Chapter 30

INVESTMENT IN AUSTRALIA BY NON-RESIDENTS

The challenge for taxation policy

Balancing revenue objectives and the impact on investment

30.1 Australia, like most countries, generally imposes some level of source country tax on investment in Australia by non-residents (as distinct from taxing our residents on their worldwide income). This basically reflects a desire to ensure that non-residents pay an appropriate amount of tax on Australian source income while not unduly affecting the cost and level of foreign investment in Australia.

30.2 The proposed new entity regime would bring with it a change to the way non-residents are taxed on their Australian source income. As a consequence it would be necessary to ensure that the regime does not unduly raise the cost of capital to Australian business or have adverse effects on the level of foreign investment necessary for the Australian economy to function effectively and efficiently.

30.3 At the same time, when considering how the entity regime should be applied to investment in Australia by non-residents, a balance has to be struck between obtaining a reasonable revenue contribution from non-residents and continuing to attract foreign capital.

30.4 In considering questions as to the cost of capital it needs to be borne in mind that non-residents will factor into the tax equation the availability in the investors' home jurisdiction of credits for tax paid in Australia.

A strategy for reform

One which depends upon other policy options

30.5 Chapters 15 and 16 discuss options for achieving greater integrity through the entity chain and for the treatment of collective investment vehicles (CIVs) within the proposed new entity regime. The approach to the taxation of non-residents investing in Australia depends largely on which of those options is adopted.

30.6 If the deferred company tax option were adopted, it would have the effect of raising the tax on tax-preferred income of a company from the current dividend withholding tax (DWT) rate of 30 per cent — generally reduced to 15 per cent by Australia's double tax agreements (DTAs) —

imposed on unfranked dividends (dividends paid out of tax-preferred income) of a non-resident to the company tax rate (36 per cent). In the case of investment through a trust, the tax-preferred income will change from not being subject to tax in the hands of a non-resident beneficiary to being taxed at the company rate. However, the terms of reference for the Review include an examination of the scope to move towards a 30 per cent company tax rate by bringing the tax value and commercial value of investments closer together. Such a trade-off is to be achieved in a revenue neutral manner and, if achieved, offers the opportunity to ameliorate the impact of the full franking approach on non-resident investors.

30.7 If the company tax rate were not reduced, the increase in Australia's cost of capital will depend on the ratio of tax-preferred income of an entity to the taxed profits of the entity. Current indications are that in relation to public companies around 85 per cent of their dividends are franked, although this may decrease if the proportion of foreign source income increases over time. Accordingly, at least in relation to portfolio investors — where it could be expected that the investor would seek a balanced portfolio — a marked increase in the cost of capital from the proposed new entity regime applying to companies is unlikely. On the other hand, while dividends are franked on average at around 85 per cent the distribution across companies ranges from nil to 100 per cent so the effect would fall differentially in relation to companies as far as foreign investors are concerned.

30.8 These costs for portfolio investors may be further reduced by the introduction of a dividend withholding tax/entity tax rate switch similar to New Zealand's Foreign Investor Tax Credit regime. This regime, which is explored further below, relies on the country of residence of the foreign investor allowing a credit for the DWT on the grossed-up 'dividend'.

30.9 The entity regime, in its tax treatment of the profits of a trust, could potentially impact on investments returning dividends and interest where those investments are made through trusts. The entity regime in these circumstances would tax the investments at the entity rate rather than the nil rate on franked dividends, the general DTA rate of 15 per cent on unfranked dividends and the 10 per cent rate applicable to interest.

30.10 One option is to facilitate this type of investment through special funds set up for purely non-resident investors which would be taxed in the same way as similar types of investment trusts are currently taxed. Another option is to tax certain resident CIVs on a flow-through basis — these could be allowed to have both resident and non-resident investors, and hence remove the need for a vehicle purely for non-resident investors. This option is discussed in Chapter 16.

30.11 The possible introduction of a deferred company tax also raises the issue of tax neutrality between branches of a non-resident entity and a subsidiary.

30.12 If, instead of deferred company tax, resident dividend withholding tax (RDWT) were introduced or unfranked inter-entity distributions were taxed, the need would be reduced for tax neutral treatment of branches given that they are not currently taxed on their tax-preferred (unfranked) income. There would also be less need for the DWT/entity tax rate switch — though the option could still be considered in order to give more favourable treatment than currently to non-resident investors at no cost to revenue.

