treated potentially as a CFC of Australia**. If that foreign joint venture group itself has service companies around the world, those service companies potentially create attribution of income to the Australian investor company, and distort the tax profile even where the minimisation of Australian tax is totally irrelevant to the corporate structure.

Example 5.4

Assume that an Australian company has a 50% interest in an international joint venture with a foreign venturer (say a US shareholder) and has management control. A new company is established in, say, Japan to conduct the international venture.

Assume that the joint venture company establishes subsidiaries in various countries in Asia and in Europe and establishes two service companies – one to serve the European subsidiaries and another to serve the Asian subsidiaries. Assume that the service companies are established in Belgium and Hong Kong respectively.

In this situation, the service companies will be CFCs (because the Australian investor's interest will be sufficient to constitute them to be CFCs) and the service income will be categorised as passive income. The service income of the Belgium and Hong Kong subsidiaries will be attributed to Australia.



Further, even if the Australian company had only a 40% equity interest but had management control of the international business the service companies would be taxed as CFCs.

The scenario and the impacts described above are further exacerbated if the business of the joint venture is to provide services like telecommunications or media, and where those services are provided to Australian customers. The expansion of Australian businesses through joint ventures with overseas partners is hampered by the CFC rules that disproportionately tax the Australian partner.

The net outcome of this feature of Australia's tax law is to:

(a) treat service companies associated with Australian entities in a harsh way;

(b) disadvantage the service and knowledge economy (through CFCs providing services and knowledge) as compared with CFCs which sell a product; and

(c) create additional impediments for Australian companies seeking to internationalise from an Australian base.

Recommendation 14: CFC rules need to allow for cross-border services without attribution

Australia's tax laws need policy adjustment to avoid Australia being an unattractive location for parent and conduit holding companies in the context of the provision of cross border services. Internationally traded services have become a major feature of the economic environment since the original measures were developed. Moreover, the heavy handed treatment of international services under the CFC rules is a disincentive to the location of international headquarters companies (with offshore subsidiaries) in Australia.

5.9 Option 2 and CFCs

The RBT recommended adoption of The Tax Value Method (commonly known as "Option 2"). This is under review by the Board of Taxation.

If this recommendation were implemented, there would be a basic change in the assumptions under which the CFC measures operate. In our view Option 2 should not be applied to CFC's at all and particularly not to the calculation of CFC income as this would overlay another level of complexity to these rules.[43]

Recommendation 15: Ensure that CFC income is not restated using Tax Value Method

If the Tax Value Method is adopted, it should not be applied to CFC's at all and particularly not to the calculation of CFC income.

5.10 Senate Select Committee on Superannuation and Financial Services

In March 2001 the Senate Select Committee on Superannuation and Financial Services published its report "The Opportunities and Constraints for Australia to Become a Centre for the Provision of Global Financial Services".[44]

In considering international tax measures, a number of constraints around the use of Australia as a financial services centre were identified in various submissions to the committee. These included:

- Various issues around the Australian offshore banking unit (OBU) measures which required technical correction and policy adjustment.
- Difficulties in relation to the treatment of foreign investment funds under the entity tax proposals previously planned to be introduced (collective investment vehicles).
- Issues around the Australian interest withholding tax rules.
- The need for adjustment of the inter-company dividend rebate rules to enable Australian companies to invest offshore using joint venture companies without tax disadvantages.
- The need for the Government to deal with the issues of "dividend streaming", a process whereby investors can receive particular types of income (such as dividends or interest) which have beneficial characteristics to them.

43 In developing the CFC measures, an extensive analysis of the existing law was conducted to determine what provisions should apply to the calculation of the attributable income of a CFC and, if applicable, what modifications were necessary in the context of the CFC measures. This same exhaustive analysis will need to be applied to the calculation of the attributable income of a CFC if Option 2 is implemented. The interaction of all the RBT changes, and especially Option 2 with the CFC rules needs comprehensive consideration before implementation.

44 The Parliament of Commonwealth of Australia, available on the Parliamentary website at www.aph.gov.au

- The current transfer pricing rules in Australia, which under an ATO ruling require a fixed mark-up to be charged on intercompany non-core services.
- Several issues surrounding the application of goods and services tax to OBUs and the treatment of share acquisitions on the US market.

The Committee noted cautionary remarks by the ATO in its final submission to the Committee, but stated its view that the **"Government should take urgent action to ensure that Australia's taxation system is at least competitive with other existing national regimes, compatible with the objective of promoting Australia as a global financial centre, and consistent with the necessity to provide a fair and equitable tax basis"**.

The Committee reviewed also the various problems and tax challenges revolving around the taxation of expatriate employees and inpatriate employees in Australia and made various recommendations.

We support the recommendations of the Select Committee, to the extent they are consistent with the recommendations of this White Paper.

The OBU concessions need careful attention to ensure that they are meeting the policy objectives of Government, to allow OBUs to operate in Australia attracting a 10% tax rate. It appears to us that these are so rigorously drafted that they do not allow commercial operation of OBU and related funds management activities in Australia:

The tax-related recommendations of the Select Committee were that:

Recommendation 4

In order to ensure that Australia has a competitive taxation regime, the Treasurer refer the taxation issues raised during the inquiry to the Board of Taxation for review and advice, and to take action as appropriate.

Recommendation 5

The Treasurer review the superannuation arrangements for expatriate staff, in order to ascertain whether:

- Superannuation Guarantee arrangements can be streamlined; and
- portability of funds for expatriate employees leaving the country could be effected more expeditiously through the present process of establishing bilateral agreements or through other, or interim measures.

Recommendation 6

The Board of Taxation review the arrangements for the taxation of salaries and remuneration for expatriate staff employed to work for varying periods of time in Australia and, within the limits and guides of the various international treaties, advise the Treasurer on whether or not:

- the systems or regimes are onerous or complicated making compliance by companies difficult;
- the systems or regimes are fair with respect to the levels of taxation required;
- the systems or regimes are sufficiently attractive so as to not unduly deter prospective employees from coming to Australia; and
- the current system of electing to defer tax to the time of ultimate realisation of assets is fair and equitable.

Recommendation 7

The Treasurer review the entitlements of expatriate staff to Medicare and consider ways to streamline the exemptions requirements.

6. Corporate Residency: The Central Management and Control Test

The CM&C rules … push the management of offshore subsidiaries out of Australia, with consequential adverse impacts for Australian employment and business development.

Australia taxes all Australian-resident companies on their worldwide income. The rules for treating foreign companies as residents create difficulties for Australian business and need to be modernised.

Countries determine corporate residency in various ways by tests based on one or more of the following:

- central management and control;
- effective management; or
- place of incorporation.

Australia imposes taxation on a foreign incorporated company which can be treated as a resident of Australia if it is either:

- incorporated in Australia; or
- not being incorporated in Australia, carries on business in Australia and has either its voting power controlled by Australian residents or its central management and control (CM&C) in Australia.

Any foreign incorporated company, which has significant management or Board connections to Australia, has the risk of having its CM&C in Australia. This will result in the foreign company being taxed as an Australian resident on its foreign income and capital gains.

As a result, the CM&C rules encourage breaking the links between Australian head offices, managements and their offshore subsidiaries. They push the headquarters and management of offshore subsidiaries out of Australia, with consequential adverse impacts for Australian employment and business development. As well, they restrict the growth of Australia as a regional headquarters location for foreign-owned groups.

An alternative approach to determining the residence of companies for taxation purposes is to base residency on the more certain concept of legal registration. The U.S. is an example of a country which relies on a purely formal test of place of incorporation.

Continuing with the CM&C residency test is anachronistic given the development in recent years of:

(a) capital gains tax which taxes Australian shareholders of foreign companies on the increment in value of the foreign entity;

(b) CFC tax measures introduced in 1990; and

(c) the strong Australian regulation of the transfer pricing rules dealing with international companies (as enhanced and better administered by the Australian Taxation Office during the 1990s).

6.1 Outdated CM&C rules are not in Australia's interest

When Australia's tax law was developed in the early twentieth century, it may have been appropriate to focus on the CM&C of companies because:

- there was no system of taxing controlled foreign companies in any other way;
- there was no transfer pricing law of any substance and no benchmarking of charges for services;
- Australia had no, or few, holding companies with overseas subsidiaries; and
- managers and controllers of subsidiaries tended to be located permanently in one location (because of minimal electronic communications) so the identification of CM&C was relatively simple.

However, with the development of international business and international groups, the notion of CM&C is now:

- confusing and unclear; and
- counterproductive to Australia's economic interests.

The CM&C test, in seeking to draw foreign subsidiaries into the Australian taxation net, actually has the reverse effect of discouraging Australians from becoming involved in the activities of foreign companies and foreign subsidiaries.

It is a brake on Australia's development as an attractive location for world-class international emerging companies and for the location of major international companies.

In the absence of a new test for residency, there should be statutory clarification of the scope of the CM&C test.

The CM&C test, in seeking to draw foreign subsidiaries into the Australian taxation net, has the effect of discouraging Australians from becoming involved in the activities of foreign companies and foreign subsidiaries.

This growth-retardant policy operates for emerging high-growth companies, for the major fast-growth Australian business groups as well as for international joint venture companies.

6.2 The impact for Australia's emerging growth businesses

> ***Example 6.1***
>
> *Assume that an emerging Australian company has developed world-class intellectual property. It is now increasingly common, to attract venture capital and early stage capital funds, for it to establish a subsidiary overseas (say, in the United States or United Kingdom).*
>
> *Australia's CM&C rules mean that, even though a US subsidiary will be subject to tax in a comparably taxed overseas jurisdiction, if the CM&C of the subsidiary is in Australia, then it will also be subject to Australian tax.*

As a result, an emerging company will manage its overseas subsidiary deliberately to minimise the involvement of the Australian parent company, the Australian parent company's directors and the Australian parent company's executives. Tax advisers will generally recommend that the foreign subsidiary:

(a) has its headquarters offshore;

(b) has a majority of foreign directors;

(c) has a majority of foreign office holders and executives; and

(d) ensures that all directors meetings and major policy or commercial decisions are made in the overseas location.

This is against Australia's economic interests. It reduces the scope for involvement of Australian executives, Australian head offices, Australian financial and other advisers and service industries generally. Businesses adopt strategies for reduction of the risk of foreign subsidiaries' residency status through Australian CM&C, which effectively push the management and head office function of the subsidiary out of Australia.

6.3 A similar problem arises for larger companies

Major Australian companies with internal operations will frequently establish overseas subsidiary companies.

> ***Example 6.2***
>
> *A growing Australian-based international group that wishes to expand may seek to raise capital by a direct listing of an overseas subsidiary (say, a listing of its US subsidiary in the US stock market, to attract US investors to a domestic listing).*

The CM&C risk will again cause the advisers and the company to ensure that the overseas subsidiary will have:

(a) its headquarters in the US;

(b) a majority of directors not being Australian-based, resulting in reduced involvement from existing Australian-based directors;

(c) the executive team not being Australian based;

(d) the directors meetings not being in Australia; and

(e) the Australian connection being largely restricted to the shareholding by the Australian parent.

For these companies too, the Australian CM&C rules therefore actively work against Australia's economic interests. The rules minimise the potential for Australian parent companies to retain an active involvement in the activities of their spun-off vehicles and affiliated companies. They push talented Australian managers, who could manage overseas subsidiaries using modern communications, out of Australia – together with their families, their sub-managers, assistants and their financial and other support teams.

6.4 Impact of CM&C rules on joint venture companies and subsidiaries of foreign companies

Australia cannot be selected as an international headquarters or regional headquarters for a new international business, where … overseas subsidiaries may technically qualify as Australian residents and subjected to Australian tax.

However, Australian subsidiaries will rarely have ownership of overseas subsidiaries, in newly established groups.

The CM&C legacy restricts Australia's potential as a location for world headquarters or regional headquarters of joint venture corporate groups emerging out of strategic relationships or international joint venture activities. Australia might not be selected as an international headquarters or regional headquarters for a new international business **where that headquarters company might have shareholdings in overseas subsidiaries**. One key reason for this is the risk that the overseas subsidiaries may technically qualify as Australian residents and subjected to Australian tax.

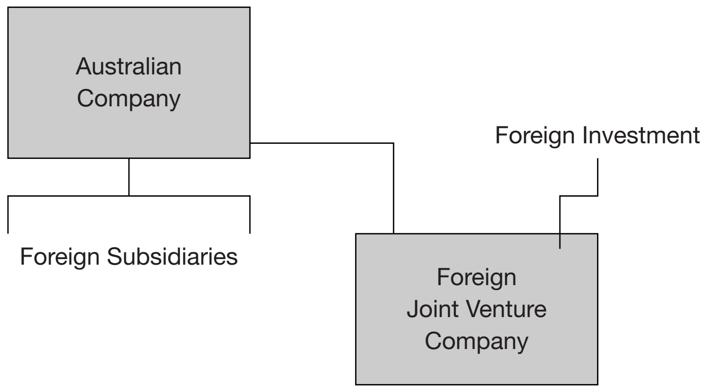
Even without the strict CM&C residing in Australia, the simple voting control of the foreign entity along with any business said to be carried on by the foreign subsidiary in Australia could trigger Australian residency pursuant to the legislative definition of corporate residency.

As a result, a foreign group's regional or international activities will usually be structured so that the ownership of international subsidiaries bypasses Australia.

Australian subsidiaries might be used as research and development locations and as bases for technical support activities and coordination. However, Australian subsidiaries will rarely have ownership of overseas subsidiaries, in newly established groups. If any overseas subsidiaries are owned through Australia, then the Australian involvement will be critically controlled and minimised, to eliminate the risk of taxation in Australia. Over time the ownership of the foreign subsidiaries can be transferred from Australian companies. This is commonly done when a foreign company acquires an Australian based group that has overseas subsidiaries.

Example 6.3

In the example below, every foreign investment might be treated as a resident of Australia if the Australian group has central management and control of the investment.



6.5 Outdated approach

These cameos illustrate that Australia's CM&C rules severely inhibit the use of Australia as a centre of business management for offshore investment. Further, in our view, **the CM&C rules are in a sense potentially obsolete as their function is duplicated by other more modern measures such as:**

(a) **Australia's CFC rules** impose tax on CFCs where Australians have control over foreign subsidiaries. The CFC rules themselves are problematical but they do regulate the operation of Australian companies' overseas associates and affiliates. As well, they provide express exclusions for activities in comparably taxed countries, and active business operations in overseas locations. The CM&C rules have no such exclusions or policy settings.

The CM&C rules duplicate the effect of the CFC rules, and their effect is particularly harsh because, unlike the CFC rules, there is neither exemption nor relaxation for active comparably taxed income or gains.

(b) **Australia's transfer pricing rules** require appropriate charges for Australian services provided by headquarters companies. Any international agreement (which includes the provision of headquarters and offshore management services) requires the setting of a justified pricing policy and pricing structure. In other words, the transfer pricing rules require any Australian headquarters services to be properly recovered by way of intercompany charges.

(c) **Australian capital gains tax** will assess any Australian shareholder on the incremental value of the foreign holding when the shareholder disposes of the shares.

The CM&C rules are therefore not only a disincentive to the growth of the Australian headquarters industry and services sector but somewhat anachronistic bearing in mind more recent measures.

The current Australian tax law encourages uncertainty, and creates situations where taxpayers fear uncertain outcomes and therefore overcompensate to Australia's detriment.

6.6 Changing the test for corporate residence of Australia

We consider that the CM&C rules create difficulties when Australia wishes to promote itself as an attractive location for international business. They are redundant given recent day policy developments, and add confusion and complexity to the Australian tax system.

The test for residence of companies could be based on the place of incorporation. Australia has ample power to regulate and tax relevant foreign-incorporated companies under its CFC and transfer pricing regimes.

Altering the CM&C test will allow the law to be simplified. The current CM&C laws also allow foreign companies to engineer Australian corporate resident status as part of international tax planning strategies, to create dual resident companies. The CM&C test results in various companies being classified as dual resident companies, which in turn require numerous consequential anti-avoidance rules, flow on adjustments and limitations in various areas of the income tax law.[45]

The CM&C rules are therefore not only a disincentive to the growth of the Australian headquarters industry and services sector but redundant in their operation.

If Australia had a simple incorporation test, such as used in other countries, this would allow for simplification and removal of many of the anti-dual resident company rules.[46]

If Australia were to follow the US approach and restrict itself to taxing only Australian incorporated companies, this would also provide certainty for both inbound and outbound international companies.

For example, the Australia/US DTA does not contain any "tiebreaker" rule to set out how the two countries will deal with a company which could be effectively a resident of both countries. The management of the US DTA is complicated by the fact that Australia can tax a US incorporated company as an Australian resident. The elimination of the outdated CM&C rule would simplify the administration of the US DTA and DTAs with other jurisdictions.

6.6.1 Revenue issues

We believe there is no revenue risk from this policy improvement. Australia's revenue is well protected by the more modern policy initiatives of:

- CFC rules.
- Transfer pricing rules dealing with the requirements to impose arm's length pricing in relation to services provided from Australia. In relation to services for non-core services, transfer pricing methodology requiring a mark-up of services need to be changed so that cost is appropriate.
- CGT rules which ultimately claw-back any deferral of income by taxing the ultimate shareholders.

45 For example the 1997 introduction of a series of measures to deny "prescribed dual resident companies", which are treated as Australian resident companies under domestic law, access to various tax concessions such as dividend rebates.

46 The UK at one stage had a tax system which created quasi-resident status for UK non-resident companies. The UK removed those provisions, because of a concern that the UK was inappropriately being used as a jurisdiction for flow through international tax planning

6.7 Removing transfer pricing loading for charges for non-core services

We note that, in relation to intercompany charges by Australian headquarters to their offshore affiliates for non-core services, Australian transfer pricing rules currently require a profit mark-up to be loaded onto the costs.

International comparisons such as OECD and US positions support a cost-recovery approach as being sufficient.

We suggest that this is an area for consideration, to alter the practice relating to mark up of services so that cost is appropriate.

6.8 Allow for re-incorporation of foreign companies in Australia

Where a foreign incorporated company has CM&C in Australia, it is currently treated as a resident, but under our recommendation it would be treated as a non-resident.

To enable some foreign-incorporated companies to maintain an Australian resident status, we recommend that consideration be given to amending the Corporations Law to for Australian incorporation of a foreign corporation as a continuing legal entity.

To enable some foreign-incorporated companies to maintain an Australian resident status, we recommend that the Corporations Law should be amended to provide for Australian incorporation of a foreign corporation as a continuing legal entity.

Such a reincorporation rule **as a continuing entity** should allow a foreign entity to be treated as an Australian entity with no immediate Australian capital gains tax consequences. Legislative relief to achieve this continuing entity status is provided in many countries including New Zealand.

6.9 Issues to be resolved arising from altered residence test

We recognise that there are a number of issues to be refined with a move to using place of incorporation as the primary test for corporate residency. The issues include:

(a) Australia’s DTAs would need to be reviewed, in particular any tie-breaker rules based on the notion of CM&C. However, this should not be used as an excuse for delay and this test may require very little work. Many DTAs refer to Australia’s domestic tax law, without specifying any detailed test in the DTA. Therefore, if Australia’s domestic tax law definition of residency changes, these changes might automatically have effect for purposes of the treaty.

(b) Some might argue that the CM&C rule should be retained as a “belt and braces” support for the CFC rules. However, there is no basis for retaining redundant policy constructs as belt and braces measures, when they retard Australia’s economic development. Such an argument is at odds with the entire notion of modernising Australia’s tax laws.

