1 April 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Sir

Business Tax Reform
Australian Multinationals
Submission in Response to Consultative Document - "A Platform for Consultation"

The purpose of this letter is to provide **early** input to the Committee on its request for submissions with respect to the consultative document entitled "A Platform for Consultation" dealing with the current Australian Business Tax Reform process.

Arthur Andersen will be making one or more detailed submissions to the Committee covering a number of issues.

This letter provides early feedback to the Committee on certain key issues and concerns which we believe Australian based multinationals have on the topic of Business Tax Reform. These issues (amongst other matters) will be fully supported in a detailed submission to be lodged by 16 April 1999.

Background

Our views herein deal with certain generic issues faced by Australian multinationals that are globally minded in their business operations and future directions. These companies will continue to focus on offshore growth not only because of the need to be internationally competitive but also because they are typically restricted in their ability to grow domestically because of market share and related ACCC limitations.

As many of these companies will or have become truly international companies, it is to be expected that the ongoing contribution to global earnings by their Australian operations will reduce and in many cases may eventually represent less than one third of their total earnings.

Moreover, their increasing percentage of foreign earnings is typically matched by an often substantial and increasing percentage of foreign shareholders. In many cases, it is the foreign shareholders who effectively fund the Group's endeavours to grow internationally.

A review of Australia's taxation system must pay particular attention to the specific needs of such multinationals. These Groups not only provide significant job opportunities for Australians but they also provide immense indirect benefits for the country. Amongst other benefits, their head office presence in Australia leads to a much more robust and globally attuned Australian debt and equity market; it supports a significant head office services support sector (which also encourages foreign regional centres) and clearly results in more significant direct investment into Australia than if these multinationals had been located elsewhere. It also provides the opportunity for Australian resident investors - both large and small - to invest in global growth by investing in Australian companies rather than foreign ones.

Much has been written in the recent press about the possibility of such multinationals leaving Australia and redomiciling, for example, in the US, the UK or elsewhere. There is truth in this. Whilst historically tax reasons alone would not, on their own, lead to such an outcome, the time is fast approaching where this may be the case - particularly so if the current tax reform process either adds additional tax impediments or fails to adequately address the existing tax problems these multinationals face.

The issue is whether our Australian tax regime will support the international aspirations of our existing and growing multinationals or rather inhibit them from being internationally competitive with likely adverse ramifications for their long term future. It is plainly obvious to us and anyone with a global business view that Australia's tax regime should not discourage such multinationals from remaining Australian.

Our present concern with the Tax Reform process is that it is severely constrained by a Revenue neutrality principle and by a political will to be actioning changes to our business tax regime within an unrealistic timeframe. We are concerned that important advancements to our future business tax regime may be glossed over or ignored in the process. Moreover, harmful measures could be introduced due to Revenue and time expediencies.

We therefore believe it is important to establish certain key policy principles - particularly in respect of the long-term interests of multinationals - and to vigorously test proposed legislative changes against these principles within a timeframe better reflective of the importance of the issues at hand and the long-term interests of Australia.

Key Policy Principles

We would wish to see at least three key policy principles enshrined in the design of our future taxation system to cater for the interest of both existing and aspiring globally competitive companies.

These are as follows:

1. An Internationally Competitive Tax Rate Regime for Equity Providers

It is deceptive to look at solely the corporate tax rate in assessing international competitiveness when focussing on business income tax rates. Reference to the corporate tax rate is only a starting point to international tax competitiveness.

First, the corporate rate is, in the context of a full imputation system, effectively only a withholding tax applied to shareholders.

Second, for multinationals who derive an ever decreasing percentage of their earnings from an Australian base, the corporate tax rate is of reducing significance. The existing national debate over whether our tax rate should be 36%, 30% or something in between is therefore not as important (or beneficial) an issue for many multinationals. It will be of particular significance only if it has the effect of adding significant additional tax to the Group's foreign earnings which have typically already been taxed offshore. (For example, if a Deferred Company Tax was introduced).

