Chapter 31

Conduit investment through Australia

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The challenge for taxation policy

Encouraging investment activities while avoiding profit shifting

31.1 The fundamental basis of international taxation is that residents of a country are subject to tax on their worldwide income — with either a credit or exemption being allowed in respect of income sourced in another country that is subject to tax in that country — while non-residents are subject to tax only on the income sourced in the country seeking to tax the income.

31.2 This fundamental basis does not, however, deal with the issue of taxing 'conduit income', that is, income derived by a non-resident from investment in an Australian resident entity where the income of the resident entity is, in whole or in part, foreign source income.

31.3 There are broadly two circumstances where the treatment of 'conduit income' is crucial. One is in relation to collective investment vehicles (CIVs), such as fixed trusts, that invest in foreign assets on behalf of non-resident investors. This type of business (funds management) is highly mobile and can be conducted in almost any country aspiring to be a regional financial centre. In these circumstances, the level of Australian tax on these activities can impact markedly on whether this type of business is located in Australia or elsewhere.

31.4 The second circumstance is where Australian entities (such as companies resident in Australia) have major (often non-portfolio) investments in foreign countries and there is a significant proportion of non-resident investors in the Australian entity. In such cases an adverse tax treatment of conduit income could ultimately influence companies to move offshore.

31.5 An issue arises, however, as to how conduit income derived in low tax countries should be taxed in order to avoid resident entities shifting profits to low-taxed countries (for example, through non-arm's-length pricing arrangements) and to avoid placing pressure on anti-tax-avoidance provisions and associated administration. For these reasons it may be desirable to ensure that Australia levies additional tax on conduit income that has not been taxed at an effective tax rate comparable to that imposed on Australian source income.

Current arrangements

31.6 In both cases where the taxation of conduit income has an effect, existing tax provisions relieve conduit income from some Australian tax. In the case of investments managed on behalf of non-resident investors, offshore investment trusts subject to the Offshore Banking Unit (OBU) regime are exempt from tax on foreign source income that is for the benefit of non-resident investors. For companies that have major foreign investments, the current foreign dividend account (FDA) mechanism allows foreign source non-portfolio dividends to be passed to non-resident investors without bearing Australian dividend withholding tax (DWT).

31.7 The effect of the FDA mechanism is that non-portfolio dividends from listed countries passing to non-resident investors are not subject to Australian tax. Non-portfolio dividends from unlisted countries are subject to company tax but not DWT, the effect of which is to top up the tax on these dividends to the Australian rate.

31.8 In the absence of specific provisions, several of the proposals currently under consideration would impact on conduit income:

- the entity treatment of trusts would subject all the foreign source income of trusts to Australian entity tax; and
- if the deferred company tax were introduced, it would apply to foreign source income of companies including when distributed to non-residents.

A strategy for reform

Promoting investment and minimising avoidance

31.9 Any proposed reforms must address the two circumstances discussed above. The highly mobile nature of the funds management business suggests that income from portfolio foreign investments flowing to non-resident investors should not be taxed in Australia. Even modest amounts of Australian tax on these investors is likely to impede the growth of this business. Only the income of the Australian funds manager should be subject to Australian tax.

31.10 Where income from major foreign investments flows through Australian entities to non-resident investors, Australia should not levy additional tax where that income has already been comparably taxed in the country where the income is derived. Australia should not cause the income to be double taxed.

31.11 Leaving the income to flow on to non-resident investors without any Australian tax would be consistent with the notion that neither the income nor the non-resident investor has any connection with Australia.

31.12 Where foreign source income is lightly taxed in the country where the income is derived there is a question whether or not Australia should top up the tax to the Australian company tax rate before it flows on to non-resident investors.

31.13 Topping up the tax would avoid criticism from other countries that low-taxed foreign income, that will ultimately be distributed to their residents, could be sheltered in Australian companies. Failure to take account of such criticism could lead to other countries treating Australian companies more harshly than otherwise under their controlled foreign company regimes. Topping up the tax would also ameliorate concerns of our treaty partners that income derived in their countries could be passed through Australia, thus attracting lower DTA withholding tax rates, to investors in countries with which they do not have treaties.

Key policy issues

How should conduit treatment be provided for CIVs that invest on behalf of non-resident investors?

31.14 The proposal to tax trusts as companies has implications for trusts that manage portfolio foreign assets for non-resident investors. Taxing trusts in the same manner as companies would result in some of the income from these investments being subject to Australian tax, for example, dividends subject to low levels of source country tax. Since such conduit income is often not taxed in other countries, the management of these assets would be likely to shift to offshore entities.

Option 1: A flow-through treatment for all CIVs

31.15 One option to address this issue would be to tax certain widely held CIVs on a flow-through basis as discussed in Chapter 16. That would allow certain foreign source income such as dividends passing through Australian CIVs not to be taxed at the entity level but to be taxed in the hands of the investors, including non-resident investors.

Option 2: Use Non-Resident Investment Funds

31.16 Another option is the dedicated non-resident investment fund discussed in Chapter 30.

31.17 If Australian CIVs were to be taxed under the entity regime, the taxation of conduit income could be handled by allowing the special purpose entities discussed in Chapter 30 for investments by non-residents in Australia (non-resident investment funds or NRIFs) also to invest in foreign portfolio assets.