(c) It might be argued that the interaction of this recommendation with the CFC rules for countries with broad-exemption status might be used in some way to create avoidance opportunities. We have difficulty with this proposition, as those countries predominantly have CFC regimes of their own.

(d) The form of the new rule needs to be developed carefully. A simplistic “effective management” test would not resolve the issues, given the many delegated management functions in corporate groups.

Given the combined effect of the controlled foreign company, transfer pricing rules and capital gains tax, Australia’s CM&C rules should be reviewed.

Recommendation 16: Alter the corporate residence test

The test for corporate residence of foreign companies in Australia could be based on a company's place of incorporation only, so that foreign incorporated companies would not be residents of Australia. Australia has ample power to regulate and tax either the relevant foreign incorporated companies under its CFC and transfer pricing regimes or to ultimately assess the Australian shareholders under its CGT rules.

Alternatively, the CM&C test and its scope should be narrowed by way of statutory amendments.

6.10 Issues if CM&C Residence Test is not adjusted

Australia's current corporate residence test creates significant issues not only for subsidiaries of Australian companies but also for dual listed companies or entities with significant Australian Board and management involvement. Any Australian group contemplating a DLC structure needs to consider the implications of the Australian residence rules.

With the increasing attraction of DLCs, it might be necessary to have a new statutory test to ensure the commercial operations of a DLC are not stymied by the existing test.

Such an approach could include specific conditions relating to the foreign company in the DLC structure being listed, with a certain prescribed level of shareholders and might even be confined to broad exemption listed countries to avoid any abuse.

Another reason for updating the CM&C test is the need to further clarify the subtle differences between the CM&C test and the archetypal treaty tie-breaker using the effective management test. These nuances have now become more significant given the international activities of business.[47]

47 See for example "The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule". A discussion paper from the Technical Advisory Group on monitoring the application of existing treaty norms for the taxation of business profits – February 2001.

7. Thin Capitalisation Rules: a new class of Black Hole expenditure

7.1 Thin capitalisation law: amendments required for Australian outward investors

The thin capitalisation rules introduced by Australia, operational from 1 July 2001[48], were recommended by the RBT. Very broadly, the thin capitalisation rules limit the tax deductions for interest by Australian outbound investors (and foreign inbound investors), using the primary benchmark of limiting the debt funding to 75% of their Australian assets.

An overarching principle that the thin capitalisation rules applicable to Australian companies investing internationally should be similar to the rules for foreign companies investing into Australia. The rules were also developed without much consultation until recently, when the deferral of other tax reform measures[49] meant that the original proposals enforcing capitalisation and the related debt-equity classification rules needed to be adjusted.

Even if one accepts the basis for the Government's introduction of the outbound thin capitalisation rules on the recommendation of the RBT, there are issues which require fine-tuning

Even if one accepts the basis for the Government's introduction of the outbound thin capitalisation rules on the recommendation of the RBT, there are issues which require fine-tuning.

We highlight a number of issues which require attention in order for the rules to operate appropriately and to enhance the potential for Australian business development and engagement in the international business arena.

We have identified a number of high-priority issues:

(a) Because the law has been introduced quickly, it will require inevitable fine tuning in the period up to its Royal Assent and probably subsequently. We suggest that up to 18 months will be needed before the various issues have been properly identified and resolved. In that period, it is important that the Government focus on appropriate remedies and technical corrections to the law, rather than relying on ATO practice to provide remedial "fixes" not based on the law.

(b) The asset values for thin capitalisation laws are to be based not on market values but on values as set using Australian Accounting Standards. Distortions arise because the Australian Accounting Standard surrounding the valuation of internally generated goodwill will mean that companies will not be able to record their assets at market value. So Australian companies which have "grown" the value of their businesses in ways which are accounted for as internally generated goodwill will be unable to reflect the value of their businesses and the correct tax deductions for thin capitalisation purposes.

48 Introduced as the *New Tax System (Thin Capitalisation) Bill 2001*. Different commencement dates apply for taxpayers with substituted accounting periods

49 Consolidation has been deferred until a later date, 1 July 2002 at the earliest.

(c) Debt funding costs which are disallowed, in relation to Australian companies which are outbound investors, should be carried forward for later deductibility when the Australian companies can comply with the ratios. The current law results in a **permanent disallowance** of the excess interest which, as we show below generates a substantial economic disadvantage to affected businesses.

We recommend action to remedy these difficulties.

These distortions affect not only Australian-owned companies operating internationally. They apply also to foreign-owned groups in Australia, which are prevented from recognising the full value of their business for thin capitalisation purposes, and risk permanent disallowance of funding expenses in situations where assets are being built and asset valuations are volatile.

7.2 Commitment to refining the law

The thin capitalisation law and the related law dealing with distinctions between debt and equity[49] were introduced in haste.

The measures were first recommended by the RBT and announced by the Government in September 1999 but there was little consultation on the long development of the measures after that period. Consultation commenced in a substantive way in early 2001 and was increased when, following the deferral of consolidation and entity tax, significant issues were identified which led to the announcement in the 2001 Budget to adjust certain significant features of the law.

While the laws apply for most taxpayers from 1 July 2001, there is a transitional measure which will allow taxpayers to perform their first calculations for thin capitalisation purposes as late as 30 June 2002. Given the relatively late decision to adjust the law, it is clear to us that various issues require adjustment and, because of the transitional measure, many taxpayers will not appreciate the intricacies or the problems until early to mid 2002.

Because of the significance of the thin capitalisation measures, it will be important for the rules to be reviewed and for proactive action to adjust the laws to remedy unforeseen problems which will undoubtedly arise.

7.3 Internally generated goodwill has no value for thin capitalisation purposes, disadvantaging Australian businesses

The primary test for the thin capitalisation rules is for affected Australian businesses to have debt of up to 75% of the value of their Australian assets.

However, Australian assets are to be valued[50] only in the way allowed by accounting standards.

However, accounting standards in Australia do not permit the valuation or revaluation of assets classed as internally generated goodwill[51], a widely criticised feature of the standards.

49 *New Business Tax System (Debt and Equity) Bill 2001*

50 Section 820-680

51 Internally generated goodwill is not an asset that can be recognised. In particular AASB 1013 states at paragraph 4.1 "*Goodwill* which is internally generated by the *entity* must not be *recognised* by that entity."

Australian assets are to be valued only in the way allowed by accounting standards … However, accounting standards in Australia do not permit the valuation or revaluation of assets classed as internally generated goodwill

This has the perverse result that, for thin capitalisation purposes:

- A company operating in Australia, which has created goodwill value in its business in Australia, cannot recognise the value of that asset for thin capitalisation purposes even though the creation of that goodwill will have invariably required additional funding.
- But if that company is taken over, the purchaser (whose purchase price will include the value of the goodwill) can use the purchased goodwill for accounting and thus thin capitalisation purposes. However the purchaser cannot later restate the goodwill to a higher market value.

This is economically inexplicable. It has the following effects:

Example 7.1

An Australian company has funded and developed an industrial process and a business, say a new method of producing automotive components. The company has at 1 July 2001 a patent valued at $20 million, brand name valued at $4 million and goodwill valued at $30 million. The Australian company decides to establish a subsidiary overseas to develop its business.

For accounting and thin capitalisation purposes the internally generated goodwill ($30 million in the example) may not be valued, although it is an asset.

Example 7.2

Another Australian company purchases the Australian company for $60 million. The purchaser has expended $60 million and is entitled to record as an asset for accounting and thin capitalisation purposes the $60 million – including the goodwill which was previously internally-generated but no longer has that classification for either purpose.

However, if the purchaser funds additional marketing expenses, which increase the goodwill value in the next year, the purchaser cannot restate the goodwill at market value for the same reason. The purchaser is limited in valuing the goodwill to the purchase price less the enforced accounting write-off.

This quirk of the tax law treatment, so closely tied to the accounting standard, results in non-neutral and inequitable tax outcomes.

This quirk of the tax law treatment, so closely tied to the accounting standard, results in non-neutral and inequitable tax outcomes:

(a) growing companies and businesses being restricted in their growth potential internationally;

(b) a bias against organisations debt funding internal R&D and business development; while

(c) allowing purchasers of businesses to reflect the very same assets.

Recommendation 17: Thin Capitalisation – Improving the law

A. The thin capitalisation and related debt-equity laws have a significant effect for Australian businesses operating internationally. There needs to be a concerted approach of ensuring that the laws are updated and corrected when the inevitable issues requiring improvement are identified, which we predict will peak in mid-2002.

B. We recommend that for thin capitalisation purposes internally generated goodwill should be eligible to be valued at market value. Otherwise a significant distortion will continue, depressing the ability of companies which have developed Australian businesses to properly recognise the value of their businesses for thin capitalisation purposes.

It might be said that the relevant company could look to the "arms-length debt amount" rules introduced in Section 820-105 of the thin capitalisation rules.

However, the arms-length debt amount test, which we do support in the thin capitalisation law, is intended to be a secondary test. It has complex rules involving a combination of subjective and objective factors[52], and will involve significant compliance expense for taxpayers. Finally, there is considerable uncertainty as to the precise application of that section.

So it is insufficient for the inappropriate operation of the primary safe harbour test in the above circumstances to require all taxpayers having internally-generated goodwill to revert to the secondary arm's-length amount test. The primary test needs to be adjusted in relation to the valuation of internally generated goodwill.

The current policy setting creates disadvantages for any Australian business which has developed valuable business processes and systems, and prevents the business receiving proper recognition for having funded the development of these assets in this context.

7.4 Treatment of the excess disallowed interest

Another major issue relates to the treatment of disallowed interest under the thin capitalisation rules for Australian businesses expanding overseas.

The thin capitalisation rules require an annual test (with options for taxpayers to use half-yearly or quarterly tests). But that test does not take account of increases in asset values after the test period. This "snapshot" test creates difficulties for companies with volatile or growing asset values.

The thin capitalisation rules require an annual test (with options for taxpayers to use half-yearly or quarterly tests). But that test does not take account of increases in asset values after the test period. This "snapshot" test creates difficulties for companies with volatile or growing asset values.

Example 7.3

Consider a fast growing Australian business with Australian assets of $12 million which borrows $10 million to establish an overseas subsidiary. Some of its interest expense is disallowed under the thin capitalisation rule. In the second year, the Australian assets have a value of say $22 million and the borrowing is within the debt limits in the second year.

The interest disallowed in the first year is not available for deduction in the later year. ***The interest is non-deductible forever even though excess deduction capacity exists in the next year(s).***

52 We refer in particular to the list of 11 relevant factors in 820-105(3) and factual assumptions in 820-105(2)

A new black hole expense has been created, in effect.

We consider that this policy setting will disadvantage Australian companies competing and operating internationally.

Deductions for funding offshore growth are available in, for example, both the US and the UK without such limitations.

For example the US simply restricts the availability of foreign tax credits in some circumstances when profits are repatriated. Where interest deductions and limitations are directly imposed eg US “interest stripping” rules for foreign investors, this is a timing difference as the US allows such companies to carry forward any excess interest for deduction into future years.

It might be argued that this policy is justified because Australia allows Australian companies a tax exemption for dividends received from countries which are listed for CFC purposes, whereas other countries tax dividends received from foreign countries, allowing foreign tax credits. However the permanent denial or a deduction for the excess interest, particularly given the vagaries of the valuation requirements tied to accounting standards, is problematical

It might also be said that the company can look to the “arm’s-length debt amount” rules introduced in Section 820-105. However, those rules require a complex set of assumptions looking principally to the year in question, without allowing for a forward-looking two to three year smoothing of asset values.

We see two possible solutions:

(a) a carry forward rule so that disallowed interest in a year can be carried forward and (if in a later year there is excess thin capitalisation capacity) can be claimed then;

(b) an allowance in the Section 820-105 rule for anticipated increases in value by way of smoothing. Specific rules could be developed in consultation in a way which will protect the interests of the Revenue.

    One possible mechanism to achieve this could be akin to averaging ie. taking into account the increase in the value of assets over a two to three year period. This approach is used currently for Australian tax purposes to smooth out fluctuations in income of authors, “special professionals” and primary producers.

Recommendation 18: Carry forward rule for excess disallowed interest

We recommend that excess disallowed funding costs under the thin capitalisation rules should be dealt with in one of two ways:

(a) disallowed funding costs in a year could be carried forward and (if in a later year there is excess thin capitalisation capacity) can be claimed then; or

(b) an allowance could be built into the rule for anticipated increases in value of the relevant assets (as a smoothing rule) with specific rules developed with proper consultation.

8. Intangibles, Brand Names and Royalties

A major trend in international business is the increased dealing in and development of intangible business property.

Intangibles, in a business sense, include:

(a) basic research and development;

(b) product development;

(c) brand development;

(d) improving business systems and processes;

(e) packaging of these intangibles into business systems and know-how; and

(f) licensing of the intellectual property, within a country and internationally.

Australia has many potential advantages in this area, including the high quality of our educational institutions, research skills and general business skills. It is unfortunate that the Australian tax system tends to discourage the maximum effectiveness of these advantages.

8.1 Australia's DTA and domestic policy for royalties is not responsive to our needs

Australia's tax system has been designed for an economy importing intangible property, with:

- limited deductions for acquisition of intangible property (other than patents, copyright and designs);
- little regard for Australia as a possible location for international management and coordination of intangibles; and
- an emphasis on imposing withholding taxes on payments made for intangibles.

This was noted by the RBT in its call for Australia's DTA policy to be adjusted in relation to the treatment of royalties and intangibles as well as interest issues.

In the same way, Australia's royalty withholding tax rules and DTA approaches need to be adjusted.

We welcome the major development seen in the November 2001 announcement of the Australia/US DTA protocol, for tax withholdings on royalties to be reduced to 5%. This could act as a model for DTA renegotiations with Australia's other major trading partners (notably UK, Germany and Japan).

Australia is no longer an economy which is based overwhelmingly on inbound capital and intellectual property. Increasingly Australia is an outward looking economy, where the outward orientation of business is being restricted by inappropriate DTA and domestic tax policy.

For this reason, Australia should adopt in its DTA policy a stronger focus towards residence-based taxation. That is, the DTAs should allow the country of residence (Australia) to impose tax on foreign-sourced inbound royalties and should seek a reduction in the foreign countries' withholding taxes levied on royalties paid to Australia.

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It might be argued that there is a cost in such a policy since Australia will need to conversely reduce withholding taxes on royalties paid by Australian residents to overseas licence or owners of intangible property.

However, many foreign licensors of intangible property and technology to Australia **merely pass the Australian tax costs on to the Australian residents** by requiring that the non-resident receives the royalties free and clear of Australian taxes. So, if Australian taxes are payable then the Australian resident is obliged to gross up the royalties. A typical arrangement of this type was set out in the case of *The Commissioner of Taxation v Century Yuasa Batteries Pty Ltd* [53].

So the higher tax withholdings:

(a) add to the cost structure of Australian businesses which are paying royalties, and

(b) disadvantage Australian companies which are receiving royalties from other countries.

International business responds to the Australian tax environment by ensuring that the ownership of intangible property is not located in Australia and is not licensed through Australian intermediary companies.

8.2 International business and licensing of intangible property is increasingly significant

International business responds to the Australian tax environment by ensuring that the **ownership of intangible property is not located in Australia and is not licensed through Australian intermediary companies**. Royalty income is not channelled through Australian companies because the foreign withholding taxes are not reduced using DTAs and Australia imposes withholding tax on outbound royalties.

Australia could seek to focus on adding value and attracting international research and intangibles development activity if our tax system was redesigned to be more appropriate for a country creating and exporting intellectual property. To achieve this, we recommend that Australia's tax system be modified to:

- facilitate ways of bringing foreign royalty and revenue streams into Australia; and
- create an internationally attractive environment for intangibles to be developed in Australia.

The current research and development concessions in Australia are specifically targeted incentives that have been the subject of recent Government action. They are applicable only to a limited range of expenditure.

We further set out below the action we believe is needed more generally in this area.

8.3 Australia does not allow write-off of much intangible property

Australia is becoming increasingly an exception to the international trend for all business assets acquired to be deductible in some form over time. Australia has several "black holes" in this regard.

Many developed countries and some so-called undeveloped countries provide tax regimes where acquired intangible property and brand names are deductible over time for tax purposes. Not only the US but even countries like Indonesia have a regime for the tax amortisation of purchased intangible property.

53 98 ATC 4380. In that case a company borrowed funds (but the royalty arrangements are similar), and the relevant agreement provided that "All sums … shall be paid … without any deduction or withholding for or on account of any tax. … so that the Lender receives free and clear of any tax the full amount …"

We distinguish intangible property (rights capable of ownership and recognition for tax purposes) from mere goodwill not being property (for example, knowledge which is not protected). This distinction is currently established in the tax systems of Australia and other countries.

The "goodwill" of a business is in fact a collection of various assets being intangible property, many of a wasting nature.

The "goodwill" of a business is in fact a collection of various assets being intangible property, many of a wasting nature. These include intangibles such as:

- Going concern value.
- Workforce expertise and systems.
- Information base.
- Know-how.
- Customer-based intangibles.
- Government licenses and permits.
- Franchises, trademarks and trade names.
- Insurance policy expirations.
- Bank deposit base.
- Covenants not to compete.
- Right to receive tangible property or services under a contract or granted by a governmental unit, agency or instrumentality.
- Mortgage servicing rights secured by residential real property.
- Other rights under contract of a fixed duration.

Only some of these are eligible for capital allowances or deductibility in Australia. Capital allowances are currently available only in respect of "intellectual property" being the interest of the holder or licensee of a patent, registered design; or copyright.

We think that there is strong basis for allowing the amortisation of all intangible assets, as follows:

(a) the vendor of a business is generally subject to CGT in respect of the gains on disposal of that business;

(b) correspondingly, the purchaser under Australia's current tax regime has only limited entitlement to any amortisation in respect of the significant business assets comprising the various intangible assets (discussed above); and

(c) as a result, every time a business is sold for a capital gain, there is a withdrawal of taxation revenue by the Government from the vendor, without a corresponding taxation benefit in respect of the acquirer of the business. This constitutes an economic inefficiency and provides a sound basis for a staged amortisation of the acquired intangibles over time.

Under the current Australian domestic and CFC context, such capital outlays remain "black hole" expenditures that are never deductible. This:

(a) places Australian companies at a disadvantage when competing for offshore assets with non-resident bidders,

(b) places Australian companies at a disadvantage when competing for Australian assets in competitive bids with foreign investors.

Australia's recent experience with the privatisation of energy assets demonstrates the lack of tax competitiveness that Australian companies find themselves in compared to, say, their US bidding rivals. This factor also provides a disincentive for non-resident investors to seek to invest in non-Australian assets through Australian resident structures.

At the moment, Australian business is doubly disadvantaged:

(a) the proposal for amortisation of intangibles was deferred by the RBT; and

(b) the limited proposals recommended by the RBT, for the amortisation of contractual rights, have been deferred under the review of the Tax Value Method (Option 2) and are unlikely to commence before 1 July 2003, if at all.

This issue was identified by the RBT. Unfortunately, the RBT considered that the revenue constraints within which they were operating prevented them from acting on this proposal.

At the moment, Australian business is doubly disadvantaged:

(a) the proposal for amortisation of intangibles was deferred by the RBT; and

(b) the limited proposals recommended by the RBT, for the amortisation of contractual rights, have been deferred under the review of the Tax Value Method (Option 2) and are unlikely to commence before 1 July 2003, if at all.

