Submission to the Ralph Committee

‘Australia – No Place for a Foreign Multinational with Genuine Foreign Income!”

27 April 1999

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

Dear Sir

A Platform for Consultation
Australia – No Place for a Foreign Multinational with Genuine Foreign Income!

Arthur Andersen have prepared the attached submission on behalf of the Accor Asia Pacific group ('Accor') in response to the publication of a 'Platform for Consultation' (PFC).

I am seriously concerned that, for a foreign multinational company with genuine foreign income, the proposals in the PFC serve as a positive disincentive to establishing or maintaining a regional headquarters company (RHQ) in Australia.

The submission addresses the current tax treatment of RHQ operations in Australia and considers the further tax impediments that will arise from the implementation of the proposals outlined in PFC. The submission also makes suggestions for the way ahead in the form of comparisons with three other locations in the Asia Pacific region being Singapore, Malaysia and Hong Kong and recommends alternative tax treatment for RHQs that should go a long way to removing the current disincentives.

Thank you in advance for your consideration of our submission. I would appreciate the opportunity to discuss the matter with your Committee at an early opportunity.

Yours faithfully

DAVID BAFFSKY
Chairman

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BACKGROUND

This submission is made on behalf of the Accor Asia Pacific group ('Accor'). The holding company for the Asia Pacific region, Accor Asia Pacific Ltd, is currently resident in Australia. Accor is engaged in hotel management and the operation of tourism services. It is a significant organisation in the Asia Pacific region with approximately 24,000 employees and annual revenues in excess of $100m per annum.

Over the years, Australian governments have promoted Australia as a regional base for multinational companies but persisted with a non-competitive tax system that has acted as a disincentive to many such opportunities. While it is encouraging that the process of genuine tax reform is now underway, it is inconceivable that this overdue process should itself create further disincentives to such organisations. This submission seeks to highlight the problems presented by the proposals in 'Platform For Consultation' (PFC) and promotes alternative strategies that would support Australia's potential role as a significant regional base for foreign multinationals.

If the Government acts on the PFC proposals, Accor will reconsider maintaining an area holding company in Australia given the incentives offered by other countries in the region. We would expect that many other foreign multinationals with genuine foreign income will also be dissuaded from establishing or maintaining a regional headquarters ('RHQ') in Australia.

1. SUMMARY OF SUBMISSION

Australia is a competitor in the market for global capital. Accordingly, Australia must compete with other locations in the Asia Pacific region when organisations such as Accor are considering where to site their RHQs. As part of that competition, it is important that Australia provides a tax regime that is attractive to RHQs. Other locations in the Asia Pacific region currently offer much more favourable destinations for RHQs.

This report sets out the current tax treatment of RHQ operations in Australia and also the tax impediments that arise from the implementation of proposals that are outlined in the PFC. A discussion of examples of concessional RHQ type regimes that exist in other jurisdictions is also provided. The countries that are used as comparatives are Singapore, Malaysia and Hong Kong because each has extensive models for providing tax incentives in this area. These are also countries where Accor currently has operations.

The key concerns and associated proposals that arise from the discussion are summarised below:

1.1. Dividend flow through

It would appear from the options in the PFC that conduit tax relief is favoured for dividends paid from a company located in a 'comparable tax' country or from a company located in a low tax country to the extent that the profits of the payer are from sources in a comparable tax country. This is consistent with the existing law. However, under the existing law, other dividends are taxed in Australia, that is, Australian 'top-up' tax applies. This acts as a major disincentive to companies wishing to use Australia as a regional holding company location.

The PFC raises the possibility that such income, to the extent that it accrues for the benefit of non-resident shareholders, should be exempt from any Australian tax. We support this option. In addition, a system similar to that used in Singapore should be implemented in Australia. Similar incentives to the Operational Headquarters (OHQ) and Finance and Treasury Centre (FTC) schemes in Singapore should be used.

1.2.CFC measures

CFC measures can apply to tax on a current basis a range of profits if they are concessionally taxed in the overseas location. For example, any untaxed capital gains on the disposal of shares will be taxed in Australia under the CFC measures.