Key policy issues

How should Australian tax be levied on non-residents investing in Australian entities?

30.13 The prevailing international practice is for distributions from entities to non-residents to be subject to DWT at rates agreed bilaterally between countries and reflected in DTAs. Limiting Australian tax on income distributed to these investors could be achieved by either removing the DWT or reducing the entity tax paid by these investors.

Option 1: Impose full entity tax but no DWT

30.14 The Australian tax on income distributed to non-residents could be limited to the Australian company tax rate by not applying DWT to fully franked dividends. If the deferred company tax approach is adopted and all dividends are fully franked, all DWT could be removed.

30.15 However, eliminating DWT may not be in Australia's interest given the prevailing practices of international taxation and Australia's DTAs. The agreements generally require the country where the investor resides to allow a credit for withholding taxes paid in the country from where the dividend is paid. Consequently, removing the DWT may not reduce the tax burden on non-resident investors but rather would provide a benefit to the revenue of their country of residence to the disadvantage of Australian revenue.

Option 2: Impose DWT and refund some entity tax

30.16 A preferable option would be to limit the total amount of Australian tax on non-residents by refunding part of the entity tax to them rather than by

not levying DWT. This would be particularly advantageous for foreign shareholders with portfolio investments in Australia because these investors do not receive a foreign tax credit for entity tax but do receive a credit for DWT.

30.17 The refund which is referred to below as the Non-Resident Investor Tax Credit (NRITC) could be used to ensure maximum possibility of Australian tax being credited overseas. When an Australian company is paying a dividend to a foreign portfolio shareholder, a proportion of the entity tax could be refunded to the company on the condition that this refund is paid as a supplementary dividend to the foreign shareholder.

30.18 DWT would be levied on the dividend plus any refund of entity tax paid to the foreign portfolio investors. The percentage refund of entity tax would be set such that the refund equalled the DWT to be paid after applying the general DWT rate of 15 per cent to the dividend and refund. The total Australian tax on the dividends would be equal to the entity rate but the proportion of DWT in the tax mix would be increased by the NRITC. This would include dividends paid to foreign portfolio investors that are currently exempt from DWT.

30.19 Where an entity pays a dividend to an entity that is not part of the entity regime, such as a CIV or a nominee company, the CIV or nominee company would need to advise the entity paying the dividend the proportion of its members that are non-residents so that the entity paying the dividend could determine the amount of the NRITC. This would be necessary because the CIV or nominee company may effectively represent non-residents.

30.20 The impact of the NRITC as compared with the current tax treatment of portfolio investors is shown in Table 30.1 for the situation where the entity is currently paying fully franked dividends.

Table 30.1: Operation of entity tax/DWT switch — fully franked dividends

	Current $	Reformed $
Profit of the Australian entity	100.00	100.00
Taxable income of the entity	100.00	100.00
Less company tax (at 36%)	-36.00	-36.00
After-tax distribution to non-resident	64.00	64.00
NRITC — 17.64% of the dividend		11.29
Total distribution	64.00	75.29
Less DWT (15%)		-11.29
Net distribution to non-resident	64.00	64.00
Total Australian tax	36.00	36.00
Income tax paid by non-resident (at 40% tax rate)[(a)]	-25.60	-18.83

Net return to non-resident	38.40	45.17

(a) After credit for Australian DWT.

30.21 In this case, a foreign tax credit of $11.29 would be available for the foreign portfolio investors which would lower foreign tax whilst the Australian tax on the investment would be unchanged.

30.22 This treatment of franked dividends using the NRITC would be the same irrespective of whether the deferred company tax or one of the alternative options (RDWT or taxing unfranked inter-entity distributions) is introduced for improving integrity through the domestic entity chain.

30.23 In relation to entities currently paying unfranked dividends the level of Australian tax would increase (by the difference between the company and DWT rates) if the deferred company tax option were pursued, but the consequential decrease in the creditable amount would be partially offset by the NRITC. This is shown in Table 30.2.