8.4 US and UK action to remove the corresponding "black hole"

The US allows amortisation of certain acquired intangible property over a number of years (in the United States the period of amortisation is 15 years)[54]. This amortisation:

(a) appropriately spreads the cost to the revenue; and

(b) provides a signal to the community that the taxation system is operating neutrally in relation to business combinations and acquisitions.

The US measures were introduced … after recognition that the previous US approach created distortions

The US measures were introduced in 1993, after recognition that the previous US approach created distortions, notably:

(a) taxpayers who acquired businesses with principally physical assets eligible for depreciation-style write-offs were advantaged compared with taxpayers who acquired businesses (such as service businesses) with largely intangible assets,

(b) taxpayers who created intangible assets, such as goodwill or customer lists could write-off the costs of creating the intangible (eg advertising), whereas the purchasers of businesses could not fully amortise the intangibles.

The US allows taxpayers an amortisation deduction for the capitalised costs of acquiring "Section 197 intangibles" that are held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction is determined by amortising the adjusted basis of the acquired intangible rateably over the 15-year period beginning in the month in which the intangible was acquired irrespective of the asset's actual useful life.

The United Kingdom is now consulting on the precise form of intangible amortisation, to commence on 1 April 2002. The scheme is to grant tax amortisation for acquired intangibles, following accounting practice as closely as possible in respect of intangible assets which change hands between unrelated parties. An acquirer of IP will be entitled to tax relief for any amortisation charge in its accounts. For a vendor of assets acquired after 31 March 2002 any gain, including a clawback of relief previously given, will be taxable as ordinary income (and losses deductible).

54 Section 197 of the Internal Revenue Code provides amortisation for acquired intangible assets.

8.5 An internationally attractive tax amortisation of intangible property

A significant international trend in DTAs has been to reduce the paying country's royalty withholding limit below 10%, to 5% or even to 0%. Australia has not been part of this trend in its recent DTA negotiations

We consider it important to provide an internationally attractive environment for the ownership or structuring of intangibles. Currently, the unfortunate fact is that, whenever a US group acquires an Australian operation, a US parent will be inclined to acquire the intangibles directly in the United States, because of the tax amortisation offered for business intangible property.

The RBT explored this issue but determined that the time was premature (in 1998/9) for this concession to be offered, given the uncertain revenue effects.

An Australian measure could generate substantial benefits. These include:

- enhanced export of services;
- enhanced employment in the general business services area, as well as research and development; and
- enhancing the scale, and retention, of ideas developed in Australia.

8.6 The trend in double tax treaties to reduce royalty withholding tax

8.6.1 How royalties are taxed by paying countries

Businesses pay royalties and licence fees internationally for the licensing and use of intangible property such as knowhow, patents and licences. The royalties represent a transfer of funds from the business in the paying country to the recipient in the receiving country.

The United Kingdom is now considering a form of intangible amortisation, with proposals including granting tax amortisation for acquired intangibles in line with the accounting write-offs claimed by companies

Countries such as Australia typically impose taxation obligations on the foreign recipients of the royalties so that the foreign recipients are taxed at ordinary corporate tax rates by the country of residents of the payer.

The DTAs entered into between countries provide limitations on the taxes withheld by the countries from which the royalties are paid. The standard royalty withholding limit under the OECD model DTA is 10% of the royalty, so that the paying company limits its tax to 10% of the gross royalty paid.

The royalty recipient is taxed by the paying country at the ordinary corporate tax rate applied to their royalty (minus any deductible expenses) or at the limit under the applicable DTA.

8.6.2 International trend to reduce royalty withholding limits under DTAs

A significant international trend in DTAs has been to reduce the paying country's royalty withholding limit below 10%, to 5% or even to 0%. Australia has not been part of this trend in its recent DTA negotiations.

The table below compares Australia's royalty withholding rates in DTAs with those of some other relevant countries:

	Royalty paid by Resident of:								
Royalty paid to Resident of:	**Australia**	**Belgium**	**Germany**	**Malaysia**	**Netherlands**	**Singapore**	**Sweden**	**UK**	**USA**
No Treaty	30%	15%	26.38%	10%	0%	15%	0%	22%	30%
Australia		10%	10%	10%	0%	10%	0%	10%	10%
Belgium	10%		0%	10%	0%	15%	0%	0%	0%
Germany	10%	0%		10%	0%	0%	0%	0%	0%
Malaysia	15%	15%	10%		0%	15%	0%	8%	30%
Netherlands	10%	0%	0%	8%		0%	0%	0%	10%
Singapore	10%	15%	0%	10%	0%		0%	10%	30%
Sweden	10%	0%	0%	10%	0%	0%		0%	0%
UK	10%	0%	0%	8%	0%	10%	0%		0%
USA	10% / 15%**	0%	0%	10%	0%	15%*	0%	0%	

* no treaty identified, applied as "no treaty" rate

** 5% limitation under the new Australia/US protocol when enacted

This table illustrates, for example, that a royalty paid from a US resident to a German or UK resident will attract a 0% US withholding tax, and vice versa. The table graphically illustrates the minimal bilateral action in the renegotiation of Australia's DTAs to reduce the withholding taxes below the standard 10% limitation.

8.7 Why royalty withholding tax limits are important

The DTA royalty withholding tax limits are important, and have been receiving action internationally for a number of reasons.

It might be thought that there is no problem with a paying country imposing a 10%-of-gross limit on royalty withholdings because, after all, the recipient will receive a tax credit in their recipient country.

The recipient will not always be able to claim the full foreign tax credit in their recipient country, for reasons which include:

(a) the recipient may not have sufficient taxable income in the recipient country to absorb the foreign tax credit due to increasing investment in research and development activities; or

(b) the recipient might have other business activities or other reasons why its home-country tax rate is low and so the foreign tax credit cannot be utilised.

These reasons along with the trend for countries to position themselves, as attractive locations for the holding and outbound licensing of intellectual property underpin the general trend to a reduction of royalty withholding limits under DTAs.

Countries are prepared to consider … limits in their bilateral DTAs because, while they give up tax in relation to outbound royalties, the countries gain more tax and other commercial benefits from the proliferation of inbound royalties

Countries are prepared to consider such limits in their bilateral DTAs because, while they give up tax in relation to outbound royalties, the countries gain more tax and other commercial benefits from the proliferation in relation to inbound royalties.

Example 8.1

Assume that a US company has acquired an intangible asset for $10 million, and licences the Asian rights to an Australian company responsible for the exploitation of the IP in the region, which in turn licenses the technology to other countries. The US company's royalty from the Australian company is $1 million per annum. The Australian company receives $1.5 million from Asian licensees.

For US purposes the recipient might be entitled to a tax deduction for the intangibles under the US rules discussed above. So the US net taxable income might be minimal.

The Australian royalty withholding will be 10% of the royalty paid to the US company, ie. $100,000. The US company's intangibles amortisation is not deductible for Australian purposes and so a lower Australian tax withholding cannot prima facie be achieved. So the US recipient would in this example find that the Australian royalty tax would not be fully creditable or might not be creditable at all.

Normally, the US company might require in the licence that the Australian company should be responsible for the tax. So the royalty withholding tax would be grossed up and paid by the Australian company.

Correspondingly, the Australian company receiving royalties from Asian licensees would typically find that the DTAs would allow the Asian countries to withhold up to 10% of gross royalties.

In this example the US recipient would be more likely to structure the licences through a resident of another country that would be seen as more beneficial with lower royalty tax overlays. The above table suggests that the licensing might be undertaken through a UK, Dutch or German company.

The uncompetitive DTA environment, coupled with Australia's tight rules limiting amortisation of intangible property, makes Australia a sub-optimal location for international licensing and the licensing management activities involved.

The example demonstrates how the uncompetitive DTA environment, coupled with Australia's tight rules limiting amortisation of intangible property, makes Australia a sub-optimal location for international licensing and the licensing management activities involved.

8.8 Reduction of royalty withholding limits under Australia's DTAs

Australia should seek to improve its relative position as a country for head licensors or intermediate licensors of intangible property, and as a location in which intangible property can be developed.

We recommend two strategies:

(a) Australia should seek to reduce, in its DTAs with other countries, the withholding taxes imposed on royalties paid to Australian residents. Australia should ensure, as a matter of formal policy, that the environment is maximised for Australian businesses to be able to extract royalties from other countries, at the lowest possible withholding tax rates.

(b) Australia will also need to offer reciprocal reductions in royalty withholding taxes in respect of royalties paid to residents of certain selected countries. Strategically this will be in Australia's interests, if Australia can position itself as one of the international centres for exploitation of intangibles.

We recognise that this issue involves consideration of the costs of taxes foregone against the benefits to be gained, to be determined bilaterally with each country. This arrangement might not be appropriate for every country and might take time. We welcome the Australia/US DTA protocol, for tax withholdings on royalties to be reduced to 5%.

However, it appears clear that this issue has not received significant attention in Australia's DTA policy with major developed countries. We suggest it needs concerted action.

Recommendation 19: Intangibles and royalties

We recommend:

- Australia should provide an internationally attractive environment for the ownership of intangibles. The US-style approach of a 15-year write-off for intangible property, which does not currently qualify for capital allowances, warrants serious consideration.
- Australia should seek to reduce withholding tax imposed on royalties paid to Australian residents in its DTAs with other countries. This should also involve reciprocal reductions in royalty withholding taxes on payments to residents of those countries. The US/Australia DTA protocol could provide a model.

9. Foreign Investment Fund Measures, and Tax Rules for International Funds Management

In particular, the FIF regime needs to be reviewed in the context of the funds management industry to ensure that the measures are consistent with the anti-avoidance objective. In particular, foreign investment trusts need an active business exemption

Australian resident companies are also subject to the Foreign Investment Fund (FIF) measures in relation to their offshore interests which are below the threshold for the CFC measures. The FIF measures tax, on an accruals basis, investments in foreign companies and trusts. The Government's stated objective when it introduced these measures was:

> " … to prevent the avoidance of Australian taxation through investment vehicles which facilitate the accumulation of passive income offshore without the concurrent imposition of Australian tax."

We understand this policy rationale.

However, unfortunately, the implementation of the FIF measures extended the reach well beyond the original policy rationale. They currently operate in a number of ways which are inconsistent with the original policy and create frustration in relation to Australia's:

(a) international businesses,

(b) funds management industry and

(c) the savings and investments of ordinary Australians.

9.1 Overview

The FIF measures (very broadly) operate as follows. Where an Australian has an interest in a foreign entity (be it a company trust or similar entity) and the Australian has a substantial interest or control interest, then potentially the CFC rules will apply (discussed in section 5).

Australians might have investments in offshore vehicles which fall below the threshold for the CFC rules and as a result no attribution of income arises under the CFC rules. The intent of the FIF measures was to ensure that, as noted above, this feature could not be used to accumulate wealth offshore. The FIF rules provide that certain income is deemed to arise in relation to FIFs and certain transactions are deemed to arise in relation to FIFs irrespective of their actual taxable income if this cannot be identified.

The FIF rules were designed to have exclusions for active income. That is, the FIF rules were not designed to apply to offshore business activities.

In our view, the law does not reflect the original policy rationale.

They have the effect that:

(a) Many investments in major overseas organisations are treated as FIFs.

(b) Many investments by Australian businesses in joint venture companies, which are conventionally structured, are treated as FIFs.

(c) Excessive compliance obligations arise.

The FIF rules thus stifle investment by Australians and Australian businesses in overseas affiliated entities.

To mitigate the effect of the FIF rules, a partial exemption was introduced in relation to certain investments in the US entities. However, the concession is extremely narrowly drafted, and proves difficult to satisfy in relation to many conventional investments. For example:

- An investment in a US bank is treated as being exempt from the FIF rules;
- An investment in a US financial services company which operates credit card financing but which is not registered as a bank, is not exempt; and
- An investment in a US insurance company is not exempt.

We understand the policy approach of the Australian Government in needing a measure to deal with the potential accumulation of offshore passive income. However, the FIF measures do not operate in a way which achieves the policy of the Government and are not consistent with the international dimensions of Australian business, and of Australian savings.

9.2 Problems

Whilst the anti-avoidance objective was sound, we consider the execution of the measures to be fundamentally misconceived. They apply where there is, on an objective basis, no reasonable likelihood that the investment was made for tax avoidance purposes i.e. we believe that the measures go well beyond the original policy rationale.

(a) The FIF provisions are intended to attack closely held investment vehicles devised for the purposes of avoiding the CFC measures. That is, their focus was not the nature of the investment alone, but the combination of the motive of the taxpayer and that taxpayer's choice of investment. By their nature, superannuation funds and their investments should not (and were never intended to) be the target of the FIF measures.

(b) Secondly, it was not anticipated that listed public companies would be caught by the FIF rules. It would be exceedingly rare for Australian listed companies to be established as passive investment vehicles that Australian residents could use for tax avoidance purposes, especially when the companies are listed on major exchanges (London, New York, Tokyo).

In a location such as the Asia Pacific region, these rules can also have quite adverse impacts on Australian investors. Investing in this region often requires investment on a joint venture basis where the Australian investor may have less than a 50% interest in the foreign company

To bring them into line with the original objective, we recommend that the FIF measures:

(a) should not apply to investments by widely held investment funds or to complying superannuation funds.

(b) should not apply to investments held by listed companies.

(c) should also not apply to any other company or trust unless the business of the principal business of the company or trust was investment (directly or indirectly through other trusts or companies) in cash or other financial instruments (bonds debentures, discounted securities etc).

These changes should ensure that the FIF measures are consistent with the original policy and therefore confined to cases where it is reasonably likely that the transaction may be motivated by tax avoidance.

In addition, we would recommend that certain other changes be made to ensure that the measures do not adversely impact normal investment activities.

(d) The exemption from FIF rules for investment in US companies should be widened to include investment in (at least) the seven countries comprising broad-exemption listed countries for CFC purposes.

(e) There is an exemption for active businesses but this exemption is typically difficult to satisfy and has onerous information requirements that a shareholder who does not have a controlling interest will often find difficult to obtain.

In a location such as the Asia Pacific region, these rules can also have a quite adverse impact on Australian investors. Investing in this region often requires investment on a joint venture basis where the Australian investor may have less than a 50% interest in the foreign company.

9.3 RBT recommendations

In *"A Platform for Consultation"*, the RBT noted that problems have been identified in respect of the operation of the FIF measures and raised the following options for consultation:

- complete removal of the active business test in the measures; and
- replacement of the active business exemption with one or more exemptions.

The new exemptions would differentiate between portfolio and non-portfolio investments. For portfolio investments, the active business test could be replaced with a jurisdictional test, which would exempt FIFs located in comparable tax countries. For non-portfolio investments, the active business test could be replaced with an active income test, similar to the CFC rules.

In *ATSR*, the RBT has limited its recommendations to aspects of the rules that deal with foreign trusts and has recommended a comprehensive review of the foreign source income rules.

Any review of the FIF regime needs to have an objective of seeking to ensure that the FIF measures are targeted at deliberate deferral situations and do not impinge upon genuine commercial investment decisions.

Any review of the FIF regime needs to have an objective of seeking to ensure that the FIF measures are targeted at deliberate deferral situations and do not impinge upon genuine commercial investment decisions.

9.4 Funds management industry

Quite apart from the need for review and adjustment of the FIF rule in the context of business generally, the FIF regime needs to be reviewed in the context of the funds management industry to ensure that the measures are consistent with the anti-avoidance objective. Foreign investment trusts need an active business exemption. Exemptions from the FIF regime should consider the following:

(a) funds that track recognised indices, where the underlying stocks are active;

(b) funds that invest predominantly in active business companies; and

(c) offshore funds that invest in other funds, where the underlying investments are exempt.

9.5 Offshore Banking Units

The Offshore Banking Unit (OBU) concessions were introduced in 1992 to enhance the competitiveness of the Australian funds management and international banking industry. The provide that (broadly):

(a) an OBU's income from eligible OB activities is taxed at only 10%, and

(b) income of OBU offshore investment trusts (in which investments are made by foreign investors) is exempt from tax.

As noted in section 5.10 of this White Paper, In March 2001 the Senate Select Committee on Superannuation and Financial Services published its report "The Opportunities and Constraints for Australia to Become a Centre for the Provision of Global Financial Services". That report identified several areas in which the OBU concessions needed to be reformed to be made internationally competitive and to achieve the Government's policy objectives.

For example, the current OBU regime has a number of technical deficiencies and an inability to apply in practice as a result of unrealistic requirements/hurdles that need to be met to qualify for the concession. For example the need to set up separate unit trusts for non-resident investors is commercially unattractive.

Under current Australian tax law there is a risk that adverse tax consequences arise for a non-resident investor where the assets are managed by an Australian asset manager.

As noted by the Senate Select Committee, the concession needs to be reviewed for its effectiveness.

Recommendation 20: Adjustment of the Foreign Investment Fund (FIF) rules

The FIF rules need to be reviewed in line with the recommendations of the RBT to achieve two objectives:

- to streamline the active business concession so that Australian participants in international joint venture companies will find it capable of being satisfied; and
- to align the rules more closely with the needs of Australia's funds management industry by introducing an active business exemption for foreign investment trusts, and exemptions from the FIF regime for the following:
  - funds that track recognised indices, where the underlying stocks are active;
  - funds that invest predominantly in active business companies; and
  - offshore funds that invest in other funds, where the underlying investments are exempt.

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Part II –

The Human Capital Challenge

10. Making Australia Attractive to Key Employees

Growth oriented companies which operate internationally need world class management and expertise. There is an increasing trend for high-growth companies to seek international executives to operate in their headquarters and as CEOs. World-class companies are also increasingly international and will use the best people at appropriate locations, regardless of nationality.

This is a two-way traffic, and companies post talented Australians overseas, developing careers overseas and even heading up major international companies.

Skilled employees of all levels and nationalities are increasingly mobile. They are attracted to rewarding positions, to attractive locations and to financial incentives.

Australia has always been considered a high tax country for individuals, a perception driven by a high headline marginal tax rate. As a result, it can be difficult to convince talented individuals to accept employment here. The adverse features of Australia's taxation of inpatriates magnify this problem.

This invariably means that Australian companies either have to pay higher salaries to attract such individuals to Australia, or compensate those individuals for the increased tax burden (commonly referred to as tax protection or tax equalisation). Generally, this is a very expensive policy for an employer.

This high tax cost affects the international competitiveness of Australian organisations and the tax costs tend to fuel salary inflation in executive ranks in Australia. Accordingly, to help ensure that we remain attractive as a base for the headquarters of growing companies, Australia needs an attractive tax system for inpatriates working in Australia.

With Australia's geographic location and relatively small economy, our tax system needs to be an incentive, not just a neutral factor in the decision to relocate an employee to Australia. To achieve this, Australia's inpatriate tax regime could benefit from redesign to ensure that key personnel are not discouraged from relocating to Australia.

Australia must attract not only executives to Australia, but also a wide range of skilled people with experience working in international environments, and who can pass those skills onto Australians. An improved tax system should also produce long-term benefits as these people look favourably upon Australia in dealings after they have departed.

Australia needs to become internationally competitive, and other countries are continuing to further enhance their attractive tax regimes. For example, Singapore's recent budget announced a further 2% reduction in the top marginal tax from 2002 and in the United States, President Bush's proposals call for a 3.6% reduction in the top tax rate.