Third, when looking at the effective tax rate applied to equityholders, the interaction of a domestic based imputation system, a comparatively inefficient set of Tax Treaties and the foreign tax credit system differences that arise for a resident shareholder investing directly offshore as opposed to indirectly via an Australian based multinational, must all be taken into account.

Our current imputation and foreign tax credit regimes discriminate against Australian resident investors investing in Australian based companies that are growing offshore. They favour resident shareholder investment in purely Australian based growth, or in offshore growth directly (i.e. in an offshore resident entity) as opposed to via an Australian multinational.

It is not surprising therefore that much of the offshore growth of Australian multinationals has been accompanied by an increase in offshore investors. The UK and the US investor markets are particularly prominent here.

In this context it is also important to note two further matters.

First, neither the US nor the UK (especially after its recent abolition of ACT) discriminate from a tax perspective as to whether US or UK resident investors respectively should invest in local or offshore growth in the way that Australia's tax regime does.

Second, there are tax leakages resulting from Australia's outmoded Tax Treaty network and its capital gains tax regime for US and UK investors investing in Australian multinationals. These leakages would not apply if such US and UK investors invested directly in local US and UK companies respectively.

As a result, Australian based multinationals with ever increasing foreign earnings will continue to appear - at least tax wise - less and less attractive to Australian resident investors and would become more attractive to US/UK funds markets if they were in fact based in the US or the UK.

The end result being a desire for multinationals to relocate their Australian domicile. Alternatively, they may well remain Australian but internationally less competitive in respect of investor attractiveness.

This is a critical issue and it is therefore important that we have an internationally competitive tax rate regime for equity providers (both resident and non-resident) and not simply focus on the rather narrow corporate tax rate debate. This narrow focus substantially ignores not only in part the impact of Australia's imputation system but also the sensitive and more complex position of multinationals seeking to efficiently access global equity markets.

2. An Internationally Competitive Debt and Equity Funding Regime

There is much reluctance to remain Australian based if Australian tax rules work against a contemporary international approach to both debt and equity fundraising.

This is not solely a tax issue but requires serious consideration of the Corporations Law and Accounting Standards to ensure that regulatory issues are consistent with a framework designed to ensure that Australian companies can use modern, innovative and efficient means of raising debt and equity in a manner as favourable as that available to other global companies. This not only positions them to be more internationally competitive but goes towards fostering a robust Australian debt and equity market which is modern, innovative and attuned to global trends.

There is some overlap between this principle and the earlier principle dealing with effective equity provider tax rates.

However, this second principle encompasses the importance of being able to tap into innovative forms of debt and equity (as well as hybrid) fundraising options which the international financial community is constantly creating, redesigning and distributing to global corporations. It also encompasses the need to look at dividend streaming, stapled stock arrangements, virtual mergers, etc. of the kind that many foreign multinationals can readily avail themselves to.

Moreover, financial markets are sophisticated and many funding instruments are hybrids of traditional debt and equity. Australia's existing rules dealing with hybrids such as convertible notes, convertible shares, perpetual debentures, warrants, etc. require significant overhaul. The proposed changes with respect to the Taxation of Financial Arrangements (TOFA) was partly an attempt to come to grips with the rapid change that has occurred in the financial paper arena.

Our concern is that this area requires careful consideration and that shortsighted policy positions or specific legislative amendments that fail to take into account the complex comparisons that are required to properly develop policy in this area may place Australian multinationals at a disadvantage to other global companies. Careful and constant rigour is required to ensure that Australian tax and other regulations do not disadvantage such multinationals from raising efficient and competitive sources of funds.

There will also undoubtedly be a continuous balance between allowing for innovation in fundraising and the protection of the Australian Revenue. But that, like any other balance involving Revenue issues, requires ongoing monitoring and judgment calls within a given policy framework.

This framework must include the need to ensure that Australian based multinationals are not disadvantaged in the area of modern and innovative debt and equity fundraising.