Table 30.2: Operation of entity tax/DWT switch — unfranked dividends

	Current $	Reformed $
Profit of the Australian entity	100.00	100.00
Taxable income of the entity	0	0
Less company tax (at 36%)	0	0
Less deferred company tax	na	-36.00
Distribution to non-resident	100.00	64.00
NRITC — (17.65% of the dividend)	na	11.29
Total distribution	100.00	75.29
Less DWT (15%)	-15.00[a]	-11.29[b]
Net distribution to non-resident	85.00	64.00
Income tax paid by non-resident (at 40% tax rate)[c]	25.00	18.83
Net return to non-resident	60.00	45.17

(a) 15% of the $100 unfranked dividend.
(b) 15% of total distribution.
(c) After credit for Australian DWT.

30.24 This demonstrates one effect on non-resident investors. However, there is no evidence as to whether portfolio investors target individual companies paying unfranked dividends. They would more commonly invest in a balanced portfolio and receive primarily franked dividends but the structuring of their portfolio would be likely to be influenced to some extent, even if it cannot be estimated. Table 30.3 reflects the situation where a portfolio

investor has a balanced portfolio, that is, is entitled to $90 in taxed income and $10 in unfranked income.

Table 30.3: Operation of entity tax/DWT switch — balanced portfolio

	Current $	Reformed $
Profit of the Australian entity	100.00	100.00
Taxable income of the entity	90.00	90.00
Less company tax (at 36%)	-32.40	-32.40
Less deferred company tax	na	-3.60
Distribution to non-resident	67.60	64.00
NRITC — (17.65% of the dividend)	na	11.29
Total distribution	67.60	75.29
Less DWT (15%)	-1.50[(a)]	-11.29[(b)]
Net distribution to non-resident	66.10	64.00
Income tax paid by non-resident (at 40% tax rate)[(c)]	-25.54	-18.83
Net return to non-resident	40.56	45.17

(a) 15% of the part of the dividend that is unfranked — $10.
(b) 15% of total distribution.
(c) After credit for Australian DWT.

30.25 A summary of the impact of the NRITC arrangement and the deferred company tax on portfolio investors is given in Table 30.4 below.

Table 30.4: Portfolio investor — effect on $100 of distributed income (36 per cent company rate and deferred company tax)

	Australian tax	Foreign tax credit
Franked dividend	$0.00 ($0.00)	↑ $11.29 ($0.00)
Balanced equities	↑ $2.10 (↑ $3.60)	↑ $9.79 ($0.00)
Unfranked dividend	↑ $21.00 (↑ $36.00)	↓ $3.71 ($0.00)

Notes: Figures in brackets are for non-taxable investors (e.g. US pension funds).

30.26 As will be seen from Table 30.1 in the case of franked dividends there would be no increase in Australian tax. A taxable non-resident should, however, be able to claim a foreign tax credit in their country of residence of $11.29 as a result of the NRITC.

30.27 In the case of a balanced equities portfolio the deferred company tax on the $10 unfranked part of the dividend will be $3.60 whereas currently the tax collected is $1.50 by way of DWT. Overall, therefore, there would be an increase in Australian tax of $2.10 ($3.60 in respect of non-taxable investors

such as US pension funds which are currently generally exempt from DWT). For taxable non-resident investors this increase should be more than offset by the higher foreign tax credits for DWT.

30.28 In the case of unfranked dividends Australian tax would rise from $15 DWT to $36 as a consequence of the introduction of the deferred company tax. After the NRITC the foreign tax credit of a taxable non-resident taxpayer would be reduced by $3.71.

30.29 Comparable figures for the alternative options to the deferred company tax (RDWT or taxing unfranked inter-entity distributions) and assuming the entity tax/DWT switch when dividends are paid to non-resident are given in Table 30.5.

Table 30.5: Portfolio investor — effect on $100 of distributed income (36 per cent company rate and RDWT)

	Australian tax	Foreign tax credit
Franked dividend	$0.00 ($0.00)	↑ $11.29 ($0.00)
Balanced equities	$0.00 ($0.00)	↑ $10.17 ($0.00)
Unfranked dividend	$0.00 ($0.00)	$0.00 ($0.00)

Notes: Figures in brackets are for non-taxable investors (e.g. US pension funds).