10.1 Inpatriates become highly-taxed very quickly in Australia

Typically an expatriate or inpatriate (in this report we call a foreign expatriate who is in Australia an "inpatriate") may be in a country for up to four to six years. It is increasingly common for an inpatriate to remain for this medium term, particularly where international companies are undergoing significant change and are being refocused. Also, particularly where an inpatriate is located in a regional holding company with regional responsibility, it is optimal for the inpatriate to be based in that location for some years.

In these circumstances, it is clear that Australia's tax features add significant costs to inpatriate assignments in a number of key respects:

Australia's tax features add significant costs to inpatriate assignments in a number of key respects

(a) The approach of the ATO, to treat inpatriates as residents if they are in Australia for more than six months, means that there is a very quick imposition of full Australian taxes – which occurs at a far earlier point than is the case with many other OECD countries which have reviewed their policies.

(b) The imposition of capital gains tax on the inpatriates' foreign assets when they leave Australia (at any time after five years) again imposes a substantial cost on inpatriates' exit from Australia.

The detailed rules operate in broad summary as follows:

Length of posting in Australia	Tax issues for the inpatriate
Less than 6 months	Inpatriates for **less than six month** postings are not residents of Australia and have the tax outcomes allowed to non-residents: • they are taxed only on their Australian-sourced income; and • their foreign assets and foreign income are not subject to Australian tax.
More than 6 months, under 5 years	An inpatriate in Australia on a **more than six month posting** is, as a result of Australian Taxation Office practice (which changed in 1999) treated as a resident from day 1. The inpatriate is subject to Australian tax on their global income, including not only Australian-source income, but also: • Foreign-source employment income; and • Foreign-source investment income on assets accumulated before arriving in Australia. An inpatriate is eligible for certain "living away from home" allowance concessions, but this eligibility disappears four years after arrival.
5 years or more	Australia imposes Capital Gains Tax on **unrealised gains** when an individual ceases to be a resident, on every CGT asset which does not have a necessary connection to Australia. An inpatriate is exempt from taxation of unrealised gains on pre-arrival assets if he or she departs within five years. If the inpatriate remains in Australia past the fifth anniversary after arrival, he or she is **taxed by Australia on unrealised gains on their non-Australian assets, including their pre-arrival assets** when their residence ends. For this purpose, the assets are deemed to have been acquired for market value on the day of arrival. There is an election available to defer any capital gain or loss until actual disposal of these assets or resumption of Australian residency.

So inpatriates are very quickly subject to Australian tax on their worldwide investment income from the time they become residents.

The Australian tax system sends strong signals to inpatriates to leave Australia after a few years, and develops a very short-term approach to inpatriates. They have a significant fiscal impetus to leave Australia within five years.

10.2 These are employer and business costs

The Australian tax system sends strong signals to inpatriates to leave Australia after a few years, and develops a very short-term approach to inpatriates. They have a significant fiscal impetus to leave Australia within five years.

Both costs are ultimately shifted to the Australian businesses which employ the inpatriates. In particular:

(a) Inpatriates who are located in Australia for a period of years as part of employment with a global group will typically be subject to "tax equalisation" or "tax protection" policies whereby the additional Australian tax costs of their assignment are charged back to their employers as an additional cost.

(b) Inpatriates who come to Australia other than on a global rotation or assignment program will typically be advised to ensure that their compensation arrangements are grossed up to cover excess Australian taxes. This grossing up (which is known to frequently occur) results in additional costs being borne by the Australian companies which need the services and expertise of the inpatriates; and

(c) Where the inpatriate does not have a gross-up arrangement, the alternative is for the inpatriate to simply leave Australia before the fourth or fifth anniversary and the more adverse Australian tax consequences arise. This has the risk of creating a short-term focus in the mind of the inpatriate.

10.3 The problems with Australia's inpatriate tax regime

The study also shows how Australia's tax system has a significant adverse impact on longer-term assignments, thereby encouraging talented employees to leave Australia earlier than might otherwise be in their companies' interests.

Australia's tax regime is not competitive when compared to other key international locations. This is demonstrated by the study commissioned in conjunction with this White Paper. Details of the comparative study are set out in Appendix D.

The study shows that Australia's tax system is, at best, only barely comparable to countries that do not struggle to attract human capital talent. The study highlights the comparative disincentives inherent in Australia's tax system, such as the taxation of regional duties undertaken outside Australia and the punitive impact on employee share plan entitlements relating to pre-Australian services.

The study also shows how Australia's tax system has a significant adverse impact on longer-term assignments, thereby encouraging talented employees to leave Australia earlier than might otherwise be in their companies' interests.

Not only is the top rate of tax high (at 48.5% including Medicare Levy), but also the income level at which the maximum rate cuts in is low at $60,000 (when average earnings in Australia are just under $42,000). With foreign employees assigned to Australia considered resident for tax purposes if they are in Australia for greater than six months, there is no escaping the disincentives posed by the current regime.

These costs are ultimately borne (at least partially) by Australian companies using these individuals to build their international business.

In addition to the high headline rate of tax, there are a number of other uncompetitive features of the current Australian tax system for inpatriates discussed below, including:

(a) Lack of relief for non-Australian employment duties.

(b) Taxation of non-Australian investment income.

(c) Taxation of stock options.

(d) Foreign Investment Fund and CFC rules.

(e) Capital Gains Tax deemed disposal rules.

(f) Superannuation regime.

10.3.1 Lack of relief for non-Australian employment duties

Offshore workdays are generally a key component of the duties that a senior employee is required to perform, regardless of where the individual is based. For very senior people this could mean as much as 50% of their workdays are spent outside their normal work location.

Many countries recognise within their tax laws that where an individual is temporarily resident in their country, and required to perform duties outside their country, this income should not be subject to tax. This is particularly true where the regime has been designed to attract individuals in relocating to that country eg the United Kingdom (see Appendix G).

By comparison, employees relocating to Australia are subjected to both higher tax rates and a broader tax base, by being unable to obtain relief for duties that are not performed in Australia. Needless to say, the exemption afforded by Section 23AG of the ITAA for continuous periods of foreign service of not less than 91 days does not alleviate the situation for many inpatriates. For example, an individual relocating from Australia to the United Kingdom would benefit from a lower tax rate as well as relief for non-UK workdays, whereas an employee relocating from the United Kingdom to Australia would be penalised by a higher tax rate and no relief for workdays spent back in the United Kingdom or elsewhere.

In the United States, where generally no relief exists, the marginal tax rate at the Federal level is lower and a number of States allow relief for non-US workdays.

Employees who are granted options well before coming to Australia can become taxable in Australia at exercise on the entire benefit. This is notwithstanding that a significant portion of the benefit represents the accrued, but unrealised, gain on their options that arose before coming to Australia.

Australia is one of the few countries that allow no tax relief in respect of duties performed outside of the country for periods shorter than 91 days. This is obviously a disincentive for employees and for employers and this adds to the overall employment cost, particularly if a policy of tax equalisation is in place.

10.3.2 Taxation of non-Australian investment income

Australia, like the United States, is one of the few major commercial centres that impose tax on investment income that is generated from non-Australian sources that is not remitted to Australia. In addition, investments which are tax-free or tax-effective in the home country (with correspondingly lower rates of return) generally do not receive similar recognition in Australia. For individuals who have substantial investment portfolios, this increases the overall tax cost, particularly as the marginal tax rate in Australia is higher than in most other key financial centres.

10.3.3 Taxation of options

A. Options granted prior to Australian residency

The Australian tax regime has complex rules governing the taxation of stock options, which are extremely uncertain in their operation to international employees. For many employees, income from stock options constitutes a substantial component of their remuneration. The tax treatment of this income is often of far greater concern to the individual than that of salary income or personal investment income.

For individuals with substantial options that are unexercised prior to establishing Australian residency, the tax treatment can be a key determinant in the relocation decision.

The Australian approach is to allow the individual to elect whether to be taxed at the time of grant or exercise of the options. Secondly, the lack of any clear sourcing rules for employee stock options makes it difficult for inpatriates to clearly ascertain the tax implications of exercising options.

However, the clear downside is that employees who are granted options well before coming to Australia can become taxable in Australia at exercise on the entire benefit. This is notwithstanding that a significant portion of the benefit represents the accrued, but unrealised, gain on their options that arose before coming to Australia.

Such a tax regime is both unattractive and inequitable. In some cases, individuals may postpone establishing Australian residency or choose not to accept an assignment due to fluctuations in the stock market. This is in contrast to individuals going to other study countries that tax the options on exercise, regardless of when they were granted. In those countries, individuals may find a certain level of comfort in the fact that they can plan and be aware of the exact consequences of exercising the options.

Employees who are granted options well before coming to Australia can become taxable in Australia at exercise on the entire benefit. This is notwithstanding that a significant portion of the benefit represents the accrued, but unrealised, gain on their options which arose prior to coming to Australia

10.3.4 Taxation of options

B. Options granted during Australian residency

The difficulties in the Australian tax regime with options are not restricted to options granted before commencing Australian residency. Individuals granted stock options while on assignment, that may not be exercised for a number of years, may be caught by the proposed rules to tax options upon cessation of residency or by the capital gains tax deemed disposal rules that come into effect when the individual leaves Australia. This can result in individuals having to pay tax on unexercised (and in many cases unvested) options based on market conditions at the time they leave Australia.

Ultimately, this will translate into an increased cost to bring inpatriates to Australia, as it will be their employers who will usually end up having to meet (or partially meet) this unjustified tax cost on unrealised (and possibly unrealisable) gains on stock options.

10.3.5 Foreign Investment Fund and CFC rules

The current structure of the Foreign Investment Fund “FIF” rules and CFC rules is another disincentive for individuals with such investments in coming to Australia.

Under these rules, a deemed capital gain or capital loss may crystallise even though no physical disposal of an asset takes place, and despite there being no realisation of a gain, nor money received to pay the tax on the deemed gain.

Investment decisions of inpatriates will generally be dictated by market conditions and investment structures prevailing in the country they consider their long term home. Frequently, this will involve the indirect holding of investments in entities that may fall within the FIF rules. Whilst some exemptions apply, these are relatively narrow.

It is totally unrealistic to expect foreign employees to restructure their investments during a period of temporary residence in Australia. As a result, the employer often ends up bearing (or at least an element of) the increased tax cost of these rules.

10.3.6 Capital gains tax deemed disposal rules

Currently, where a taxpayer ceases to be an Australian resident, the CGT rules apply to deem a disposal of every asset owned for its market value at the date of departure. An exception applies to assets "having a necessary connection with Australia" for example, land or buildings situated in Australia, shares in a private company or interests in Australian trusts or partnerships. Assets which are subject to the deemed disposal rules include shareholdings in Australian and foreign public companies.

Under these rules, a deemed capital gain or capital loss may crystallise even though no physical disposal of an asset takes place, and despite there being no realisation of a gain, nor money received to pay the tax on the deemed gain.

The deemed disposal rules do not apply to assets held on arrival provided the assignee has been tax resident for tax purposes for less than five out of the ten previous years. However, the taxpayer may opt to ignore the deemed disposal of assets treatment and agree instead to pay Australian tax at the time the asset is actually sold regardless of tax residency status. This has the effect of increasing (or reducing) the tax payable in Australia based on movements in value after a person has actually ceased residence. Moreover, no exemption exists for assets acquired after establishing Australian residency, regardless of the length of period that the individual is resident in Australia.

When the inpatriate leaves Australia at the end of the assignment, then Australia will require a valuation of the overseas assets as well as the Australian assets, and will impose taxation on the increased value of the overseas assets, whether or not they have been disposed of.

Example 10.1

An executive comes to Australia from the UK to operate as a scientist in a specialist area in an Australian company. The inpatriate has a house and some investments overseas, together with a managed fund maintained for the purpose of creating an eventual retirement income, and has stock options granted by their former employer.

On arrival in Australia for a six year posting the non-resident becomes taxable in Australia on their global income, including income from the investment activities and from the retirement savings account. Additionally if the pre-arrival employee stock options are exercised, Australia will impose taxation on the total profit.

If, during the term of the Australian posting, the inpatriate sells the foreign assets, then Australia would impose capital gains tax.

When the inpatriate leaves Australia at the end of the assignment, then Australia will require a valuation of the overseas assets as well as the Australian assets, and will impose taxation on the increased value of the overseas assets, whether or not they have been disposed of.

As can be seen the Australian taxation is imposed on foreign unrealised gains, and at higher rates than imposed internationally in relation to capital gains.

As a result, these rules can have a significant impact on departure for inpatriates who stay for more than five years or who acquire assets while they are here.

10.3.7 Superannuation

The ability of individuals to remain in their home country retirement system is another key factor that employers must address when attempting to attract key personnel.

For many senior level executives, particularly those close to retirement age, it is important to remain in their current plan to maximise the return on their investment and the ultimate retirement benefit. Many such schemes have been carefully planned and funded for a number of years to ensure the correct level of retirement benefit.

Employers are sometimes faced with the prospect of having to make dual contributions into both the home country retirement scheme and Australian superannuation – together with the further burden of the home country contribution being non-deductible.

Australia's superannuation laws ignore this fact, by not only making it compulsory to contribute to an Australian superannuation fund, but also by making contributions to an executive's home country plan largely non-deductible. As a result, employers are sometimes faced with the prospect of having to make dual contributions into both the home country retirement scheme and Australian superannuation, together with the further burden of the home country contribution being non-deductible.

Therefore, there is a potential triple cost to Australian employers in providing retirement funding for international executives.

The issue of retirement provisions not only affects senior management but inpatriate assignees at all levels, although there is an 'executive exemption' under which a limited class of senior executives need not make superannuation contributions. (The criteria for qualifying for this exemption are extremely stringent.)

Accordingly, most inpatriates are faced with having to suspend home country contributions and contributing to Australian superannuation funds, often for a period of only a few years. Due to the preservation requirements in place in Australia, individuals have to deal with the administrative and tax consequences of their accrued entitlements upon return to their home country. This can lead to additional complexity in complying with their home country tax requirements. There is even a risk that we may see some foreign assignees in the future never claiming their accrued Australian entitlements because the size of the benefit and administrative process may not be worth their effort to pursue payment.

Ultimately, it is usually the employer that bears the increased cost from not being able to properly integrate retirement funding for international employees.

In these times of low inflation and cost pressure, the net effect of these costs is for employers to explore international employment arrangements, which will see international inpatriate employees bypass Australia.

The OECD has done work in this area, recognising the need for pension arrangements to operate appropriately in a world of mobile employees.

There are, simply, better places to locate talent than in Australia – particularly if the talent is focused on international business. Australia is the poorer for not attracting these talented people, their knowledge, the clustering of activity around them and the taxes on their local income.

10.4 ATO policy has made the need for action more urgent

This change in ATO policy has been one of the catalysts of the groundswell for reform. It has highlighted the necessity to remedy these disincentives in Australia's tax system, in particular, the lack of relief for non-Australian workdays and the taxation of offshore investment income.

Until 1998, the ATO considered foreign employees assigned to Australia 'non-residents' if the assignment was for less than two years. The ATO has now changed its practice compounding all of the problems identified above. This has resulted in most foreign employees working in Australia now being taxed on worldwide income, whereas, the old approach permitted individuals who were on relatively short term assignment to be taxed as non-residents and therefore subject to tax only on Australian source income. For these employees, this meant that if their assignment was short term, they received relief for their non-Australian duties as well as being exempt from tax on their non-Australian source investment income.

This change in ATO policy has been one of the catalysts of the groundswell for reform. It has highlighted the necessity to remedy the disincentives in Australia's tax system, in particular, the lack of relief for non-Australian workdays and the taxation of offshore investment income.

10.5 ATO focus could facilitate the process

We perceive also that there is no focus on streamlining the treatment of inpatriates within the Australian Taxation Office, nor in Australian tax policy development arm of Government.

We perceive also that there is no focus on streamlining the treatment of inpatriates within the Australian Taxation Office, nor in Australian tax policy development.

The ATO is structured along industry lines and particular segments, with no single segment or line that has direct responsibility for inpatriates. This leads in our experience to a situation that whenever any issue arises, there is no obvious "champion" or "owner" of the issue within the ATO. There are substantial delays in resolving any issue because of the large number of potential stakeholders or supervisors within the ATO.

We suggest that substantial improvements might be achieved if there was a unit or centre of expertise within the ATO looking to the needs of inpatriates, and identifying the issues for speedy resolution.

We note that Singapore has adopted such an approach, in order to ensure that inpatriates perceive Singapore to be a tax-friendly environment in which to operate. Such a focus may yield significant benefits.

10.6 Assessment of potential solutions

Many different models have been tried to address these issues. The RBT report addresses some of the issues, albeit with shortcomings. Numerous other countries have also adopted inpatriate friendly regimes. Some of the key countries are discussed below. Some further variations are also set out in Chapter 11.

10.7 RBT proposals are a useful first step, but not enough

The RBT recognised the fact that the Australian tax regime is currently unattractive to inpatriates. In fact, the Report acknowledged that "a wider review of personal taxation issues may identify other changes which need to be made to ensure that Australia's tax arrangements are appropriately treating internationally mobile executives and skilled employees generally" and that "Australia's tax rules should not result in unrelieved double taxation of the income of people who move between Australia and other countries in the course of their employment – and not impose excessive costs on local businesses employing foreign inpatriates".

The RBT made four recommendations on foreign inpatriates and residents departing Australia. The RBT recommendations were:

(a) That a **non-resident's salary and wage income** be subject to final withholding tax at the company rate (Recommendation 22.17).

(b) That individuals who enter Australia on a temporary entry permit – where the visa is for four or fewer years' duration – and become residents for tax purposes for the first time be exempt from:
   - Australian tax on foreign source income derived from the ownership of **pre-residence assets**; and
   - Australian interest withholding tax on interest payments in respect of **pre-residence liabilities** (Recommendation 22.18).

(c) That, in the income year an employee ceases to be an Australian resident, the taxable income of the employee include the value of share discounts given to the employee under a 'qualifying' employee share scheme while a resident (**employee share plan issues**) (Recommendation 22.19).

(d) That to provide some assurance that deferred capital gains tax is eventually paid when relevant assets are disposed of, a resident who elects to defer capital gains tax when ceasing to be an Australian resident be required to give appropriate security to the Australian Taxation Office (**CGT security deposits**) (Recommendation 22.20).

Consequently, this recommendation is only helpful to a limited number of individuals. The recommendation does not provide any tax relief for those individuals who are entering Australia on a temporary basis, albeit for more than six months.

These recommendations provide a first step towards reform; however, we believe there remain a number of shortcomings. These are discussed below.

10.7.1 Non-residents' salary and wage income

Whilst recommendation 22.17 certainly benefits non-residents, the change in ATO interpretation of residency has meant that fewer individuals are now considered a non-resident of Australia for tax purposes. Consequently, this recommendation is only helpful to a limited number of individuals. The recommendation does not provide any tax relief for those individuals who are entering Australia on a temporary basis, albeit for more than six months.

10.7.2 Pre-residence assets and liabilities

The RBT recommended a limited shelter from Australian tax for the investment income on pre-residence assets. However, these recommendations have raised a number of issues.

- The RBT recommendation does not operate effectively where an inpatriate has pre-residence foreign assets in a portfolio of shares or other investments and the portfolio of foreign assets is replaced as part of ordinary personal financial planning. Assume for example that if a non-resident has a portfolio of 10 stocks listed in the US or the UK and one company was taken over, another commenced to trade unprofitably and the inpatriate sought merely to adjust the portfolio by replacing that investment. The replacement foreign investments would no longer attract the concession.

- Additionally, as discussed below, the general process of tracking and separating pre-residence and during-residence assets will generate very substantial compliance workloads. We wonder whether this will be effective from the viewpoint of the Australian revenue and the national interest.