3. An Internationally Competitive Holding Company Regime

Australia should not impose tax disadvantages on the use of Australian holding companies compared to the holding company regimes of other developed countries such as the US or the UK.

Our current holding company regime for Australian multinationals has certain clear disadvantages compared to such countries.

For example:

- The controlled foreign company (CFC rules) have become intractable and prevent companies from entering into commercially motivated corporate reorganisations or co-venture arrangements. **In our experience, this issue is a constant significant frustration for Australian multinationals and clearly puts them at a disadvantage to other international groups.**

- **The historical treatment of intra-group dividends received by Australian resident holding companies requires serious reconsideration.** Very often a Head Office (or sub-Head Office) company within a multinational group will have significant expenses referable to Head Office related functions. For Corporations Law and franking reasons it will require the receipt of dividends from its wholly owned subsidiaries in order to onpay dividends to its own shareholders. Dividends are historically assessable but then rebatable and therefore effectively tax free where the recipient does not have tax losses. However, where there is a tax loss within an entity, the tax loss is effectively lost by virtue of dividends flowing through that entity. This issue becomes particularly acute in the case of multinationals that incur significant Head Office expenses. Serious attention needs to be given to this issue. (Note, whilst the proposed introduction of a Consolidation Regime is partly aimed at resolving this issue, it has many unwarranted complexities and other adverse ramifications).

- **The historical inefficiencies of our Double Tax Treaty network naturally create serious inefficiencies for having Australia remain as the structural Head Office for multinationals.** Whilst many of our competitor countries have been constantly renegotiating more efficient double tax treaties, Australia has not and is now lumbered with an inefficient treaty network which will take many years to change. For instance, recent indications from the US Government is that the US has no intention or desire to renegotiate the Australia / US Treaty in the near term.

- **Unlike the US or the UK, interest incurred on debt used to fund offshore growth is not deductible.** Careful consideration should be given to the comparative advantage other country based multinationals have in this regard with particular reference to emerging (as opposed to well established) Australian based multinationals.

In addition to these issues, the threat of a Deferred Company Tax (DCT) has now been proposed by Government. This issue alone has the potential to drive many multinationals to relocate offshore. The possible impact of a DCT on corporate earnings, dividend policy and therefore shareholder value should by now be apparent to all concerned and clearly cannot be seriously contemplated in any form.

Conclusion

Changes to our tax regime which inhibit or encourage the success of Australian multinationals are too important to be raised and concluded on over a short period of time, without the benefit of important theoretical and practical input and within the confines of a Revenue neutrality and political expediency constraint.

Moreover, unfortunately the position has become more concerning given that many business associations, corporates and advisors are now devoting considerable time and resources to justifying to the Committee why the **existing** position on various issues is better than that proposed on a number of fronts. (We all seem to be working hard - in an already compressed timeframe - to justify why it is that we should stay where we are on certain tax issues as opposed to working towards moving forward and designing an improved system).

Our key suggestions therefore are structured in a twofold manner.

First, a strong recommendation that we avoid the introduction of a Deferred Company Tax regime in any form and regardless of any perceived trade-offs or modifications thereto. In fact, we do not see any strong reasons to change the existing corporate imputation system. However, if change is politically unavoidable, a resident withholding tax or inter-company dividend taxation system (both with important adjustments) are clearly more acceptable.

Second, we would strongly urge that Australia's taxation policy design principles be specific enough to encapsulate the following three design criteria for all tax changes as they relate to corporates and multinationals in particular:

- An internationally competitive tax rate regime for equityholders.

- An internationally competitive debt and equity funding regime.

- An internationally competitive Australian holding company regime.

We believe that within the context of these policy design principles, ongoing work can proceed on a more realistic timeframe, reflective of the importance of the issues under consideration and culminating in better specific tax change recommendations for the benefit of Australian companies and Australia as a consequence.

Should you have any comments or questions, please do not hesitate to contact Alf Capito on (02) 9964-6000.

Yours sincerely

Copy to:
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