30.30 Foreign portfolio investors would be major beneficiaries if the company tax rate were to be lowered towards 30 per cent. Table 30.6 illustrates the impact on portfolio investors of a 30 per cent rate together with the deferred company tax and NRITC.

Table 30.6: Portfolio investor — effect on $100 of distributed income (30 per cent tax rate and deferred company tax)

	Australian tax	Foreign tax credit
Franked dividend	↓ $6.00 (↓ $6.00)	↑ $12.35 ($0)
Balanced equities	↓ $3.90 (↓ $2.40)	↑ $10.85 ($0)
Unfranked dividend	↑ $15.00 (↑$30.00)	↓ $2.65 ($0)

Notes: Figures in brackets are for non-taxable investors (e.g. US pension funds).

30.31 As shown in the table taxable investors with a balanced portfolio will pay less Australian tax on distributions and benefit from increased foreign tax credits. With the lower tax rate, non-taxable investors also pay less Australian tax on a balanced portfolio.

30.32 For non-portfolio shareholders, the benefit of the NRITC would not be as large because in many cases they currently receive foreign tax credits for underlying company tax. Even where there would be benefits for

non-portfolio shareholders of applying the NRITC, there may be treaty reasons to restrict it to portfolio dividends.

30.33 While most DWT rates for portfolio dividends have remained at 15 per cent, there is an increasing trend to lower DWT rates for non-portfolio dividends. Negotiation of lower rates of DWT in bilateral tax treaties for non-portfolio dividends would benefit Australian companies with significant foreign operations.

30.34 Applying the NRITC to non-portfolio dividends may require renegotiation where Australia has already agreed to lower rates of DWT. Further, the NRITC could make it more difficult to negotiate lower DWT rates for non-portfolio dividends with additional countries.

How should non-residents investing in Australian CIVs be taxed?

30.35 The proposal to tax trusts as companies has implications for non-residents that invest in Australian CIVs structured as trusts. In particular, where non-residents use trusts to invest in Australian interest bearing assets, taxing trusts as companies would result in this income being taxed at the company tax rate rather than only being subject to interest withholding tax (IWT). This would mean that, in the absence of the tax treatment for CIVs outlined in Chapter 16, interest income of non-residents acquired through domestic entities would be taxed at higher rates than their interest investments made directly or through offshore bodies.

30.36 Where non-residents use CIVs to invest in portfolio equity holdings, taxing these vehicles as entities would also subject non-residents to capital gains tax on the sale of the equities by the entity, tax that would not apply if they invested directly or via a foreign institution.

30.37 This outcome would likely see the management of these assets shift to offshore entities.

Option 1: A flow-through tax treatment for special CIVs holding investments solely for non-residents

30.38 If Australian CIVs were to be taxed under the entity regime, the attractiveness of Australian equity and debt issues could be maintained by creating a type of vehicle for tax purposes that would hold investments solely on behalf of non-residents. These CIVs, which are referred to here as Non-Resident Investment Funds (NRIFs), would be 'flow-through' vehicles for tax purposes. They would not be subject to Australian tax, including on

gains on the sale of portfolio interests in Australian equities — income derived by the NRIF would be attributed to the non-residents and would retain its character in the hands of those investors. NRIFs would be allowed to invest in interests in Australian entities and in interest bearing securities but would not be allowed to derive other business income.

30.39 Under this approach it is expected that most NRIFs would be fixed trusts. DWT and IWT would be levied on income passing through the NRIF, and the residence country of the foreign investors is most likely to provide a foreign tax credit for the withholding taxes if that country recognises the entity as a 'flow-through' entity such as a trust.

30.40 However, allowing different types of entities to be NRIFs would enable commercial considerations to determine the type of entity used.

30.41 Disposal of assets held by the NRIF would be taxed in the same manner as if disposed of directly by a non-resident. The tax would be levied on the non-resident but collected by the NRIF. Assets that are not taxable Australian assets if held directly by non-residents would not be subject to capital gains tax if held through a NRIF.

30.42 Dividends paid to NRIFs would be treated in the same manner as dividends paid directly to non-residents — the dividend would benefit from the NRITC and DWT would be collected by the resident entity paying the dividend. IWT would be collected by the NRIF where the security and the investor are subject to the tax.