- As a further condition proposed by Treasury and ATO the ATO indicated that it might seek to impose a 'subject to tax' test for the exemption recommended by the RBT. Such a test would look to see whether the income had been subject to tax or not in the individual's home location. This proposal seems to have been prompted by a concern that taxpayers would move their assets from their home location to a lower tax jurisdiction to avoid paying tax in their home country whilst at the same time being exempt from tax in Australia.

  Such an approach would increase the complexity of an already complex system and would give rise to practical difficulties since it would become necessary to examine in greater detail Australian tax legislation, as well as that of the foreign jurisdiction to determine the appropriate tax treatment. For example, whether the income has been subject to tax or at least sufficient tax in the foreign jurisdiction will need to be assessed to determine whether Australian tax would apply. Using a test like this would undermine the RBT's aim to reduce the compliance costs and create a more simple system. It is also symptomatic of an approach by Treasury and the Taxation Office that Australia should be responsible for policing the revenue bases of other countries. This approach fails to recognise the policy inherent in the proposal – that it is intended to be an incentive.

We need to allow for replacement or top-up of pre-residence assets

Because the recommendation does not appear to shelter from Australian tax:

- Disposals of pre-residence assets, and
- Assets acquired from new investments acquired as a result of reinvesting proceeds from sale of pre-residence assets,

the proposed exemption would potentially limit the ability of international employees to reassess their investment portfolio from time to time and adjust it as necessary.

The exemption by Australia of pre-residence assets from Australian Capital Gains Tax is a compelling proposition.

We consider, in the same way, Australia should exempt from Australian tax the proceeds of conversion of pre-residence assets into new foreign assets. For example, if an inpatriate has shares in a UK company held as an investment, and the UK company is taken over or the investment needs to be converted into another UK company, it would seem to us highly inappropriate for Australia to tax the gain on the replacement asset, even though it was acquired during the period of the Australian transfer, because that asset represented the reinvestment of pre-Australian-assignment assets.

It might be argued, even if the above concessions are provided, that there should be no concession for new assets acquired during the period of the Australian assignment to the extent that these are acquired from Australian earnings of the inpatriate. While this argument appears attractive on the surface we note that:

(a) Such an approach would mean that the temporary resident would need, in relation to every asset, to undertake a tracing obligation. Assume that a US or German company has a dividend reinvestment plan, and the inpatriate buys additional shares during the term of the Australian assignment under the dividend reinvestment plan. The compliance aspects rapidly become excessively costly.

(b) The trend is for overseas countries to give inpatriates concessional treatment in relation to all of their foreign assets. The rationale includes the fact that if an inpatriate acquires foreign assets then, on eventual departure from the assignment country, there will typically not be a realisation of the foreign assets and thus to impose taxation on unrealised gains amounts to a form of wealth tax, in addition to the ordinary income tax which will have been withheld from the ordinary earnings in the country.

For this reason, we suggest there would be merit in extending the concession to exempt from Australian tax all income from foreign assets held by the inpatriate.

It would be clearly accepted that the inpatriate would be subject to Australian tax on Australian assets acquired.

10.7.3 Employee share plan issues

The RBT did not address the treatment of unrealised gains on pre-residence employee stock options. Arguably, these should be eligible for the same treatment as proposed for pre-residence assets.

Further, the RBT report recommended that when the inpatriate ceased to be a resident (ie on conclusion of their positing) this should be considered a taxing event for any share plan entitlement granted during an employee's assignment in Australia, and that this would trigger tax at this point.

We consider that this recommendation is problematic in that cash flow issues will arise where an individual is required to pay tax when ceasing residency, even where the share plan benefits have not been realised, and may not be capable of realisation at that time. Again, ultimately it is likely that the result of this change is an increased tax cost borne by the employer.

10.7.4 CGT security deposits

The RBT recommended also that individuals who elect to defer CGT on accrued but unrealised gains on certain assets held on the date of departure would be required to provide appropriate security to the ATO. This recommendation is based on similar legislative proposals in Canada.

By introducing such a system, Australia would create a strong disincentive for individuals to remain in Australia beyond five years. Few countries in the world have a deemed disposition system, relying instead on the tax being collected at the time of actual disposal of the asset let alone a system of security deposits to collect the tax on the unrealised gains. A review of the DTA would normally be the appropriate way to determine the correct tax treatment in each location.

10.8 Conclusion in relation to current system

The current legislation and proposed recommendations clearly highlight the problems with the current system, namely:

- a complex and confusing system where the individual is required to make elections based in part on speculation;
- potential cash flow issues for individuals who have a notional gain crystallised without receiving any income from the actual disposition of the asset; and
- administrative and compliance burden on the individual to ensure compliance with home and host country tax laws.

10.9 Government Proposals in "Securing Australia's Prosperity"

The Government proposed in its October 15 Election Statement "Securing Australia's Prosperity" (see Appendix D for extracts) a series of measures for dealing with the tax issues of expatriates.

We welcome that announcement. The announcement does not address all of the issues and recommendations raised in this White Paper, however we trust that opportunities to address the unresolved issues will arise in the consultation process around the international tax system generally, which has been foreshadowed by the Government.

11. International Competitiveness of Australian Tax Treatment of Inpatriates

We prepared a detailed study of Australia's tax regime in respect of inpatriate employees, looking at the total tax that would be payable (both by the employee and by the employer.

As well we have compared the tax rules in various other relevant countries, to provide indicators of international practice when dealing with the tax issues around expatriates and inpatriates.

11.1 Our Study

Our detailed study, contained in Appendix D, compared Australia's tax regime in respect of inpatriate employees, looking at the total tax that would be payable (both by the employee and by the employer) if a key executive was asked to work in the following locations:

- Australia;
- New York, USA;
- London, UK;
- Hong Kong;
- Singapore.

We have chosen these locations not only because they are key financial centres, but also because they demonstrate different approaches to the taxation of inpatriates.

Four scenarios were examined:

- Three-year assignment with all duties being performed in the host location.
- Three-year assignment, with duties performed in the host location, and inpatriate exercises stock options granted before the assignment.
- Three-year assignment, and 30% of the duties are performed outside the host location.
- Assignment is extended from three years to six years.

11.1.1 Three Year Assignment

Even under the simplest scenario of a three-year work assignment with no regional duties requiring offshore travel, Australia's tax burden is, at best, barely comparable to the United States and the United Kingdom. It is significantly higher than our regional competitors. Looking to offshore investment income, only Australia and the United States (of the countries in the study) seek to tax this investment income.

Australia also has the highest level of payroll and/or employer social security taxes, other than the UK. However, reciprocal social security agreements (of which Australia is party to few) often mitigate the UK employer social security cost. Employer organisations in Australia rarely have such an ability.

11.1.2 Pre-employment stock options

Of the five countries considered in the study, all except the United Kingdom will tax the employee when these options are exercised. The detrimental impact of Australia's high marginal tax rates is immediately apparent, pushing Australia's effective tax rate to levels significantly higher than our competitors.

This scenario clearly illustrates one of the great inequities of residency based tax systems such as Australia's. Individuals holding valuable but unrealised (and probably unrealisable) employee stock options entitlements at the time their assignment commences, can become subject to the full impact of Australia's high marginal tax rates. They may be taxable on the full value of these entitlements at exercise, notwithstanding that all or most of the benefit accrued at a time when they had no connection to Australia. Even Australia's capital gain tax rules only seek to tax increases in value after coming to Australia.

Other than the United States, Australia is the only country in the study that seeks to tax such stock option entitlements at high marginal tax rates. Our regional competitors whilst also taxing, do so at significantly lower marginal tax rates.

11.1.3 Regional responsibilities

Hong Kong, Singapore and the United Kingdom will not generally seek to tax compensation earned by inpatriates for services outside their country. Even in the United States example, New York State income tax relief applies in these circumstances, reducing tax rates by a few percent. Therefore, Australia is alone in not providing any tax relief for regional duties.

11.1.4 Extending an assignment

Extending assignments is very costly as far as Australia is concerned. The loss of LAFHA concessions clearly puts Australia on a tax platform all by itself and illustrates the adverse impact of Australia's tax system. This is even without taking into account the Australian capital gains tax implications which have draconian impact on inpatriates who stay in Australia for more than five years.

11.2 How some major countries impose tax on inpatriates

11.2.1 United Kingdom

The United Kingdom, like Australia, is generally perceived to be a high tax country because it has a high marginal tax rate that cuts in at a low-income threshold. However, the United Kingdom is generally a favourable place for inpatriates due to the tax treatment of non-UK income for individuals who are on temporary assignment.

Individuals who are on assignment in the United Kingdom that last more than six months but less than three years are considered to be 'resident but not ordinarily resident' for tax purposes. This special tax status allows for relief from tax in relation to compensation income for non-UK workdays if the income relating to those workdays is paid and retained offshore. This can result in substantial tax savings. Other measures designed to reduce the level of inpatriate taxation include allowing Home Leave travel to be provided tax-free for the first five years of an individual's assignment, as well as exempting from tax options granted outside the United Kingdom but exercised in the United Kingdom (provided the grant was not in connection with the UK employment).

In addition to having a favourable tax regime for employment income, the taxation of foreign investment income is another attraction for foreign inpatriates and their employers. The United Kingdom will only tax foreign investment income if it is remitted to the United Kingdom. Furthermore, for individuals who are not domiciled in the United Kingdom, capital gains arising offshore are exempt from UK tax.

Overall, the United Kingdom has been has been able to mitigate many of the disadvantages associated with a high tax regime by legislating special concessions which result in favourable treatment for international employees

… the Dutch Government introduced the 30% allowance regulation … an employer is entitled to pay an eligible inpatriate employee a maximum of 30% of their salary tax-free.

Overall, the United Kingdom has been has been able to mitigate many of the disadvantages associated with a high tax regime by legislating special concessions which result in favourable treatment for international employees. In doing so, the United Kingdom has remained one of the top countries in terms of the number of inpatriates assigned there each year.

11.2.2 The Netherlands

In an effort to increase its country's competitiveness and to compensate employers for the significant expense of foreign employees, the Dutch Government introduced the 30% tax-free allowance regulation, for:

- an employee with specific expertise that is not, or scarcely, available on the Dutch labour market; or
- an employee who is assigned within a group in accordance with an international job rotation policy whereby the employee has been employed within the group for at least two and half years.

An employer is entitled to pay an eligible inpatriate employee a maximum of 30% of their salary tax-free.

The eligibility conditions were enacted to ensure that the regulation was not abused and yet to attract the correct labour pool that the Dutch Government considered was necessary to increase the country's competitiveness. Most notably, the Dutch Government has recognised that top managers, senior executives and product specialists meet the specific expertise criteria. The allowance is granted, in principle, for up to ten years, however various tests are applied during this time to determine if that individual's specific expertise remains scarce in the market.

By enacting this regulation, the Dutch Government immediately increased the competitiveness of Dutch businesses in attracting key specialists from overseas.

11.2.3 Belgium

In Belgium, foreign executives are required to declare their worldwide income, however, they are allowed to exclude from tax the portion of income related to activities carried on outside Belgium. In addition, individuals are also entitled to exclude an allowance considered a reimbursement of the costs incurred by the employer (limited at BEF 450,000 approximately A$555,000).

In order to qualify for the special tax regime, the individual must be an executive or specialist who is temporarily assigned to Belgium and:

- keeps the centre of their economic interests outside of Belgium; and
- must be employed by a Belgium or foreign company belonging to an international group.

This regime allows for substantial tax savings for individuals temporarily assigned to Belgium.

11.2.4 Sweden

Following on from the Dutch example, the Swedish Government recently presented a bill for a new Swedish tax act for the taxation of key foreign persons working in Sweden. This proposal has still to be approved by the Swedish parliament.

According to the Bill, certain persons, such as executives, experts in areas where there is a lack of competency in Sweden and researchers may enjoy tax relief on income attributable to their work in Sweden. The tax relief will apply provided the individual's stay in Sweden is temporary ie. not longer than five years and their employer is a Swedish company or a foreign company with a permanent establishment in Sweden. The relief will be granted for the first three years.

The Government has presented two alternative forms of tax relief. According to the first alternative, 25% of the individual's gross income will be exempted from tax. This also applies to certain reimbursements such as home leave and education expenses. Critically, the individual will not be liable to the high social security charges on the tax-exempted income. According to the second alternative, the individual's gross income will be taxed at a flat rate of 25%. However, social security taxes would be due on the whole amount, including the exempted income.

11.2.5 France

As with the other Europeans countries above, the French Government recognised the importance of having a special tax regime to attract inpatriates. Similarly, the principal focus is by providing relief for non-French workdays. However, the French system is slightly different from those outlined above.

French tax law provides for the payment of a tax-free foreign service premium with respect to days worked outside of France. The main criteria to enable this premium to be exempt from tax is that the individual must be considered a tax resident of France and that he must be sent outside France to work by an employer who is established in France. In addition, the premium must be detailed in the contract of employment and must constitute additional compensation over and above base salary or normal compensation he would receive if he did not travel outside of France. It must, therefore, be an amount paid for the inconvenience of overseas duties and determined as a percentage of base compensation in direct proportion to the number of days actually worked outside France.

It should be noted however, that this is not a blanket provision. One key criterion for being eligible is that the individual must be a national of a country with which France has signed a tax treaty containing a non-discrimination clause.

11.2.6 Hong Kong

Like most Asia-Pacific countries, Hong Kong has an extremely favourably tax regime, more so if the individual is an inpatriate. Similar to the European regimes, the Hong Kong Government allows for time-apportionment of income based on workdays spent outside of Hong Kong.

In order to qualify, an offshore company must employ the individual and the contract of employment must be entered into and must be enforceable outside of Hong Kong. In addition, the remuneration in relation to these days must be paid outside of Hong Kong.

11.2.7 Japan

Japan, like the United Kingdom, has adopted a system whereby a special residence status exists for temporary assignees. Inpatriates who are non-Japanese nationals and reside or intend to reside in Japan for 1-5 years are considered to be non-permanent residents (as opposed to non-resident or resident).

Non-permanent residents are taxed on the greater of their Japanese source income or their total funds remitted into or paid in Japan (limited to worldwide income). For Japanese tax purposes, the source of a non-permanent resident's employment income is determined based on where the services are performed.

12. Our Recommendations on Inpatriate Tax Issues

Our recommendations for an internationally competitive system of taxing inpatriates, in order to address the inherent problems within the Australian inpatriate tax regime, are as follows.

Some of the recommendations have been referred to in the Government's October 15 Election Statement "Securing Australia's Prosperity" (see Appendix D for extracts). We trust that opportunities to address the unresolved issues will arise in the consultation process around the international tax system generally, which has been foreshadowed by the Government.

12.1 Adoption of 'temporary resident' status

In order to be competitive, Australia should adopt a temporary resident status for the taxation of individuals. Eligibility could be determined by visa classification and should apply for up to five years. The criteria for qualifying for the 'Living Away from Home' rules should also be aligned with this approach.

Special exemptions could then be made available for the individuals considered 'temporary residents'.

In addition, we recommend that the Government should consider a process whereby certain employees who are inpatriates of Australia should be granted temporary resident status, even after five years. We note:

(a) the experience in The Netherlands (discussed above) where tax concessional status is granted for up to ten years where necessary to increase that country's competitiveness; and

(b) the willingness of the Australian Government to target business migration for concessional treatment in relation to visa status and residency status in the past.

By adopting such a status, special exemptions could then be made available for the individuals considered 'temporary residents'. Our recommendation would be to adopt an approach, similar to the United Kingdom and Japan, providing the following benefits.

- Allowing relief from Australian tax in respect of non-Australian workdays, provided that the income is paid and retained outside of Australia.
- Providing an exemption for share plan benefits granted in relation to non-Australian service.
- Exempting non-Australian investment income and capital gains, provided it is not remitted to Australia.

This would immediately make Australia more attractive for international employees, without having to adjust the general tax rate scales.

Recommendation 21: Adoption of 'temporary resident' status

Australia should adopt a temporary resident status for the taxation of individuals, in Australia on visitor visas for a period of up to five years. The qualification for tax 'Living Away from Home' rules should also be aligned with this approach.

Temporary residents would be eligible for specific tax exemptions on:

- income attributable to non-Australian workdays which are worked outside Australia and which do not relate to management of the Australian business of the group, provided that the income is paid and retained outside Australia;
- share plan benefits granted in relation to non-Australian service; and
- non-Australian investment income and capital gains not remitted to Australia.

We further recommend a tapered concession allowing foreign assets to be partially freed from tax for a further two years.

Under the tapered exemption proposal the exemption would operate as follows:

(a) Executives in Australia for periods up to five years would not be subject to Australian capital gains tax on their foreign assets.

(b) This concession would be progressively scaled back for two further years after the fifth year.

The tapering of the CGT exemption would apply on a half-yearly basis, so an executive leaving Australia between five and five and a half years after arrival would have a 75% exclusion from Australian capital gains tax in relation to their foreign assets, an executive leaving between five and half and six years would have a 50% exclusion, and so on. An executive in Australia after the seventh year would be subject to Australian capital gains tax with no concession.

"Securing Australia's Prosperity" refers to more limited concessions to expatriates resident in Australia for less than 4 years, applying to investment income and certain capital gains other than portfolio interests in Australian listed companies.

A simple solution for the current problems with superannuation would be to extend the current 'executive exemption' from Australia's superannuation system to all individuals entering Australia on assignment with their employers. The employee would then be able to either remain in their employers' home country superannuation system, or if this was not possible, make private arrangements in their home country.

12.2 Superannuation

A simple solution for the current problems with superannuation would be to extend the current 'executive exemption' from Australia's superannuation system to all individuals entering Australia on assignment with their employers. This would be tied to the 'temporary resident' status approach suggested above. The employee would then be able to either remain in their employers' home country superannuation system, or if this was not possible, make private arrangements in their home country.

An alternative solution would be to remove the preservation requirements on individuals requiring them to keep the funds in Australia.

These measures were originally introduced in an attempt to stop Australian citizens becoming non-resident and withdrawing their superannuation funds. A more appropriate approach would be to tie superannuation preservation requirements to visa classification (or other appropriate methods), thereby making it possible for inpatriate assignees to withdraw their funds and roll them back into their home country accounts.

This would align the Australian regime more closely with its competitors. For example, the United Kingdom and the United States do not require any mandatory contributions to retirement schemes. Hong Kong does not require contributions to the Mandatory Provident Fund where the individual remains in their home country pension scheme. Singapore recently announced a change in their system whereby inpatriate employees were no longer required to contribute to the Central Provident Fund.

In addition, the prohibition on deductions for employer contributions to offshore funds on behalf of individuals who qualify for the temporary resident status should be lifted.

Recommendation 22: Superannuation

We recommend that inpatriates in Australia as temporary residents should not be subject to Australia's compulsory superannuation arrangements.

We recommend extending the current 'executive exemption' from Australia's superannuation system to all individuals entering Australia on assignment with their employers, who have "temporary resident" status according to our recommendation 20 on that status. An alternative solution would be to remove the preservation requirements on individuals requiring them to keep the funds in Australia.

In addition, the prohibition on deductions for employer contributions to offshore funds on behalf of individuals who qualify for the temporary resident status should be lifted.

"Securing Australia's Prosperity" makes no reference to these issues.

12.3 Income from investment and share options

Temporary residents should be exempt from Australian tax on foreign source income and capital gains derived from the ownership of pre-residence assets not remitted to Australia.