31.18 NRIFs would be exempt from tax on foreign source income and gains on the disposal of foreign assets. Where the NRIFs are trusts, the non-resident investors would be presently entitled to the income of the NRIFs. OBU offshore investments trusts could be retained as a subset of NRIFs: where the proportion of the assets of the NRIF invested in Australia remains below 10 per cent, the investment management income could remain taxed at the rate of 10 per cent.

How should conduit income derived by other resident entities be taxed by Australia?

Current arrangements

31.19 Non-portfolio foreign source dividends from listed countries can currently be repatriated to Australian companies without bearing any Australian tax because they are considered to have borne foreign tax (entity tax and DWT) comparable to the Australian rate. The current FDA arrangements provide relief from DWT when Australian companies receive such dividends and subsequently pay unfranked dividends to non-resident investors. In the case of non-portfolio dividends from unlisted countries that are taxable and a foreign tax credit is provided, relief is provided so that the amount sheltered from Australian tax by foreign tax is not subject to DWT (the amount that is taxed in Australia is franked and therefore exempt from DWT).

31.20 These arrangements could be applied to relieve conduit income passing through Australian companies from the deferred company tax (if that option were chosen) and extended to other entities that fall within the new entity regime.

31.21 Where entities that derive foreign source income other than non-portfolio dividends (such as foreign branch income, portfolio dividends, and capital gains) distribute those profits to non-resident investors, the dividends are currently subject to DWT. Unless the conduit arrangements are extended, they could also be subject to deferred company tax. This could

discourage entities that derive substantial foreign source income and have a significant level of non-resident investors from locating in Australia.

Option: Extend the current conduit provisions using a foreign income account

31.22 An option is to modify and extend the current FDA arrangements to relieve more types of foreign source income passing to non-resident investors from deferred company tax or DWT.

31.23 The issue of whether the foreign source income passing to non-resident investors should not be subject to Australian tax irrespective of the level of source country tax, or whether the measures should merely prevent double taxation was discussed above. If conduit income was exempt from Australian tax irrespective of the level of foreign tax, it could be difficult in the case of foreign branches to check that Australian tax had not been avoided.

31.24 If relief is to be limited to conduit income that has already been taxed in a 'comparable tax' country, the current approach could broadly continue. Other types of foreign source income that have not been comparably taxed could be required to be topped up to the Australian rate before they are treated as conduit income.

31.25 The foreign income that is available to be distributed to non-resident investors could be recorded in an account similar to and replacing the current FDA (referred to here as the foreign income account or FIA).

Further policy issues

How should the foreign investment account operate?

Option 1: Record total income

31.26 Adding the total income to the account would be administratively simple but would depart from the underlying rationale for the mechanism and could be open to misuse. It would allow credits to accumulate in the account without regard for the proportion of non-resident investors at the time the income was derived. At some subsequent time, the proportion of non-resident investors could increase and the accumulated income be distributed free of Australian tax. However, the benefit to non-resident shareholders could be partly reflected in a higher price paid to resident shareholders who may be subject to tax on any capital gains.

Option 2: Apply a proportional approach

31.27 An alternative approach would require the company to ascertain its proportion of non-resident shareholders near the time that the income is derived. The proportion at the time of a recent dividend payment could be used. If no dividend had been paid in the last year, the company could be required to determine the proportion of non-resident shareholders at the start of the year. The company will also require information on the proportion of non-resident shareholders to determine eligibility for the non-resident investor tax credit discussed in Chapter 30.

31.28 Chapter 17 discusses the options for recording franking accounts on a taxed-income basis or a tax-paid basis. To ease compliance, the basis of recording the FIA would be aligned with that applying to franking accounts. In the following examples, the FIA entries are calculated on a tax-paid basis.

31.29 In relation to exempt non-portfolio dividends, the FIA credit would allow the proportion of dividends flowing to non-resident investors to be relieved of Australian tax as shown in Table 31.1 below.

Table 31.1: Operation of foreign income account — exempt non-portfolio dividends

Item	
Exempt non-portfolio dividend repatriated	$100.00
Proportion of non-resident shareholders	50%
FIA credit ($100.00 × 0.5 × (0.36)/1-0.36)[(a)]	$28.13
Australian entity tax	Nil
Income available for distribution	$100.00
Dividends paid to non-residents	$50.00
Debit to FIA	$28.13
Dividend to non-resident relieved of further tax by FIA[(b)]	$50.00
Dividend to non-residents subject to further Australian tax	Nil

(a) Tax-paid basis, i.e. the tax that would normally be paid on after–tax income of $50.00.
(b) The after-tax dividend for tax of $28.13 calculated as $28.13 × (1-0.36)/0.36.

31.30 For foreign income that is subject to the foreign tax credit system, the FIA credit would be the foreign tax paid (subject to the foreign tax credit not exceeding the Australian tax on the foreign income) being multiplied by the proportion of non-resident shareholders.