30.43 NRIFs could also be used as a vehicle for managing investment by non-residents in foreign source portfolio investments and could include the offshore investment trusts subject to the Offshore Banking Unit regime. This is further discussed in Chapter 31.

Option 2: A flow-through tax treatment for all CIVs

30.44 Another option to address this issue would be to treat certain widely held resident CIVs as flow-through vehicles as discussed in Chapter 16. This would allow taxable income passing through those Australian CIVs, in effect, to be taxed in the hands of the investors including non-residents.

30.45 The issues outlined in Option 1 regarding non-residents investing in Australian CIVs — such as the treatment of the disposal of assets held for the benefit of non-residents and the collection of withholding taxes — would also need to be addressed under this option.

How should profits remitted by branches of foreign companies be taxed?

30.46 Currently, Australian branches of foreign companies pay no withholding or other tax on remittances to their head office. Currently, tax-preferred income derived by Australian branches can only be taxed when it is paid as a dividend by the non-resident company. However, because the company paying the dividend is not a resident of Australia, there are considerable difficulties in determining when the company is liable for this tax and in collecting the tax.

30.47 In contrast, subsidiaries of foreign companies pay DWT (usually 15 per cent) on unfranked dividends paid to non-residents. The investment neutrality principle set out in *A Strong Foundation* suggests that the proposed new entity tax regime should apply to Australian branches of foreign companies in a similar manner to subsidiaries.

Under the deferred company tax approach

30.48 Under the deferred company tax option, dividend distributions from subsidiaries where the underlying income has not been taxed would be subject to deferred company tax. That might increase the incentive of some non-resident companies to operate in Australia through branches rather than subsidiaries. To avoid that bias there is a case for seeking to align the treatment of tax-preferred Australian sourced income of branches and subsidiaries.

30.49 Some countries have addressed the advantage provided to branches over subsidiaries by levying a surtax on the taxable income of the branch. However, this has no impact on a branch deriving only tax-preferred income and can impact harshly on branches that are fully taxed at the company rate.

30.50 Consistency between branches and subsidiaries could be achieved by levying deferred company tax on untaxed remittances by a branch to its head office. The remittances by a branch could be derived from the accounting relationship that the change in the net assets of the branch is equal to the excess of branch profits over remittances plus any net capital injection by the parent. Because only Australian source profits of the branch are taxable in Australia, the accounting identity has to be adjusted to exclude foreign source profits and assets and liabilities connected with the earning of those profits.

30.51 Deferred company tax, if introduced for all entities, would then be payable where the estimated remittances (or dividend equivalent amounts) exceed the tax-paid (or franked) amount available for distribution.

30.52 This would be a new approach to the taxation of branches and there have been questions raised as to whether such a basis of taxation would conflict with certain provisions of Australia's DTAs. Two types of provision are in question. The most common permits Australia to levy tax on the after-tax income of a branch (and was required for the previous tax of this kind in Australia prior to 1987) but limits the amount of tax that may be levied. In a few treaties there is also a provision that prevents the levy of additional tax on the undistributed profits of a non-resident enterprise.

30.53 There may be significant complexity involved in measuring the dividend equivalent amounts. The United States has issued detailed regulations to implement their tax on branch remittances and Australia's rules could require similar detail. Apart from the requirement for a franking account for branches to record the tax paid, most of the complexity would be involved in ensuring that the accounting records sufficiently reflect the profits of the branch.

Under the alternative approaches

30.54 Under the alternative options to the deferred company tax, the RDWT option and the option for taxing unfranked inter-entity distributions, unfranked dividends paid by Australian resident subsidiaries of non-resident companies would be subject to DWT (at the general treaty rate of 15 per cent) as at present. Under these options, consistency between branches and subsidiaries could be achieved be levying DWT on branch remittances.

30.55 However, at this rate the incentive to invest using a branch rather than a subsidiary is not as great as under the deferred company tax option and so the case for equivalent treatment of branches and subsidiaries is not as strong. This smaller benefit would have to be balanced against the significant complexity of measuring the dividend equivalent amounts. If rates of DWT were to be further lowered in future for direct investment, the case would be even weaker.

What rates of tax should apply to non-residents?