The exemptions as outlined in the RBT Report (Recommendation 22.18) should be adopted without a 'subject to tax' test and applied to temporary residents, not just those with a duration of four or five years.

The exemption should be extended to cover:

(a) all foreign investment income, as well as capital gains; and

(b) stock options granted before commencing Australian residency unless granted as a condition of their Australian assignment.

Recommendation 23: Income from pre-residence investments and share options

Temporary residents should be exempt from Australian tax on foreign source income and capital gains derived from the ownership of pre-residence assets not remitted to Australia.

We also recommend that temporary residents should be exempt on stock options granted before commencing Australian residency unless granted as a condition of their Australian assignment.

Australia could also consider applying this exemption to **all** gains from foreign assets by temporary residents, not just to pre-arrival foreign assets. Such a measure would be consistent with general international practice, would involve minimal revenue costs and would streamline the law by not requiring complex tracing of foreign assets into pre-assignment and post-assignment assets.

"Securing Australia's Prosperity" refers to more limited concessions to expatriates resident in Australia for less than 4 years, applying to investment income and certain capital gains. "Securing Australia's Prosperity" also refers to a desire to address capital gains tax issues on a country-by-country DTA basis, citing the protocol to the US-Australia DTA as an example of this approach. It remains to be seen whether these recommendations will be covered.

Recommendation 24: Treatment of gains attributable to discounts on shares awarded

RBT Recommendation 2.19 (a) was that, in the income year an employee ceases to be an Australian resident, the taxable income of the employee include the value of share discounts given to the employee under a 'qualifying' employee share scheme while a resident. This is problematical.

We strongly support Australia participating in an international review, perhaps through the OECD, of the allocation among different countries of taxing rights where employee shares and rights relate to service in more than one country.

"Securing Australia's Prosperity" does not refer to this issue except implicitly in other statements. This issue will not be solved merely by addressing Australia's capital gains tax rules, because Australia's employee share scheme tax rules deem the gains to be income, not capital gains.

12.4 CGT deemed disposal rules

Even if the Government didn't accept our recommendations in this area, for the reasons discussed above, the CGT deemed disposal rules should be abolished.

Recommendation 25: CGT deemed disposal rules on inpatriate leaving Australia

The CGT deemed disposal rules should be abolished.

"Securing Australia's Prosperity" refers to a desire to address these issues on a country-by-country DTA basis, citing the protocol to the US-Australia DTA as an example of this approach. This will take a long time to achieve.

13. Complete Listing of Recommendations

Recommendation 1: An internationally competitive holding company regime

The Australian Government should focus urgently on creating internationally attractive holding company tax regimes for:

- Parent holding companies – an environment to encourage the parent holding companies of Australian-based international businesses to remain centred in Australia; and
- Conduit holding companies – an environment to attract foreign-owned businesses to locate their regional headquarters and other activities in Australia. This issue needs to be recognised by the community as affecting emerging businesses and not simply being a "big end of town" issue. Emerging Australian high growth businesses are potentially more mobile than "big business".

Recommendation 2: Design Australia's tax system for flow-through of foreign source income and certain gains to foreign investors

In setting the policies for taxation of income flowing through Australian entities, Australia should consider an approach of encouraging the flow of foreign source income and certain gains and general foreign activity through Australian entities to foreign investors in a non-taxed manner. This is consistent with the principle of not taxing foreigners on foreign profits.

Recommendation 3: Review of the imputation system

At a conceptual level, Australia should reconsider whether in respect of foreign income an imputation system is the most efficient way to encourage and facilitate the growth of Australian companies in overseas markets. A complete review of the imputation system is outside the scope of this Paper, although this should be addressed on the basis of the powerful international trend described in the Paper.

Australia should modify the current system in order to remove the well-documented distortions …

However, **irrespective of the potential for future debate and redesign, Australia should immediately modify the current system to remove the well-documented distortions as set out in Recommendations 4, 6 and 7 below.**

Recommendation 4: Allowing foreign source dividends to be paid without adverse franking impact

We recommend changes to the taxation treatment of dividends when paid out of foreign sourced income of an Australian company to its foreign shareholders. Australian companies should be able to pay unfranked dividends out of foreign income to foreign shareholders without the imposition of Australian DWT and adverse franking account consequences.

This will involve the extension of the current FDA and future FIA regime, and will make Australia a more attractive international parent or holding company location.

This recommendation is insufficient without further action to deal with the additional cost of foreign DWT, as recommended below.

Recommendation 5: DTAs need to be renegotiated to remove dividend withholding taxes

As a major initiative, we recommend that Australia should pursue vigorously the process of renegotiating tax treaties which lead to inequitable results for foreign investors. It should be a national priority to reduce the DWT rates on non-portfolio dividends during these negotiations and for changes to be implemented as soon as possible. Otherwise, Australian companies will continue to suffer restrictions on cross border capital flows, adversely impacting profits and investment decisions.

We applaud the action of the Australian Government in agreeing to the protocol to the United States/Australia DTA. This can be a model for renegotiation of other DTAs, that foreign dividend withholding taxes on income flowing to Australia are reduced to zero, with a corresponding reduction of Australian dividend withholding taxes on unfranked dividends to foreign investors.

Recommendation 6: Stapled-stock arrangements without adverse impact on franking account

Australia's tax law should allow foreign shareholders to receive dividends directly from foreign subsidiaries which are resident in listed comparably taxed countries using a stapled-stock arrangement, without creating franking debits to an Australian company's franking account.

Recommendation 7: Triangulation of imputation credits for NZ

Australia should proceed to achieve triangular imputation credits in Australia and New Zealand in respect of company tax paid by companies in the other jurisdiction.

Recommendation 8: Conduit Holding Company ("CHC") regime

A CHC regime should be introduced which will provide a CGT exemption for gains realised on **non-Australian assets** held by CHCs where those gains flow through to non-resident shareholders.

The concession may be available to all non-resident shareholders or restricted to residents in Treaty countries. If the concession was to be restricted to companies owned by treaty-resident investors then the concession should apply to disposals of subsidiaries wherever they were resident. If the concession applied to Australian companies controlled by foreign investors in any country, then there might be scope to restrict the concession.

CHCs should be defined to include companies that are incorporated in Australia, with a prescribed level of foreign ownership.

The exemption should apply where the Australian company is a wholly owned subsidiary of a foreign group. A lower level of foreign ownership might also qualify; for example at least 50% controlled or owned by non-residents. The eligibility criteria might be aligned with the definition of foreign-owned entities for purposes of the thin capitalisation rules.

A CHC would continue to be subject to Australian tax on the disposal of any Australian assets.

A CHC would attract additional Australian tax concessions in two circumstances, being an extension of the current law and policy that capital gains realised on the disposal of **active businesses** owned by CFCs of an Australian company are not taxed. No Australian tax would be imposed on:

(c) Capital gains realised on disposal of shares in CFCs of the CHC where there is an underlying active business.

(d) A proportion of capital gains realised by the non-resident investors on disposal of shares in the CHC, corresponding to the unrealised gains on non-Australian assets held by the CHC.

To be eligible a CHC would require a substantial presence in Australia with, among other possible criteria, employment of a given number of employees in the CHC or associated Australian companies. Registration as a CHC would be required.

The CHC regime could apply only on a prospective basis eg for assets acquired after the date of commencement of the concession.

Recommendation 9: Australian CGT and pre-CGT DTAs

We recommend that Australia consider the international impact of the position taken by the Commissioner, in Draft Ruling TR2000/D12. This requires:

- urgent action to resolve the issue in negotiations with the relevant DTA treaty partners; and
- potential trade-off of this ATO position for negotiated concessions from treaty partners, notably in their elimination or reduction of DWT in relation to dividends paid by companies resident in those countries to Australia.

Recommendation 10: Adjust Australian dividend rebate rules to allow for rebates from holding companies that hold foreign subsidiaries

Australia's dividend rebate laws should be adjusted to allow intercompany dividend rebates to be preserved for dividends from jointly owned Australian companies which own foreign subsidiaries, to the extent the dividend is attributable to income from foreign subsidiaries.

Recommendation 11: 1997 changes to the CFC regime were misconceived and need to be reviewed

The 1997 changes to the CFC measures restricting the number of countries falling within the "broad-exemption listed" countries were misconceived and not the subject of properly considered consultation with Australian outbound investors.

The CFC measures must be independently reviewed as a matter of priority to ensure that, consistent with their original broad policy intent, they are only applicable to cases of potential avoidance and do not impede genuine business operations. The reduced list of countries is inappropriate and should be expanded to include most of the countries with which Australia has a Double Tax Agreement and, in particular, Australia's major trading partners in the Asian region.

Companies are afforded rollover relief where … companies amalgamate or merge … The relevant sections of the UK legislation are not restricted by reference to a country of incorporation or by reference to the residence of the acquiring company

Recommendation 12: Scrip for scrip rollover in the CFC context

Australian rollover relief should be considered in the following circumstances:

- to allow for tax deferred rollover of assets between CFCs that are members of the same wholly owned group, irrespective of the countries of residence of the CFCs;
- for a CFC resident in a broad-exemption listed country where that relief is consistent with relief provided by the broad-exemption listed country; and
- for transactions in scrip for scrip transactions not involving wholly owned corporate groups, and
- no attribution should arise under the CFC rules for transactions involving foreign rollovers in comparable-tax countries.

Recommendation 13: Given the transfer pricing provisions, reduce application of CFC rules to cross-country transactions

Given the increased level of focus and expertise of the ATO on transfer pricing, the interaction of the CFC regime and the transfer pricing provisions needs to be reconsidered.

Since the CFC measures were being designed, the expertise of both taxpayers and the revenue authorities has increased dramatically in this area and transfer pricing is now a key focus of revenue authorities around the world. Wherever the potential for profit shifting embodies a transfer pricing issue, the transfer pricing provisions should be used to address the problem and not the CFC measures.

Recommendation 14: CFC rules need to allow for cross-border services without attribution

Australia's tax laws need policy adjustment to avoid Australia being an unattractive location for parent and conduit holding companies in the context of the provision of cross border services. Internationally traded services have become a major feature of the economic environment since the original measures were developed. Moreover, the heavy handed treatment of international services under the CFC rules is a disincentive to the location of international headquarters companies (with offshore subsidiaries) in Australia.

Recommendation 15: Ensure that CFC income is not restated using Tax Value Method

If the Tax Value Method is adopted, it should not be applied to CFC's at all and particularly not to the calculation of CFC income.

Recommendation 16: Alter the corporate residence test

The test for corporate residence of foreign companies in Australia could be based on a company's place of incorporation only, so that foreign incorporated companies would not be residents of Australia. Australia has ample power to regulate and tax either the relevant foreign incorporated companies under its CFC and transfer pricing regimes or to ultimately assess the Australian shareholders under its CGT rules.

Alternatively, the CM&C test and its scope should be narrowed by way of statutory amendments.

BUSINESS COUNCIL OF AUSTRALIA

Recommendation 17: Thin Capitalisation – Improving the law

A. The thin capitalisation and related debt-equity laws have a significant effect for Australian businesses operating internationally. There needs to be a concerted approach of ensuring that the laws are updated and corrected when the inevitable issues requiring improvement are identified, which we predict will peak in mid-2002.

B. We recommend that for thin capitalisation purposes internally generated goodwill should be eligible to be valued at market value. Otherwise a significant distortion will continue, depressing the ability of companies which have developed Australian businesses to properly recognise the value of their businesses for thin capitalisation purposes.

Recommendation 18: Carry forward rule for excess disallowed interest

We recommend that excess disallowed funding costs under the thin capitalisation rules should be dealt with in one of two ways:

(a) disallowed funding costs in a year could be carried forward and (if in a later year there is excess thin capitalisation capacity) can be claimed then; or

(b) an allowance could be built into the rule for anticipated increases in value of the relevant assets (as a smoothing rule) with specific rules developed with proper consultation.

Recommendation 19: Intangibles and royalties

We recommend:

- Australia should provide an internationally attractive environment for the ownership of intangibles. The US-style approach of a 15-year write-off for intangible property, which does not currently qualify for capital allowances, warrants serious consideration.
- Australia should seek to reduce withholding tax imposed on royalties paid to Australian residents in its DTAs with other countries. This should also involve reciprocal reductions in royalty withholding taxes on payments to residents of those countries. The US/Australia DTA protocol could provide a model.

Recommendation 20: Adjustment of the Foreign Investment Fund (FIF) rules

The FIF rules need to be reviewed in line with the recommendations of the RBT to achieve two objectives:

- to streamline the active business concession so that Australian participants in international joint venture companies will find it capable of being satisfied; and
- to align the rules more closely with the needs of Australia's funds management industry by introducing an active business exemption for foreign investment trusts, and exemptions from the FIF regime for the following:
  - funds that track recognised indices, where the underlying stocks are active;
  - funds that invest predominantly in active business companies; and
  - offshore funds that invest in other funds, where the underlying investments are exempt.

Recommendation 21: Adoption of 'temporary resident' status

Australia should adopt a temporary resident status for the taxation of individuals, in Australia on visitor visas for a period of up to five years. The qualification for tax 'Living Away from Home' rules should also be aligned with this approach.

Temporary residents would be eligible for specific tax exemptions on:

- income attributable to non-Australian workdays which are worked outside Australia and which do not relate to management of the Australian business of the group, provided that the income is paid and retained outside Australia;
- share plan benefits granted in relation to non-Australian service; and
- non-Australian investment income and capital gains not remitted to Australia.

We further recommend a tapered concession allowing foreign assets to be partially freed from tax for a further two years.

Under the tapered exemption proposal the exemption would operate as follows:

(a) Executives in Australia for periods up to five years would not be subject to Australian capital gains tax on their foreign assets.

(b) This concession would be progressively scaled back for two further years after the fifth year.

Recommendation 22: Superannuation

We recommend that inpatriates in Australia as temporary residents should not be subject to Australia's compulsory superannuation arrangements.

We recommend extending the current 'executive exemption' from Australia's superannuation system to all individuals entering Australia on assignment with their employers, who have "temporary resident" status according to our recommendation 20 on that status. An alternative solution would be to remove the preservation requirements on individuals requiring them to keep the funds in Australia.

In addition, the prohibition on deductions for employer contributions to offshore funds on behalf of individuals who qualify for the temporary resident status should be lifted.

Recommendation 23: Income from pre-residence investments and share options

Temporary residents should be exempt from Australian tax on foreign source income and capital gains derived from the ownership of pre-residence assets not remitted to Australia.

We also recommend that temporary residents should be exempt on stock options granted before commencing Australian residency unless granted as a condition of their Australian assignment.

Australia could also consider applying this exemption to all gains from foreign assets by temporary residents, not just to pre-arrival foreign assets. Such a measure would be consistent with general international practice, would involve minimal revenue costs and would streamline the law by not requiring complex tracing of foreign assets into pre-assignment and post-assignment assets.

Recommendation 24: Treatment of gains attributable to discounts on shares awarded

RBT Recommendation 2.19 (a) was that, in the income year an employee ceases to be an Australian resident, the taxable income of the employee include the value of share discounts given to the employee under a 'qualifying' employee share scheme while a resident. This is problematical.

We strongly support Australia participating in an international review, perhaps through the OECD, of the allocation among different countries of taxing rights where employee shares and rights relate to service in more than one country.

Recommendation 25: CGT deemed disposal rules on inpatriate leaving Australia

The CGT deemed disposal rules should be abolished.

Appendix A: Ralph Review and International Tax Recommendations

The terms of reference of the Review of Business Taxation ("RBT") released by the Treasurer on 14 August 1998 contained no specific reference to a review of the international tax regime.[55] In Section 23 of the RBT's final report "A Tax System Redesigned" (ATSR) released on 21 September 1999, the RBT noted that it was precluded, for reasons of time and scope, from a detailed examination of the foreign source income.[56] The RBT recommended a comprehensive review of Australia's foreign source income measures, including the CFC rules[57].

It is disappointing that the Government is yet to give an undertaking on the timing of any further review.

Given this limitation, the RBT did consider a number of international tax issues and its recommendations are contained in Sections 20 to 23 of ATSR.

Broadly, these recommendations can be divided between those impacting Australians investing offshore and foreigners investing in Australia.

Australians investing offshore

The RBT recommended the following:

- Imputation credits of up to 15% of repatriated dividends be allowed for foreign dividend withholding tax paid on such dividends (Recommendation 20.1).
- Australian companies not be allowed to stream foreign sourced dividends to foreign shareholders and Australian sourced dividends to Australian shareholders (Recommendation 20.2). This was due to the RBT's terms of reference that required it to be revenue neutral.[58]
- Australian multinationals be subject to thin capitalisation (interest allocation) gearing limits on their Australian operations (Recommendation 22.5).
- Australian companies be allowed to claim interest deductions for their funding costs of overseas subsidiaries and permanent establishments[59] (Recommendation 22.6).
- In negotiating Double Tax Agreements, Australia endeavour to reduce dividend withholding tax rates on non-portfolio investment (Recommendation 22.21).

55 Appendix A: Terms of Reference, **A Strong Foundation**, 1998. Its terms of reference did include reporting on the Australian business tax system compared with international experience. The RBT commissioned Arthur Andersen to produce an information paper, **An International Perspective**, 1999, examining how other countries approach business taxation.

56 Recommendation 23.1. **A Tax System Redesigned**. The RBT noted in its overview that the interaction of the Australian business tax system with the rest of the world was a crucial determinant of the international competitiveness of Australian business.

57 Many of the RBT's recommendations in the domestic context, if implemented, will have an effect on the calculation of attributable income under the CFC rules.

58 The revenue neutrality requirement imposed a tight discipline on the process and meant that the RBT only decided on a final package as a result of judgements about the weight of an argument for or against particular measures relative to other measures.

59 It is not clear how the interest allocation rules would apply in the calculation of attributable income of a CFC. Similar issues would arise, as was the case when the thin capitalisation rules applied in a CFC context.

Foreigners investing in Australia

The RBT recommended the following:

- Entity tax paid on unfranked non-portfolio distributions received by a resident entity that is 100% owned by a non-resident be refunded, but only when the distribution is paid to the non-resident and the non-resident is subject to dividend withholding tax (Recommendation 11.2).
- Thin capitalisation provisions be strengthened by applying to total debt of the Australian operations of a foreign investor (Recommendations 22.1 and 22.2).
- Australian capital gains tax be imposed where Australian assets are effectively disposed of by disposing of an interposed non-Australian entity (Recommendation 21.7).
- A withholding tax mechanism be introduced for certain types of income derived by non-residents (including capital gains) other than income connected with an Australian permanent establishment (Recommendation 21.6).

Appendix B: United Kingdom, German and Swedish Reform in 2000

United Kingdom

The UK Government has introduced various measures to promote investment by companies and to enhance the international competitiveness of the United Kingdom tax system. The Government is also consulting with taxpayers on a number of measures that may be introduced during 2002.

Dividend taxation – ACT imputation system changed in 1999

The Government has revised the particular features of its imputation system that may have resulted in the double taxation of a company's foreign sourced income. With effect from 6 April 1999, the system of Advanced Corporation Tax ("ACT") was abolished and all dividends paid to non-corporate investors moved to having an associated non-refundable credit of 1/9 of the dividend paid.

These measures, together with changes in the personal income tax rates applied to dividends received from UK resident companies, ensure a consistency of treatment for UK resident individuals for dividends received both before and after 6 April 1999.

In 'fixing' the system, the UK government did not completely abandon the imputation system but introduced modifications to ensure that the system was neutral in terms of where the profits of a UK company were sourced and taxed.