The CFC measures should be relaxed for RHQs. Locations such as Hong Kong follow a territorial concept of taxation. This means that companies are taxed only on assessable profits arising in or derived from Hong Kong. Profits arising from offshore activity are not taxed. A similar system should be introduced for RHQs in Australia.

1.3. Capital gains tax

Any real profit on the disposal of shares by an Accor RHQ in Australia arising from a corporate reorganisation will be subject to capital gains tax in Australia.

There should be no capital gains tax ramifications resulting from corporate reorganisations. This would be a similar system to that used in Singapore. If the Accor RHQ is resident in Singapore and it decides to implement a corporate reorganisation then there is no exposure to capital gains tax.

1.4. Taxation of services income

If the RHQ is based in Australia, it faces onerous requirements under the transfer pricing legislation. These requirements include, for example, the need to document all of the calculations underlying the derivation of the transfer prices used by the RHQ.

There should be less of an emphasis placed on transfer pricing requirements for RHQs in Australia. RHQs should be offered the opportunity to apply a standard mark-up, e.g. cost plus five per cent, to items such as management services. There is less of an emphasis on transfer pricing for RHQs in other Asia Pacific locations. For example, Singapore has a concept of a notional income calculation in the form of the service company concept.

2. HOLDING COMPANY ISSUES

A key aspect that is often associated with a comprehensive RHQ operation is that of the entity's capital flows. To the extent that capital flows relate to the debt funds, the financial service activities would likely encompass such circumstances. However, where the funds represent equity investments in foreign companies and the consequent flow of dividends, further issues and tax consequences may arise.

One of the main concerns arising from consideration of the proposals in the PFC is the potential increase in the level of tax applied to conduit income. By conduit income, we mean income that is sourced from overseas that is paid to an Australian RHQ and then paid on to offshore shareholders.

2.1 Receipt of dividends from foreign subsidiaries

Australia currently has both an exemption and foreign tax credit system for the taxation of dividends paid by a foreign company to a resident of Australia depending on the circumstances. For this purpose, foreign countries are divided into listed (comparable tax) and unlisted (low tax) countries. Therefore, the taxation of dividends received by a holding company that is resident in Australia from a subsidiary in Asia will depend on the country of residence of the subsidiary.

2.2 Subsidiary resident in a listed country

A dividend paid by a company resident in a listed country to a company resident in Australia will be exempt from tax in the hands of the Australian resident company, provided that the Australian resident company has at least 10% of the voting shares in the foreign company paying the dividend.

The countries in the Asia / Pacific region that are listed for these purposes include China, India, Indonesia, Malaysia, Singapore and Thailand. Some of the other countries in the Region are classified as unlisted (low tax) countries, and include significant investment locations such as Hong Kong. All of the locations mentioned above are important for Accor as the group has subsidiaries in each of those countries.

2.3 Subsidiary resident in an unlisted country

A dividend paid by a company resident in an unlisted country such as Accor Asia Pacific Hong Kong Ltd, to a company resident in Australia will be taxed at a rate of 36% in the hands of the Australian resident company, unless the dividend is paid out of profits that have been subject to tax by assessment in Australia or are subject to comparable tax in a listed country.

Whether income or gains are subject to comparable taxation depends on whether the amounts have been derived through a branch in a listed country and subject to tax otherwise than under a designated concession. Any taxes paid on the dividend may be used to offset the Australian tax payable on the dividend. Furthermore, any tax paid by the foreign company on the profits from which the dividend was paid may also be used to reduce the Australian tax payable.

2.4 Remittance of profits from Australian holding company

Dividends paid by an Australian company to its non-resident shareholders will be subject to tax under Australia's withholding tax provisions. Withholding tax is imposed at a rate of 30% of the gross dividend with no allowance for expenses. The rate of withholding tax may be affected by limitations imposed under Australia's Double Tax Agreements. Generally, dividends paid to shareholders resident in a country with which Australia has a Double Tax Agreement will be subject to tax at a reduced rate of 15% in most cases.