Current arrangements

30.56 The unfranked part of dividends, interest and royalties derived by non-residents are currently taxed on a withholding basis at rates of 30 per cent, 10 per cent and 30 per cent respectively. Commonly such rates are reduced to 15 per cent, 10 per cent and 10 per cent in Australia's DTAs.

30.57 Australia imposes tax on other types of income derived by non-residents including business income derived through a permanent

establishment, income from real property, capital gains, and personal services income. For taxpayers other than companies, this income is generally taxed using the progressive tax scale shown in Table 30.7 which excludes the zero bracket and lower rates available to residents. This rate scale will be changed, under legislation currently before Parliament, as from 1 July 2000.

Table 30.7: Rates of tax for non-resident taxpayers other than companies

Parts of taxable income	Tax rate %
not exceeding $20,700	29
between $20,700 and $38,000	34
between $38,000 and $50,000	43
exceeding $50,000	47

30.58 There are several issues relating to the use of this scale. Since the introduction of the imputation system, when DWT on franked dividends was removed, business income derived through entities and distributed to non-residents has been taxed at a maximum of the entity rate. An argument could be made that it would be consistent to tax all business income derived through permanent establishments and capital gains in the same way, that is at the entity rate, whether derived by an entity or an individual.

30.59 Another issue is that a progressive scale may not be appropriate for non-residents given that it is not applied to all the income of the taxpayer (most of their income may be derived offshore). These investors are also likely to be subject to further taxation in their own country of residence, perhaps with credit for Australian income tax. It is also possible that Australia's top marginal rate for individuals is too high to be fully creditable in the non-resident investor's home country.

30.60 Further, a progressive tax scale may be appropriate when applied to the annual income of a taxpayer but it is less relevant when taxing intermittent income or individual transactions. In particular, collection mechanisms can be harder to operate where income is intermittent and a progressive tax rate applies. This is currently the case, for example, for non-resident individuals who hold interests in Australian resident widely held property trusts. Withholding tax under the individual non-resident rate scale is applicable in such a case (which is creditable against tax by assessment if the non-resident files a tax return). The industry and the ATO have had considerable difficulties in giving effect to this rule.

Option: Apply a flat rate

30.61 These considerations support the introduction of a flat rate for taxing non-residents on their income other than interest, dividends and royalties. It was noted in the overview of international taxation that there is a general acceptance internationally that progressive rates are mainly a matter for the country of residence. A possible exception would be dependent personal services income (for example, income earned as an employee) where progressive rates may provide greater equity when compared with the treatment of residents.

30.62 As already indicated, the entity rate provides a suitable rate in some cases. It may be appropriate to use the entity rate generally as the non-resident tax rate unless there are good reasons for choosing another rate. A lower rate for withholding on a gross basis may also be justified for gains on realisation of assets because generally a taxpayer will have a substantial cost base (see below).

How should tax on income of non-residents be collected?

Current arrangements

30.63 In the absence of effective collection mechanisms, it is difficult to ensure that a non-resident's Australian tax liability is met or to detect tax minimisation and tax avoidance strategies being used by non-residents.

30.64 Under current law, income of non-residents other than the unfranked part of dividends, interest and royalties is generally taxed on a net basis following the lodging of a tax return. This approach is satisfactory where the non-resident has a permanent presence in Australia (that is, an ongoing economic presence).

30.65 However, if the non-resident does not have a permanent presence in Australia, the most effective way to collect tax is through the use of withholding tax systems. Currently, apart from the withholding tax on the unfranked part of dividends, interest and royalties, the tax administration is required to identify and serve a notice on a person who has the receipt or control of money belonging to a non-resident in order to secure the tax debt. With the speed with which money can be transferred between parties today the onus to identify a person on whom to serve a notice while that person still has control of the money is increasingly becoming an administrative impossibility.

Option: Impose a broader non-resident withholding tax

30.66 An option to address these problems would be to impose a withholding tax on the income of non-residents that is not effectively connected to a permanent establishment or fixed base of the non-resident in Australia. Failure to withhold could carry with it a personal liability for the amount that should have been withheld if the tax liability of the non-resident is not met. In circumstances where a business is being carried on by a non-resident through a permanent establishment or fixed base the non-resident would continue to be subject to tax by current assessment processes.