Dividend taxation – corporate shareholders' foreign tax credits

Any distribution received by a UK resident corporate shareholder from another UK resident company continues to be tax-exempt.

Foreign source dividends continue to be subject to UK tax with a foreign tax credit available for withholding tax and underlying tax suffered. The underlying tax credit is available subject to the shareholder satisfying the minimum ownership test of not less than 10% of voting power in the company.

However, changes were introduced to the foreign tax credit regime from 1 April 2000. These amendments may impact the foreign tax credit available by restricting the credit associated with dividends paid by lower tier group companies and by revising the rules for offshore mixing of foreign tax credits.

Capital gains concessions for restructure of corporations – from 2002

The Government is currently consulting on introducing a rollover relief for gains on substantial shareholdings held by companies. A substantial shareholding is likely to be defined as not less than 20% of the ordinary share capital and there is also a proposed minimum holding period of one year. This rollover is likely to have effect from 1 April 2002 and is likely to apply to restructures of United Kingdom and overseas companies.

This would be a major relaxation to the capital gains rules for companies and by removing the immediate tax charge when companies rationalise their substantial shareholdings should promote business efficiency. The initial proposal provided for the gain on the disposal to be rolled into the base cost of another qualifying asset acquired within certain time limits.

The Government has announced that it is prepared to consider the alternative approach of exempting gains on substantial shareholdings held by companies to meet the competitiveness objectives. This consultation process is ongoing and although it appears that the deferral method is the Government's preferred option, a participation exemption has not been ruled out.

Intangible assets – potential new write-off from 2002

The Government has accepted that it is essential to reform the tax treatment of intellectual property, goodwill and other intangibles in order to ensure the United Kingdom is an attractive place in which to do business, and that UK businesses can compete successfully.

There has been an on-going consultation process on the form of the relief for this type of expenditure. It is proposed that the new regime will have effect for intangible assets acquired after 1 April 2002. The current proposal is that the tax treatment should follow the financial statements as prepared in accordance with normal accounting practice. The precise scope of the new regime is still to be determined.

Tax grouping issues adjusted for international companies – from 2000

The group loss transfer rules ("group relief") for companies were modified with effect from 1 April 2000 to allow utilisation of UK losses, for UK tax purposes, notwithstanding complex group and consortium structures. The changes reflect that UK activities might be conducted by UK subsidiaries and branches of companies which are resident anywhere in the world. The changes respond to the increasing globalisation of business and should give, to multinational groups of companies, greater flexibility in structuring their commercial activities in the United Kingdom.

Under the new rules, a UK branch of an overseas company is able to claim losses surrendered by other UK resident group companies as group relief, to reduce its profits chargeable to corporation tax. A UK branch can also surrender its losses as group relief to affiliated UK subsidiaries, where those losses are not relievable in the overseas country.

Germany

The Upper House of the German Federal Parliament passed the Tax Reform Act on 14 July 2000. The reform was significantly slanted to enhance the international competitiveness of the German tax system.

Corporate taxation

Tax rates

The corporate income tax rate will be reduced to 25% as of the tax year 2001 (for companies with a calendar year accounting period). This rate will apply to both resident and non-resident corporate taxpayers (eg also to branches of foreign companies). The 5.5% solidarity surcharge will continue to be levied, so that the total corporate income tax burden will amount to 26.375%. Further, the trade tax on income will continue to be levied.

Tax credit system

The imputation/corporate tax credit system which has been in effect since 1977 is being abolished, subject to transition rules. Thus Germany is returning to the pre-1977 classic two tier system of taxation of corporate earnings, whereby a company taxes its earnings at its own level, and dividends are then generally taxable in the hands of the recipient shareholder.

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Dividend taxation for a corporate shareholder

Any distribution by a German resident subsidiary corporation to its German resident corporate parent is tax-exempt at shareholder level.

Foreign source dividends which have been subject to foreign income taxation which is comparable to the German corporate income tax, remain tax exempt in Germany at the level of the corporate recipient subject to the 5% deemed non-deductible business expense incurred by the German shareholder.

Capital gains treatment for a corporate shareholder

Capital gains generated as a result of the disposition of a German share investment are generally tax-exempt from 2002 for companies with a calendar year accounting period. A capital gain arising as a result of the sale of a foreign share investment is already tax-exempt under present law under certain conditions. No minimum shareholding or holding period requirements apply.

Correspondingly, capital losses realised on the sale of such investments are not deductible, and tax effective write-downs of loss-making investments are no longer possible. Additionally, other effectively connected expenses are generally no longer deductible.

The tax exemption shall also apply to any capital gains realised by the German permanent establishment of a non-resident corporate taxpayer to which the shareholdings are attributed, or if the capital gain is realised via a partnership. The aim of this amendment is to strengthen further the position of Germany as a holding company country.

Thin capitalisation

The thin capitalisation rules for non-resident shareholder and/or related party financing will be restricted in that the 3:1 debt/equity ratio for fixed interest debt will be reduced to 1.5:1 for operating companies and the 9:1 debt/equity ratio for a holding company will go down to 3:1.

The new ratios are felt to be more in line with international standards in the area of thin capitalisation rules, which are generally not as generous as those presently in place in Germany.

Tax consolidation relaxed – to apply by election to 50%-owned groups

The rules for tax consolidation for corporation tax purposes (organic unity – Organschaft) will be modernised.

In light of the return back to the classic two tier corporate tax system, a dividend is subject to taxation at the level of an individual shareholder without granting a tax credit to the recipient for corporate taxes paid … only half of the dividend will, however, be taxed by the shareholder (so-called "half-dividend taxation")

Under the new corporate tax law, organic unity shall be possible with financial integration only (which means a more than 50% share in the voting rights). In future a direct and indirect financial integration of more than 50% will suffice. The other two conditions (economic and organisational integration) will no longer be required. A profit and loss transfer agreement will still be required for corporation tax purposes. The requirements of financial, economic and organisational integration for trade tax purposes remain unchanged.

Tax losses

The system of tax loss carry backs (one year; DM 1 million – from 2001 onwards) and tax loss carry forwards (unlimited by amount and period) shall generally not be changed or restricted. However, there will be a restriction to the use of losses realised from trading in derivatives and stock.

Depreciation

The accelerated depreciation for moveable fixed assets will be reduced from 30% to 20%. The depreciation for non-residential buildings held as business property shall be reduced from 4% to 3%.

Individual Taxation

Dividend taxation for an individual shareholder

In light of the return back to the classic two tier corporate tax system, a dividend is subject to taxation at the level of an individual shareholder without granting a tax credit to the recipient for CIT paid at the corporate level.

With a view not to overstress the tax burden (combined taxes at the corporate and the shareholder level) only half of the dividend will, however, be taxed by the shareholder (so-called "half-dividend taxation").

The same taxation principles apply to foreign source dividends.

Capital gains treatment for an individual shareholder

Capital gains from the sale of shares of a corporation by an individual shareholder are **only** taxable if the individual shareholder owned at least 1% within the last five years before the sale or if they were held for less than a year. If there are taxable capital gains from the sale, there are only taxed at 50% of the relevant tax basis. Otherwise, capital (half income taxation) gains on disposal of shares in opportunities are free of CGT.

Foreign Transactions Tax Act ("FTTA") (CFC Legislation)

Where German shareholders hold more than 10% of a foreign corporation in a low taxed country with passive income, and the foreign company has a tax rate of less than 25%. passive income will be taxed at a flat rate of 38%. Passive income from group financing is eligible for a 20% tax concession.

Making Sweden a More Attractive Location

It is anticipated that the new rules will come into force from 1 January 2002.

Under the proposed rules dividends received and capital gains on Swedish and foreign business-related shares (as opposed to portfolio shares) will be exempt from tax in some circumstances

Under the proposed rules dividends received and capital gains on Swedish and foreign business-related shares (as opposed to portfolio shares) will be exempt from tax where:

- the shareholder is a Swedish limited liability company or another qualifying Swedish legal entity; or
- (for foreign companies with branches in Sweden) the shareholder is a foreign company with its place of residence within the EEA, subject to a comparable income tax.

An unquoted share would always be considered to be a business-related share and thus free of CGT. There would be no holding period requirement for unquoted shares.

A quoted share would be business-related and eligible for CGT exemption if the shareholding represents at least 10% of the voting rights in the owned company, or if the shareholding is held for sound business reasons, and the shares are held for at least 12 months.

Low taxed overseas dividends received will, in future, benefit from the dividends received exemption. Note, however, that the extended CFC regime might apply to low-taxed structures.

As capital gains will be tax-free, capital losses on business-related shares will no longer be deductible.

Dividends paid will be exempt from Swedish withholding tax where:

- the dividend would have been tax exempt if received by a Swedish entity, ie the dividend is on business-related shares; and
- the foreign legal entity is subject to comparable taxation in its country of residence, with a "white list" of countries deemed to satisfy this test.

Sweden currently has no restriction on tax relief for funding costs of domestic or overseas acquisitions. There are no proposals to change this, despite the intended introduction of a full exemption for capital gains.

Controlled foreign company (CFC) changes proposed

A CFC is proposed to be redefined as a foreign company not on the "white list" (as amended) and receives low taxed passive income exceeding 10% of the CFC's total revenues. The Swedish shareholder must still hold at least 10% of the foreign company for the rules to apply.

The Swedish shareholder will be liable to tax on the appropriate share held **directly or indirectly** of the CFC's passive revenues to the extent that it exceeds 10% of the CFC's total revenues. However, to compensate for the fact that costs will not be deductible, only 70% of this passive income will be taxable.

The proposed legislation also permits the shareholder to elect to tax all of the CFC's income and take a tax credit for any foreign taxes paid. In some cases, this will result in a reduced Swedish tax cost.

It is anticipated that the proposed rules will come into force on 1 January 2002, but will allow a one year grace period to 1 January 2003 to allow multinational groups time to adjust their group structures.

Withholding tax on dividends

There will be no Swedish withholding tax on the payment of a dividend by a Swedish company to a foreign legal entity provided that the dividend would not have been regarded as income or would not have led to a taxable capital gain if the company had been a Swedish company, ie. the shares are business-related (see above).

There will be no Swedish withholding tax on the payment of a dividend by a Swedish company to a foreign legal entity provided that the dividend would not have been regarded as income or would not have led to a taxable capital gain if the company had been a Swedish company

The foreign legal entity must correspond to a Swedish limited liability company to be able to receive the dividend without Swedish withholding tax and must be subject to a tax similar to Swedish corporate tax in its state of residence. Companies resident in a country on the new "white list" are deemed to satisfy this condition. The "white list" covers most treaty countries with the exception of the following eighteen countries: Australia, Barbados, Croatia, Cyprus, Estonia, Hungary, Iceland, Ireland, Kazakstan, Luxembourg, Malaysia, Malta, Mauritius, Singapore, Spain, Switzerland, Thailand and Tunisia.

Capital losses related to immovable property

A capital loss related to immovable property should only be deductible against capital gains on immovable property, unless the immovable property is mainly used for office or production purposes of the transferor or an affiliated party.

Appendix C: Some Regional Headquarters Concessions

There are very few incentives for foreign investors or indeed Australian-based investors to grow their international trade. The benefits provided to an offshore banking unit are an isolated example and are of benefit to a limited range of taxpayers that they can benefit.

Singapore

Singapore has a series of complimentary incentives that cover the various possible facets of a regional headquarters operation (RHQ). With respect to financial services provided by banks and other financial intermediaries, Singapore does have a similar incentive to the Australian offshore banking unit incentive applicable to such institutions.

More importantly, however, Singapore has two further incentives that are relevant to a broader range of investors, these are the operational headquarters (OHQ) incentive and the Finance and Treasury Centre (FTC) incentive. The OHQ incentive is specifically targeted at the management/support areas of activity provided on a regional basis. Qualifying activities include management, administration, business planning, technical support, marketing, training, research and development carried out in Singapore etc.

The OHQ regime provides reduced rates of tax on income and capital flows through the OHQ as follows:

Dividends

Where the Singapore OHQ holds equity in non-Singapore group companies, dividends received from those subsidiaries will be exempt from corporate tax in Singapore and can be paid out of Singapore free of withholding tax. Dividends paid out of income that is concessionally taxed in Singapore under the OHQ regime are also free of withholding tax.

Management

Income derived by a Singapore OHQ from performing OHQ type services described above may be subject to tax at a concessional rate of 10%. The tax would be normally paid on an accrued profit amount calculated for example as a 5% mark-up on the cost providing the services.

Interest

Where the OHQ borrows from financial institutions in Singapore, and on lends those funds to associated entities, the interest income may be taxed at the concessional rate of 10%.

Royalties

Where royalty payments from associates arise from R&D work carried out in Singapore, the royalties may qualify for taxation at the concessional rate of 10%.

The concessions usually have a life of five to ten years although the concession for dividends may be granted indefinitely.

Finally, the Finance and Treasury Centre incentive is targeted at non-bank entities which, by virtue of the type of operations they undertake, would normally be ineligible for OHQ status but nevertheless have significant treasury and fund management activities they wish to conduct in Singapore.

Often these may compliment similar activities conducted by the group in other time zones of the world. The range of eligible activities is consistent with similar activities that may be conducted by an OBU if conducted by a bank or financial institution.

Malaysia

Malaysia also provides concessions for operational headquarters companies (OHQs). A Malaysian HQ is a Malaysian company that carries on business in Malaysia providing qualifying services to related companies outside Malaysia. The concession is available to both multinationals using Malaysia as a regional base and Malaysian based group companies with foreign operations.

The type of services that are qualifying for these purposes includes services such as management and administrative services, treasury and funds management services, corporate finance for advisory services, research and development work and training and personnel management.

The incentives provided to Malaysian OHQ companies are very similar to those offered by Singapore.

Belgium

The Belgium Co-ordination Centre incentive is not as extensive as the Singapore or Malaysian approach.

The main difference is that as the coordination centres should operate as service centres and not as holding companies, the centres are therefore not allowed to hold any shares in other companies whether related or third party. Except for certain financial transactions, a coordination centre should be working exclusively with companies of the group and restrict itself to the centralisation and coordination of support activities including financial and treasury functions and management and headquarter type functions. Again, there are certain tax benefits provided to income flowing through a coordination centre. These incentives involve effectively reduced income tax rates, the exemption of income flows from withholding taxes as well as from other capital duties and registration taxes.

Ireland

10% corporate tax rate for International Financial Services Centre (IFSC)/manufacturing companies

Companies that carried on a manufacturing trade or a 'deemed' manufacturing trade at 23 July 1998 will continue to be taxed on profits from these activities at 10% until 31 December 2010. New manufacturing projects established after 23 July 1998 will be taxed at 10% until 31 December 2002, and thereafter at the standard rate of corporation tax, which will be 12.5% with effect from 1 January 2003 (see below).

IFSC operations which were certified before 31 July 1998 will be taxed at 10% until 31 December 2005. The 10% rate will apply until 31 December 2002 in respect of new projects approved after 31 July 1998, which will then be taxed at the standard rate of 12.5% from 1 January 2003 (see below).

In accordance with agreement reached with the EU, the standard rate of corporation tax for active business income will be reduced to 12.5% from 1 January 2003. The rate will fall in the coming years as follows:

- 24% in 2000;
- 20% in 2001;
- 16% in 2002;
- $12^1/_2$% in 2003;

A higher rate of 25% applies to profits arising from non-trading activities with effect from 1 January 2000.

Tax exemption for income from foreign branches

An exemption from corporation tax and capital gains tax applies in respect of income and gains derived from foreign branches of certain Irish resident companies. Companies, which receive a certificate from the Minister of Finance in respect of their investment plan for Ireland, will qualify for the exemption. The investment plan must provide for the creation of substantial new employment in Ireland by means of permanent capital investment. Furthermore, the new employment created must be sustained through the trading operations conducted via the foreign branches.

Appendix D: Taxation of Inpatriate Executives – Comparative Tax Study

Approach to Study

In order to compare Australia's tax regime in respect of inpatriate employees, we have analysed the total tax that would be payable (both by the employee and by the employer) if a key executive was asked to work in the following locations:

- Australia;
- New York, USA;
- London, UK;
- Hong Kong;
- Singapore.

We have chosen these locations not only because they are key financial centres, but also because they demonstrate different approaches to the taxation of inpatriates, summarised in the following table.

Location	Tax on worldwide income	Relief for offshore duties	Tax on foreign-source investment income (not remitted)	Tax on stock options granted pre-assignment	Social security/ payroll tax levied
Australia	Yes	No	Yes	Yes	Yes
New York	Yes	Yes*	Yes	Yes	Yes
London	Yes	Yes	No	No	Yes
Hong Kong	No	Yes	No	Yes	No
Singapore	Yes	Yes	No	Yes	No

* At state level only

In order to demonstrate the varying tax regimes, the following four scenarios were examined:

Scenario one – individual is on assignment for three years with all duties being performed in the host location.

Scenario two – individual is on assignment for three years with all duties being performed in the host location. It also looks at the effect of exercising stock options granted before the commencement of the inpatriate assignment.

Scenario three – individual is on assignment for three years and 30% of the duties are performed outside the host location.

Scenario four – individual is on assignment and is asked to extend from three years to six years.

The calculations have been prepared on the basis that the individuals will be responsible for all taxes on their income eg income tax and employee social security and their employer will be responsible for all mandatory employer taxes eg employer social security, payroll tax and fringe benefits tax. We have not accounted for any tax equalisation costs.

We have used the total income and benefits amount as the denominator in the calculation. This ensures that a like for like comparison can be achieved (as different countries have different regimes as to what income should be included in taxable income): total income/benefits remains constant regardless of the regime. To find the effective rate, the tax amount is divided by the total income value. All calculations have been based on the most current tax rates available in each jurisdiction. Foreign exchange rates are as of February 2001.

Assumptions

The individual is considered a national citizen of a country not being one of the five locations and is considered non-resident in his home location during his assignment. The individual is married with two children, pays A$50,000 in mortgage interest and receives the following income:

Company:	**A$**
Base salary	500,000
Bonus	500,000
Cash Housing Allowance	80,000
Home Leave	10,000
Employer Provided Medical Insurance	2,000
Cash Car Allowance	35,000
Cash cost of Living Allowance	10,000
Tax Preparation services	2,500
Children's education	50,000
Investment:	**A$**
Interest	20,000
Dividends	45,000
Long Term Capital Gains	100,000
Managed Funds Distribution	75,000
Options:	
Value of Stock options from overseas employment	650,000
Total Income/Benefits	**2,079,500**

Summary of key findings

In order to properly assess the comparative tax burdens, effective tax rates for each country have been worked out by calculating the tax levied as a percentage of the total income and benefits earned, including items which are not subject to tax. This is the only way to obtain a true comparison, given that each country has different exemptions. The tables in the Appendix illustrate the outcomes under each scenario. The results clearly show the disadvantage Australia suffers.

1. Simplest scenario

Even under the simplest scenario of a three-year work assignment with no regional duties requiring offshore travel, Australia's tax burden is, at best, barely comparable to the United States and the United Kingdom. It is significantly higher than our regional competitors, even after allowing for "living away from home allowance ("LAFHA") and Fringe Benefits Tax Concessions, applicable for many inpatriate employees. Including Fringe Benefits Tax (FBT) payable on employee benefits, but allowing for LAFHA concessions, the effective tax rate is still nearly 40%. The benefit of LAFHA concessions is clearly offset by high marginal tax rates and the impact of Australian tax on offshore investment income. Of the countries in the study, only Australia and the United States seek to tax this investment income.