The PFC addresses the current position where funds that are currently repatriated from overseas will not suffer further tax where the funds are considered to have borne foreign tax comparable to the Australian rate.
One option being considered is to extend the current FDA arrangements to relieve more types of foreign source income passing to offshore shareholders from a deferred company tax or a dividend withholding tax.

The extension of the FDA provisions is intended to operate through a new foreign income account (FIA). The system will allow relief for conduit income that has already been taxed in a ‘comparable tax’ country. However, the disincentive arises where forms of foreign source income have not been comparably taxed. In that instance, an Australian ‘top-up’ tax would be applied before the income could be treated as conduit income and, thus, the FIA system could be applied.

Clearly this will present tax costs to an Australian Accor RHQ and will act as a strong disincentive for maintaining a corporate location of this type in Australia. The section regarding overseas comparisons will consider the alternatives offered by other locations where Accor have operations, namely Singapore, Malaysia and Hong Kong (see later).

2.5 Controlled Foreign Company (CFC) measures

The Accor Holding Company currently resident in Australia must have regard for the Controlled Foreign Company (CFC) measures. Put broadly, these measures apply tax, on an accruals basis, to income and gains of a subsidiary resident outside Australia which are not subject to comparable tax in a broad exemption listed country.

For these purposes, a broad exemption listed country is one of seven countries being USA, UK, Germany, Canada, Japan, France and New Zealand. Certainly, Accor has significant operations in these countries. However, there are also many other companies within the group which are not subject to comparable tax as they are resident in other countries. Accordingly, the group must consider whether the CFC measures apply to them. An exemption may be available to entities in non-broad exemption listed countries in circumstances where the amounts constitute "active income".

The purpose of the measures is to prevent the avoidance / deferral of Australian tax on income and gains derived outside Australia that are not generated from genuine business activities.

Even where the country in which the CFC is located is a listed country (as above), CFC measures will apply to tax on a current basis a range of profits if they are concessionally taxed in the listed country. For example, any untaxed capital gains derived in a listed country on disposal of shares will be taxed in Australia under the CFC measures.

Furthermore, several other high capital exporters to the Asia Pacific region also have measures similar to Australia's CFC measures (these countries include France, where the parent of Accor Asia Pacific Ltd is resident). Accordingly, investment from the French Accor parent company through Australia into Asia may expose the company to tax under both Australian and French CFC measures.

2.6 Capital gains tax

Capital gains made by an Australian company are taxed at a rate of 36%. Only the real gain is taxed. This is achieved by indexing the cost of the asset to take account of inflation.

The capital gains that may be subject to tax include real property (such as land and rulings) and intangible assets (such as shares and trademarks). There are only limited exceptions to the range of assets that may be subject to capital gains tax in Australia, the most important being assets acquired before 20 September 1985.

In circumstances where an Australian Accor RHQ was intended to own regional subsidiary companies, the imposition of CGT may provide a less favourable result than by comparison elsewhere. Any real profit on the disposal of shares by the Australian company will be subject to capital gains tax in Australia. Limited exceptions apply where the shares are transferred to another Australian company in the same Accor group. However, there is no relief if the shares are transferred to a foreign company in the group. Therefore, besides the potential for taxation of a gain on disposal of shares where shares are transferred outside the corporate group, simple reorganisations of the corporate group can result in Australian capital gains tax liabilities arising, notwithstanding that the beneficial ownership of the subsidiary has not changed.

By comparison if Accor maintained an Asia Pacific Holding Company in Singapore, capital gains would not be taxed (although certain gains arising on a disposal within three years of the original purchase of Singapore real estate or shares in a company whose net assets substantially comprise real estate, may be deemed to be taxable income). Therefore, for example, corporate reorganisations of a holding company in Singapore are generally free of income tax.