30.67 Withholding would thus apply to rents, gains on realisation of assets and income from the provision of services from sources in Australia (including contractor income provided by an individual or by an entity, income from the exercise of a profession, and payments to visiting entertainers and sportspersons).

30.68 Withholding might be considered for some cases where there is a permanent establishment and collection of tax is difficult because of the short term nature of the activity. This would occur, for example, when projects with a very limited life require the use of substantial equipment.

30.69 A number of countries operate broader withholding on non-residents than is currently the case in Australia. In structuring any system for Australia, consideration should be given to striking an appropriate balance between protection of the revenue and costs of compliance.

30.70 Australia currently has special regimes applying to the taxation of non-residents deriving income from passengers or cargo loaded in Australia, and from insurance and reinsurance. In the development of a broader withholding regime for non-residents, consideration of including such income in the regime would seem to be sensible.

Liability for the withholding tax

30.71 The obligation to withhold tax would, as do the current withholding tax systems applying to unfranked dividends, interest and royalties, fall on the person who makes the payment to the non-resident. However, where intermediaries are used, the intermediary ultimately dealing with the non-resident could carry the obligation to withhold. A failure to withhold could carry with it — as under the dividend, interest and royalty withholding tax systems — a pecuniary penalty on conviction and a personal liability for the tax of the non-resident.

30.72 Where a non-resident taxpayer believes that there is no liability for tax (through the operation of a treaty or domestic law) it could be possible to waive the requirement to withhold where the non-resident provides adequate security for its liability under any assessment. As a non-resident may reasonably not wish to have security outstanding for the normal period it takes for an assessment to be made, a specific assessment procedure could be developed for non-residents closer to the time the income is derived. A flat rate of tax on non-residents would significantly assist in developing such a procedure.

Should indirect transfers of Australian assets held by non-residents be subject to Australian tax?

Current arrangements

30.73 Australian tax on non-residents' capital gains can currently be circumvented by the simple process of interposing a non-resident company between the relevant asset and the ultimate owner of the asset. Rather than that asset being disposed of, the non-resident company can be sold with the result that no Australian tax is payable on the capital gain. This arises because membership interests in foreign entities are not included in the list of assets with the necessary connection with Australia whereas membership interests in resident entities are included (other than portfolio interests in widely held trusts and listed companies). The Treasurer announced on 27 April 1998 in Press Release 39/1998 that the law was to be amended following the Full Federal Court decision in a case involving Lamesa Holdings BV 'to ensure that it applies to profits arising from the indirect alienation of real property by a non-resident'.

Option: Tax indirect transfers of assets

30.74 An option to overcome this form of tax planning would be to levy tax where a non-resident controls an asset which would be subject to Australian tax and which is held indirectly through an entity or entities, and by disposal of the entity or entities ceases to exercise control over the asset.

30.75 Where a transaction came within the rules, the intention would be to deem a realisation of the asset by the immediate offshore entity that holds the asset. The result would be a notional gain based on the difference between the cost base and the market value of the asset at the 'disposal' date.

30.76 The quantum of the notional gain to be taxed would be determined by reference to the proportion of the gain that equates to the level of control that is lost at the higher level, for example, where the market value of a taxable Australian asset is $100 million greater than the cost base and a foreign

controller has reduced its indirect interest in the taxable Australian asset from 52 per cent to 27 per cent the gain assessed to the entity that holds the asset would be $25 million.

Further policy issues

30.77 As this procedure is essentially an anti-avoidance rule, it will need to be targeted to ensure that legitimate transactions are not affected and compliance costs are reasonable. One way to achieve this goal would be to adopt a substantial proportion rule, that is, a substantial proportion of the assets of the non-resident entity must consist directly or indirectly of assets giving rise to Australian source income. Special rules may be necessary for cases where there is a scheme to sell back other assets of the non-resident entity after the relevant realisation so that the overall effect is the realisation of only the relevant kinds of assets.

30.78 The tax liability of the entity holding the asset at the time of its deemed disposal could be enforced against the asset. The liability of the entity holding the taxable Australian asset could be waived based on an assessment of the entity indirectly realising the asset and on the provision of security for that assessment similar to the procedure discussed above.