Australia also has the highest level of payroll and/or employer social security taxes, other than the United Kingdom. However, reciprocal social security agreements (of which Australia is party to few), often mitigate the UK employer social security cost. Employer organisations in Australia rarely have such an ability.

Whilst this best-case scenario shows Australia at a tax level almost comparable to the United States and United Kingdom, this will never be sufficient. Given Australia's geographic location and relatively small economy, our tax system needs to be an incentive, not just a neutral factor in the decision to relocate an employee to Australia.

2. Pre-employment stock options

Australia's comparative disadvantage becomes even more obvious when scenarios other than the simple base case are considered. Scenario two looks at the impact of the different tax systems, where the relocated employee holds unrealised employee stock option entitlements granted prior to the relevant assignment, a common scenario in today's international world. Of the five countries considered in the study, all except the United Kingdom will tax the employee when these options are exercised. The detrimental impact of Australia's high marginal tax rates is immediately apparent, pushing Australia's effective tax rate to levels significantly higher than our competitors.

This scenario clearly illustrates one of the great inequities of residency based tax systems such as Australia's. Individuals holding valuable but unrealised (and probably unrealisable) employee stock options entitlements at the time their assignment commences, can become subject to the full impact of Australia's high marginal tax rates. They may be taxable on the full value of these entitlements at exercise, notwithstanding that all or most of the benefit accrued at a time when they had no connection to Australia. Even Australia's capital gain tax rules only seek to tax increases in value after coming to Australia.

Clearly, an employee, or the employer who may be required to cover the additional tax cost, is severely disadvantaged, as a result of being taxable in Australia on a benefit which accrued prior to the commencement of their assignment.

Other than the United States, Australia is the only country in the study that seeks to tax such stock option entitlements at high marginal tax rates. Our regional competitors whilst also taxing, do so at significantly lower marginal tax rates. As has already been pointed out above, comparability to the United States is not sufficient incentive to attract individuals to Australia. Rather Australia's tax system should be an incentive, and share plan entitlements of cross border employees is one area requiring immediate attention.

3. Regional responsibilities

Introducing regional duties to the mix (Scenario 3) also illustrates how far out of step Australia's tax system is. Hong Kong, Singapore and the United Kingdom will not generally seek to tax compensation earned by inpatriates for services outside their country. Even in the United States example, New York State income tax relief applies in these circumstances, reducing tax rates by a few percent. Therefore, Australia is alone in not providing any tax relief for regional duties. Clearly, Australia's tax system is a significant disincentive to any employee undertaking a regional role based in Australia and, as a result, to companies considering relocating their regional headquarters to Australia.

4. Extending an assignment

Scenario 4 indicates that extending assignments is also a potential deal killer as far as Australia is concerned. The loss of LAFHA concessions clearly puts Australia in a unique position among the countries reviewed and illustrates the adverse impact of Australia's tax system. This is even without taking into account the Australian capital gains tax implications which have draconian impact on inpatriates who stay in Australia for more than five years (discussed in more detail below in section 3).

Scenario One

Individual assigned to work in the host location for a period of three years (all duties performed in the host location) becomes tax resident under domestic law. Tax effect of stock options ignored.

	Australia A$	United Kingdom A$	United States A$	Hong Kong A$	Singapore A$
Tax Payable:					
Income Tax	561,678	452,965	527,249	180,675	300,328
Social Security Tax – Employee	n/a	6,378	25,838	n/a	n/a
Social Security Tax – Employer	n/a	142,469	26,627	n/a	n/a
Fringe Benefits Tax	9,252	n/a	n/a	n/a	n/a
Payroll Tax	64,170	n/a	n/a	n/a	n/a
Total Tax Payable	**635,100**	**601,813**	**579,713**	**180,675**	**300,328**
Effective Tax Rate:					
Income Tax	39.29%	31.27%	36.88%	12.64%	21.01%
Social Security Tax – Employee	n/a	0.44%	1.81%	n/a	n/a
Social Security Tax – Employer	n/a	9.83%	1.86%	n/a	n/a
Fringe Benefits Tax	0.65%	n/a	n/a	n/a	n/a
Payroll Tax	4.49%	n/a	n/a	n/a	n/a
Overall Effective Tax Rate	**44.43%**	**41.54%**	**40.55%**	**12.64%**	**21.01%**

Key findings

Where an employee is being assigned for three years and no duties are performed offshore, then Australia stands almost alongside the United Kingdom and the United States in terms of the levels of tax that would be payable. However, within the Asia-Pacific region, both Hong Kong and Singapore offer a more favourable tax regime.

Australia – The level of income tax payable by the individual is the highest of all countries despite the fact that the individual can take advantage of the 'Living Away From Home' provisions to provide some tax relief. For the employer, the combined cost of fringe benefits tax and payroll tax make Australia an expensive place to employee an inpatriate.

United Kingdom – The United Kingdom offers a more favourable individual tax regime than Australia due to the fact that investment income is not taxed in the United Kingdom. However, for the employer, UK employer social security contributions are extremely high, although this can be mitigated under social security treaties.

United States – For the individual, the United States offers the second least favourable individual tax regime in this scenario. This is due to the fact that worldwide income is taxed and no relief is available. For the employer, the United States is more attractive than either Australia or the United Kingdom due to the lower level of employer social security contributions/payroll tax.

Hong Kong – The low individual income tax rate, coupled with no taxation of investment income make Hong Kong the most favourable of all the locations studied. No employer social security also makes this an attractive location.

Singapore – Singapore offers a lower individual tax rate regime than Australia, the United Kingdom or United States. No employer social security makes this an attractive location.

Scenario Two

Individual assigned to work in the host location for a period of three years (all duties performed by the individual in the host location) becomes tax resident. Tax effect of exercising stock options granted prior to the commencement of the assignment included.

	Australia A$	**United Kingdom** A$	**United States** A$	**Hong Kong** A$	**Singapore** A$
Tax Payable:					
Income Tax	867,178	452,965	787,684	287,925	482,328
Social Security Tax – Employee	n/a	6,378	35,249	n/a	n/a
Social Security Tax – Employer	n/a	142,469	36,038	n/a	n/a
Fringe Benefits Tax	9,252	n/a	n/a	n/a	n/a
Payroll Tax	64,170	n/a	n/a	n/a	n/a
Total Tax Payable	**940,600**	**601,813**	**858,972**	**287,925**	**482,328**
Effective Tax Rate:					
Income Tax	41.70%	21.78%	37.88%	13.85%	23.19%
Social Security Tax – Employee	n/a	0.31%	1.81%	n/a	n/a
Social Security Tax – Employer	n/a	6.85%	1.73%	n/a	n/a
Fringe Benefits Tax	0.44%	n/a	n/a	n/a	n/a
Payroll Tax	3.09%	n/a	n/a	n/a	n/a
Overall Effective Tax Rate	**45.23%**	**28.94%**	**41.42%**	**13.57%**	**23.19%**

Key findings

Where an individual is assigned for a period of three years and stock options are factored into the equation, Australia clearly emerges as the most expensive place for the individual to be based. The United Kingdom becomes considerably more attractive due to a favourable stock options tax regime.

Australia – The level of income tax rises more in Australia than in the United States due to differences in the top marginal tax rates. Australia taxes all of the option income at 47% whereas the United States only taxes the option income at a combined Federal and State level of 40%. This difference in marginal rates makes Australia particularly unattractive for individuals exercising options not related to Australian service (when options are rapidly becoming the primary component of a key executive's remuneration package).

United Kingdom – The United Kingdom benefits in this scenario due to their favourable stock option tax regime. The United Kingdom will only tax options granted prior to the commencement of an assignment if the options were granted in consideration of UK duties. As such, the United Kingdom becomes a more attractive location than the United States or Australia for option holders.

United States – Although the United States taxes options in the same way as Australia, individuals in the United States benefit from lower marginal tax rates.

Hong Kong – Hong Kong taxes individuals if they exercise options while in Hong Kong even if granted prior to the assignment. However, the overall marginal tax rate of 15% is lower (compared with 47% in Australia).

Singapore – Like Hong Kong, Singapore taxes the option exercise and similarly, the individual will benefit from the lower overall marginal tax rate.

Scenario Three

Individual assigned to work in the host location for a period of three years (30% of duties performed outside the host location) becoming tax resident although relief for the offshore duties may be allowed. Tax effect of stock options ignored.

	Australia A$	**United Kingdom** A$	**United States** A$	**Hong Kong** A$	**Singapore** A$
Tax Payable:					
Income Tax	561,678	311,425	512,033	126,473	207,281
Social Security Tax – Employee	n/a	6,378	25,838	n/a	n/a
Social Security Tax – Employer	n/a	142,469	26,627	n/a	n/a
Fringe Benefits Tax	9,252	n/a	n/a	n/a	n/a
Payroll Tax	64,170	n/a	n/a	n/a	n/a
Total Tax Payable	**635,100**	**460,273**	**564,497**	**126,473**	**207,281**
Effective Tax Rate:					
Income Tax	39.29%	21.50%	35.82%	8.85%	14.50%
Social Security Tax – Employee	n/a	0.44%	1.81%	n/a	n/a
Social Security Tax – Employer	0.00%	9.83%	1.86%	n/a	n/a
Fringe Benefits Tax	0.65%	n/a	n/a	n/a	n/a
Payroll Tax	4.49%	n/a	n/a	n/a	n/a
Overall Effective Tax Rate	**44.43%**	**31.77%**	**39.49%**	**8.85%**	**14.50%**

Key findings

Where an individual performs substantial duties outside of the host location, then Australia is again the least favourable tax regime. The United Kingdom, Hong Kong and Singapore all have tax regimes that allow a tax deduction in respect of offshore duties, while the United States taxes the income at the Federal level but allows a more beneficial tax position at the State level.

Australia – Australia emerges as the most expensive location in this scenario due to the fact that it does not have any tax provisions that take account of offshore duties. The individual remains taxable in Australia regardless of where the duties are performed. For senior executives, who typically spend a large proportion of their time travelling, this regime is particularly unfavourable.

United Kingdom – the United Kingdom allows compensation income related to non-UK duties to be free from tax in the United Kingdom provided the income is paid and retained outside the United Kingdom. The tax regime is therefore geared towards taxing the individual only on UK source income or other income remitted into the United Kingdom. This helps to make the United Kingdom a much more favourable location for the individual. For the employer, the United Kingdom still potentially imposes a high level of social security, particularly as the relief for non-UK duties does not apply to employer social security.

United States – the United States continues to tax the individual on the Federal level, thereby aligning it's Federal tax regime with that in Australia. However, for individuals on assignment in New York, specific regulations exist which allow the income relating to non-New York duties to be exempt from New York tax. Specifically, New York has a rule which allows individuals who are in New York for up to three years to be considered a non-resident of New York provided that they are not-domiciled in New York and intend to return to their home country after completion of their assignment. This has helped to make New York a more attractive place for inpatriates.

Hong Kong – Hong Kong will not tax income relating to non-Hong Kong duties provided that the employer is resident outside of Hong Kong, the employment contract must have been entered into outside of Hong Kong and the salary is not paid in Hong Kong. This is the case for the majority of inpatriates and therefore, Hong Kong's already favourable tax regime becomes even more attractive.

Singapore – Singapore will not tax income relating to non-Singapore duties although the criteria for qualifying are more stringent. The individual must be performing the duties under a separate contract of employment and needs to be compensated in proportion to their duties. Additionally, the income relating to those duties must be paid outside Singapore.

Scenario Four

Individual asked to extend assignment from three to six years.

	Australia A$	United Kingdom A$	United States A$	Hong Kong A$	Singapore A$
Tax Payable:					
Income Tax	627,478	456,965	563,705	180,675	300,328
Social Security Tax – Employee	n/a	6,378	25,838	n/a	n/a
Social Security Tax – Employer	n/a	143,689	26,627	n/a	n/a
Fringe Benefits Tax	6,592	n/a	n/a	n/a	n/a
Payroll Tax	72,850	n/a	n/a	n/a	n/a
Total Tax Payable	**706,920**	**607,033**	**616,170**	**180,675**	**300,328**
Effective Tax Rate:					
Income Tax	43.89%	31.55%	39.43%	12.64%	21.01%
Social Security Tax – Employee	n/a	0.44%	1.81%	n/a	n/a
Social Security Tax – Employer	n/a	9.92%	1.86%	n/a	n/a
Fringe Benefits Tax	0.46%	n/a	n/a	n/a	n/a
Payroll Tax	5.10%	n/a	n/a	n/a	n/a
Overall Effective Tax Rate	**49.45%**	**41.90%**	**43.10%**	**12.64%**	**21.01%**

Key findings

Where an individual is required to extend the length of their assignment from three to six years, Australia is again the least favourable tax regime. The United Kingdom and United States have a broadly similar tax level whilst Hong Kong and Singapore remain at their previous levels.

Australia – An individual is heavily penalised when the assignment extends beyond four years. 'Living Away From Home' provisions are no longer available. The amount of income subject to tax is increased and taxed at 47%, (the highest marginal tax rate in the countries studied). For the employer, payroll taxes increase as a result of more income being subject to tax.

United States – The United States remains a high tax country although in this scenario, considerably less so than Australia. The individual tax consequences of extending the assignment only impact the individual's state residency position translating into an overall increase in the tax burden of about 4%. For the employer, the tax burden remains the same.

United Kingdom – Extending an assignment from three to six years would result in an individual being considered ‘ordinarily resident’ rather than ‘not ordinarily resident’. Relief would no longer be available for offshore workdays (not factored into this analysis). Certain benefits would no longer be tax-free eg home leave travel. For the employer, the burden increases slightly as previously tax-free benefits become subject to employer social security.

Hong Kong – the overall level of taxation is not impacted as result of extending the assignment from three to six years. Hong Kong therefore remains the most attractive location from a tax perspective for both short term and long-term assignees.

Singapore – the overall level of taxation is not impacted as result of extending the assignment.

Appendix E: Howard Government International Tax Policies

In its October 15 election statement “Securing Australia’s Prosperity” the Howard Federal Government pledged action in relation to the issues raised in this White Paper. Extracts from that document are below:

Branch Office Economy

Coalition business policy will address concerns that Australia could become a ‘branch office’ economy. This includes committing to the reform of Australia’s international tax regime, and in particular, identifying those arrangements that impact on the decisions of companies to remain in Australia or locate in other countries. The recent double taxation convention signed with the United States provides a useful example of the Government’s intentions in this regard. The Coalition Government will also further examine proposals to remove disincentives for the recruitment of skilled executives and professionals to Australia.

“The Coalition remains firmly of the view that Australian companies can successfully compete on the global stage while remaining based in Australia.

It is true that factors exist which make it harder for Australian based firms to compete globally, including recent trends within capital markets, which lie beyond the control of most Governments. However Governments do have control over other factors.

The most obvious factor is the need for globally compatible taxes and taxation systems …

Venture Capital

This venture capital tax concession will be extended as part of a major programme by the Government to boost investment in venture capital. The Government proposes to provide venture capital limited partnerships with flow through taxation treatment. The exemption will therefore be extended to other tax-exempt non-resident investors, including endowment funds and venture capital fund-of-funds vehicles and taxable non-residents holding less than 10 per cent of a venture capital limited partnership. These investors will be able to invest in eligible venture capital investments through an Australian resident venture capital limited partnership or through a non-resident venture capital limited partnership.

The new arrangements will apply from 1 July 2002. While investors should find the rules simple to apply, appropriate integrity measures will apply to the measure. Consistent with the Government’s broader approach to business tax reform, industry consultations will occur with regard to implementation and compliance issues.

Expatriates

In recognition of the importance of attracting highly skilled workers from around the world, the Government will further enhance the tax exemption for certain foreign source income of expatriates resident in Australia for less than four years.

In brief:

- The exemption will apply to the foreign source income of eligible temporary residents from assets regardless of when acquired and to interest withholding tax on interest payments in respect of liabilities regardless of when incurred.
- No capital gain or loss will arise on the disposal by eligible temporary residents of assets not having the necessary connection with Australia, other than portfolio interests in Australian publicly listed companies.

There will be special provision made to ensure that the exemption applies consistently to New Zealand citizens entering under special category visa arrangements.

In addition, the existing exemption for temporary residents from the foreign investment fund (FIF) rules, will be amended with effect from 1 July 2002. The amended FIF exemption will be more generous in terms of its eligibility requirements than the general foreign source income measure as FIF income is taxed on an accruals basis, with potentially significant cash-flow difficulties and double tax risks.

The Government is also aware of concerns relating to the capital gains tax (CGT) treatment of departing residents, including expatriates. Currently, individuals resident in Australia, including expatriates, who become non-residents are liable for CGT on the unrealised gains on assets they own that do not have a necessary connection with Australia, principally foreign assets, via a deemed disposal rule. Such departing residents can elect to defer CGT until an actual disposal occurs, but in that case they are also subject to CGT on any gains that arise after their departure.

In the first instance the Government will seek to address these concerns on a country by country basis through renegotiation of double tax agreements. The recently finalised protocol to the tax treaty with the US reflects this approach.

Consultation

The Government will, as a matter of priority, consult widely with key stakeholders and industry representatives to examine whether features of the current arrangements still exist which affect the decisions of businesses to remain in Australia or to locate here in preference to other countries. Particular attention will be paid to whether Australia's international tax regime acts as an impediment to Australian companies attracting domestic and foreign equity, whether it acts as an impediment to them expanding offshore, and whether it acts as an impediment to holding companies and conduit holdings being located in Australia.

Appendix F: The authors of the report.

Michael Wachtel

Michael is currently the Tax Practice Director for Australia and New Zealand and a member of the Australian Executive.

He is the past Chairman of Andersen's Australian International Tax group and was area co-ordinator for international tax for the Asia/Pacific region. He is a senior member of Andersen's Worldwide International Tax network.

He has extensive experience in advising on both inbound and outbound transactions. Michael's clients include a broad range of public and private clients.

Michael is a past President of the Australian Chapter of the International Fiscal Association and Past State Councillor of the NSW Tax Institute. He was Chairman of the Tax Institute Committee responding to Treasury and Taxation Office on the Government's Foreign Source Income rules, Past Chairman of the NSW Tax Institute Policy and Legislation Committee and the National Reporter for Australia for the Brussels IFA Conference in 1987 on Corporate Residence.

Michael was intricately involved in the consultative process on the Controlled Foreign Corporations (CFC) Rules. He was the first person to author a book on Australia's CFC regime and Foreign Investment Fund. Michael was a visiting fellow in International Taxation at Melbourne University Law School, 1998-1999.

He is regularly listed as one of Australia's leading tax advisers in various years in various international tax surveys.

Alf Capito

Alf heads up the International Tax Group in Australia and is the Engagement Partner on some of the firm's major corporate clients. He has been a tax practitioner for over 15 years, having commenced work with Arthur Andersen in 1982.

Alf has been responsible for a number of corporate clients who have significant offshore operations and are involved in ongoing acquisitive and refinancing activities. These activities have included:

- A number of major acquisitions, divestitures, floats, and refinancing transactions, many of a cross-border nature.
- Several privatisation bid projects, and Alf is conversant with many of the structuring options available to maximise the tax effectiveness of such bids.
- In particular, Alf worked with a number of US and UK based bidders, assisting them in profit repatriation strategies, effective double-dip finance structures, income securitisation arrangements and complex hybrid instruments and structures, tailored to suit the bidder's home and foreign tax profile.

Alf is routinely listed as one of Australia's leading taxation advisors by various independent surveys.

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