2.7 Transfer pricing

In general terms, transfer pricing describes the practice whereby goods or services are provided between Australian and foreign entities at an amount other than market value. In doing so, the amount included in assessable income of the Australian resident may be less than it would be if the goods or services were provided to an independent third party.

Transfer pricing can also include the practice whereby an associated foreign entity provides goods or services to an Australian entity at an amount above the market value so as to increase allowable deductions of the Australian resident. In either case, profit is shifted from the Australian entity.

Australia has transfer pricing provisions that prevent such profits shifting from Australia by deeming an arm's length consideration to have been paid for the goods or services. Australia's Double Tax Agreements also contain similar provisions.

The Australian Taxation Office (ATO) has the power to reconstruct an international transaction for tax purposes in order to apply an arm's length consideration where the consideration for the supply or acquisition of property (or services) is less than, or greater than, the arm's length consideration. This power may be applied, for example, to interest free loans made from Australia to a foreign debtor. The Commissioner may tax the lender in Australia or a notional arm's length interest stream.

In the past there has been less emphasis placed on policing these provisions. However, the Commissioner of Taxation has stated that it is the intention of the ATO to commit increased tax audit resources to this area. Further, he has set out broad parameters requiring aspects such as contemporaneous documentation of arm's length prices, real bargaining and where necessary the need for economic analysis of the price agreed between entities.

By contrast, other jurisdictions have far less onerous requirements in this regard for groups such as Accor. For example, Singapore has a concept of a notional income calculation in the form of the service company concept. This concept has already been accepted in the context of a Singapore entity acting as a cost centre and not in direct connection with the specific OHQ incentive that may be granted to regional headquarter operations. Even so there has historically been lower emphasis on transfer pricing in either instance compared with that in Australia.

However, over the years there has been increasing emphasis and queries by the Singapore tax authorities on transfer pricing matters, particularly (but not exclusively) where both concessionary and non-concessionary income is derived by a taxpayer.

This produces an obvious impediment in the Australian context in terms of perceived complexity, administrative cost and burden when compared to other locations.

2.8 Taxation of profits derived from provision of management services

Profits on management services that could be provided by an Australian Accor company are taxed at the general company tax rate of 36%.

In determining the amount that must be charged for the management services, the Australian company must adhere to the transfer pricing rules outlined earlier. As a practical matter, it is difficult to determine the arm's length value for such services, as there are often no comparable transactions upon which to base the comparison. Furthermore, it is difficult to determine the exact contribution to the overall group provided by the management services. Therefore, resort is often made to a cost plus method to determine the ‘profit’ attached to management services.

The ATO has recently made it clear that it expects groups to charge an arm's length fee for the cross-border provision of certain intra-group services. However, relief from potential transfer pricing adjustments is afforded where the services are not integral to the profit-earning activities of the group or, alternatively, the costs of providing the services fall within pre-defined de minimis limits.

Despite relief being afforded in these cases, there are still extensive requirements to hold supporting documentation. The Accor group believes that the ATO could go much further to ensure that Australia is an attractive location for RHQs.

3. OFFSHORE BANKING UNITS (OBUs)

If financial services are provided by an Offshore Banking Unit (OBU), then they may be taxed at an effective rate of 10%. The concession is specifically targeted at the banking sector only.

The concessional tax treatment will apply to a list of specified transactions including:

- Borrowing funds from or lending funds to a non-resident (provided that, where the non-resident is an associate of the OBU, the transactions must not be denominated in A$).

- Guarantee type activity (which includes, broadly, providing a letter of credit to an offshore person, underwriting a risk of an offshore person where the risk relates to property situated outside Australia, loan syndication for an offshore person and issuing performance bonds to an offshore person).

- Trading activity (which involves, broadly, trading with an offshore person in shares, and units in unit trusts, bullion; trading on the Sydney Futures Exchange or foreign currency trading).

- Entering futures, forward swap contracts with an offshore person.

- Investment activity on behalf of an offshore person (i.e. funds management) in non-Australian stocks.

- Advisory activity (which includes giving investment advice to an offshore person in respect of "investment activities").