Table 31.2: Operation of foreign income account — income subject to the foreign tax credit system

Item	
Foreign source income	$100.00
Foreign tax paid	$25.00
Proportion of non-resident shareholders	50%
FIA credit ($25.00 × 0.5)	$12.50
Australian entity tax ($100.00 × 0.36) - $25[(a)]	$11.00
Franking credits for Australian tax paid	$11.00
Income available for distribution	$64.00
Dividends paid to non-residents ($64.00 × 0.5)	$32.00
Debit to franking account ($11.00 × 0.5)	$5.50
Debit to FIA	$12.50
Franked dividend paid to non-resident[(b)]	$9.78
Dividend to non-resident relieved of further tax by FIA[(c)]	$22.22
Dividend to non-residents subject to further Australian tax	Nil

(a) Operation of the foreign tax credit system.
(b) The after-tax dividend for tax of $5.50 calculated as $5.50 × (1-0.36)/0.36.
(c) The after-tax dividend for tax of $12.50 calculated as $12.50 × (1-0.36)/0. 36.

31.31 Although foreign branch profits derived in a 'comparable tax' country are exempt from company tax, allowing these profits to pass through Australia without tax may increase the incentive to shift profits out of Australia. For this reason, it may be more prudent to provide FIA credits to the extent that the foreign source profits have been taxed in the foreign country at the Australian tax rate. This is shown in Table 31.3.

Table 31.3: Operation of foreign income account — foreign branch profits

Item	
Foreign branch profits	$100.00
Foreign tax paid	$25.00
Profits available for distribution	$75.00
Proportion of non-resident shareholders	50%
FIA credit ($25.00 × 0.5)	$12.50
Dividends paid to non-residents ($75.00 × 0.5)	$37.50
Debit to FIA	$12.50
Dividend to non-resident relieved of further tax by FIA[(a)]	$22.22
Dividend to non-resident subject to further Australian tax	$15.28

(a) The after-tax dividend for tax of $12.50 calculated as $12.50 × (1-0.36)/0.36.

How should the FIA be treated in relation to company groups?

31.32 A single FIA account could be maintained for consolidated groups. If consolidation is not introduced, FIA credits could be allowed to be passed to another resident entity which has a 100 per cent interest in the dividend paying company, as currently applies to FDAs. The company deriving the foreign source income would look through the higher tier company to its non-resident shareholder percentage to calculate its own non-resident shareholder percentage.

31.33 A mechanism could be provided to accommodate the practice by non-resident investors of using holding companies as vehicles through which to hold their Australian investments. A holding company that is wholly owned by a single non-resident, could elect to be an 'FIA holding company'. An FIA holding company would be able to forward to companies in which it holds interests of 10 per cent or more an election to be treated as a non-resident for the purpose of the calculation of those other companies' non-resident shareholder percentages.

31.34 This option for FIA holding companies may not be required if NRIFs are introduced, as NRIFs could be used by non-resident investors to hold these investments. NRIFs would be treated as non-residents for the purpose of non-resident shareholder percentages.

Should franking credits be available to residents investing in Australia via non-resident entities — the 'triangular case'?

Current arrangements

31.35 The so-called 'triangular case' arises when a non-resident company derives income in Australia through a resident company and there are Australian shareholders in the non-resident company. When income is derived in Australia through a resident company, company tax is paid and dividends are paid to the non-resident parent. Franked dividends are not subject to DWT — the company tax that has been paid represents the total amount of Australian tax. Therefore, if the non-resident parent pays a dividend to its Australian shareholders the dividend will not carry an Australian franking credit and the dividend will be fully taxable to the Australian shareholders. Consequently, Australian investors in companies that are deriving Australian source income do not receive credit for Australian tax paid on that income.

Option: Allow franking credits to 'flow' through non-resident companies

31.36 There are conceptual grounds for addressing this issue, but the (relatively minor) efficiency and equity benefits have to be balanced against the cost of any changes in terms of increased complexity. The case for providing relief would be strengthened if full franking is adopted.

31.37 A possible solution in relation to resident companies is to allow those companies paying dividends to non-resident parents to issue dividend franking certificates to Australian residents that are shareholders in the parent. The franked amount notified to an Australian shareholder in the non-resident parent could be calculated as the product of the following two amounts:

- that part of the parent's dividend payments in the income year that can be attributed to the receipt of dividends from the Australian company; and
- the market value of the Australian shareholder's shareholding in the non-resident parent as a proportion of the market value of the non-resident parent's shares on issue.

31.38 In order to carry out the calculations necessary to provide relief, the Australian company would have to be supplied with the relevant dividend and shareholding information from its parent and would be held accountable if there was any evidence of fraudulent abuse of the system. By restricting relief to cases where the parent was a listed company resident in a broad-exemption listed country there would be a better chance of arranging any auditing on a cooperative basis with the taxation authorities of those countries. There would also be much less scope for manipulation of share valuations or shifting of headquarters overseas to avoid Australian taxation measures such as controlled foreign corporation measures.

31.39 Consideration would need to be given to the extension of relief to entities other than companies.

31.40 While reform could be implemented unilaterally, there would be advantages in negotiating a reciprocal arrangement or other comparable benefit with other countries.