- Hedging the OBU's own risk with an offshore person, but only if the risk arises from borrowing or lending.

Further, the interest paid to a non-resident by the OBU in the course of borrowing money for the OBU transactions is exempt from withholding tax. Where the OBU is owned by a non-resident, the profits of the OBU will be subject to dividend withholding tax of 30% (or, in general, 15% if the shareholder is resident in a country with which Australia has a Double Tax Agreement.).

One limitation of Australia's OBU concession is that there is no change in the rules applying to the remittance of profits of an OBU from Australia.

In order to encourage RHQs to locate in Australia, consideration must be given to extending these provisions to RHQs that engage in some of the activities outlined above.

4. OVERSEAS COMPARISONS

At present the only specific incentive provided in the Australian income tax law in relation to RHQ type activities is that of the OBU (as discussed above).

4.1 Singapore

By contrast to Australia, Singapore has a series of complimentary incentives that cover the various possible facets of an RHQ operation.

In regard to financial services provided by banks, Singapore has a similar incentive to the OBU, the Asian Currency Unit (ACU). In broad terms the eligible services and basis of taxation are in line with that of the OBU.

In addition, Singapore has two further incentives that are relevant:

1. The Operational HeadQuarters (OHQ); and
2. the Finance and Treasury Centre (FTC).

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 and also research and development carried out in Singapore.

The OHQ regime provides reduced rates of tax on income and capital flows through an approved OHQ as follows:

Dividends

Where the Singapore OHQ holds equity in approved 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 to approved qualifying subsidiaries 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, upon approval the interest income may be taxed at the concessional rate of 10%.

Royalty

Where royalty payments from associates arise from R&D work carried out in Singapore, upon approval the royalties may qualify for taxation at the concessional rate of 10%.

In general terms, the concessions usually have a life of 5-10 years. Please note that the concession for dividends is subject to a five-yearly review to ensure that management and control of the OHQ entity are retained in Singapore. In addition, Singapore's foreign tax credit system normally allows foreign dividends received by a resident company (not limited to OHQs) which have been subject to tax in the investee country at 26% or more, to be flowed through to the resident company's shareholders without further Singapore tax.

Finally, the FTC incentive is targeted at non-bank entities who by virtue of the type of operation would be ineligible for OHQ approval but nevertheless have significant enough treasury and fund management activities that they wish to conduct in Singapore.

Often these may compliment similar activities conducted by the group in other time zones of the world. Again the range of eligible activities is a subset of similar activities that may be conducted by an ACU in the circumstances of a bank.

4.2 Malaysia

Malaysia also provides concessions for operational headquarter companies (OHQs). A Malaysian OHQ 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. However, the percentage that can be applied to mark up the cost of the services is less certain and may be subject to negotiation. From a practical perspective, cost plus 5% is usually applied in relation to the provision of management services.

In addition to the OHQ incentive, any Malaysian resident company (whether it is an OHQ or not) is not taxed on foreign source income. Hence, dividends and interest received from offshore locations will normally be exempt from tax.

Income arising from services performed in Malaysia on behalf of the worldwide group (e.g. management, treasury, etc) will be taxed at a concessional rate of 10%.

4.3 Hong Kong

The current rate of profits tax on corporations is 16%. In addition, there are no withholding tax requirements for the payment of interest and dividends.

Hong Kong follows a territorial concept of taxation. This means that companies are taxed only on assessable profits arising in or derived from Hong Kong. Therefore, profits arising from offshore activity are not taxed.

Dividends are not taxable in Hong Kong.

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5. Summary

Our primary concern is to create and reinforce Australia's role as a stable and attractive base for foreign multinationals with regional investments and genuine income from those operations. The Australian tax system must not be permitted to act as a disincentive to organisations, such as Accor.

Accordingly, we believe it is critical that the Ralph Committee take this opportunity to ensure that the Australian tax system achieves this goal. The tax systems in other Asia Pacific countries present a competitive advantage and if Australia is to succeed as a preferred location for RHQs, that advantaged must be matched.