THE AMERICAN CHAMBER OF COMMERCE IN AUSTRALIA

AMCHAM SUBMISSION TO THE REVIEW OF BUSINESS TAXATION

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SUBMISSION OF THE AMERICAN CHAMBER OF COMMERCE TO THE REVIEW OF BUSINESS TAXATION COMMITTEE

Introduction

The American Chamber of Commerce in Australia – better know as Amcham – was founded in 1961 by Australian and American businesses to encourage the two-way flow of trade and investment between Australia and the United States, and to assist its members in furthering business contacts with other nations. In pursuing this goal, AmCham has grown and diversified. It finds itself not only representing the United States' business view, but also speaking increasingly for a broad range of members involved in the Australian business community.

Amcham is Australia's largest international chamber of commerce and has 1,700 corporate members. It operates nationally with offices in Sydney, Brisbane, Melbourne, Adelaide and Perth. We are part of an international network of Amcham in 70 countries. The majority of US companies operating in Australia are members of the Chamber along with Australian companies doing business in the United States.

Areas of Concern

There are several aspects of the Discussion Paper issued by the Review of Business Taxation (RBT) that are selective in creating disadvantage to non-Australian investors (including U.S. investors) in Australian business compared with Australian investors. These include:

A Deferred Company Tax

This tax, while effectively creditable (and refundable) for Australian investors will represent a real cost to U.S. investors.

- AmCham is strongly opposed to the introduction of a deferred company tax ("DCT") regime. We do not believe that it is in Australia's economic best interests and we are concerned that it will give rise to significant adverse consequences for American businesses operating in Australia. These consequences include:

  – As noted in our submission to the Federal Government dated 1st December 1998 *(copy attached as Appendix I.)*, DCT will either lead to reduced reported earnings of Australian companies or reduced cash dividends. Both will impact the share price of Australian public companies. Cash dividend payments from all companies will be reduced. The amount of the reduction will be greater than that estimated by the RBT. DCT taxes both profits which have been untaxed and profits on which tax is merely deferred due to timing differences (which particularly applies to resource companies). The existence of timing differences does not affect the income tax expense recorded in the accounts. This has not been taken into account by the RBT and this additional reduction in the reported profits of a company will make investment into Australia less attractive. Contrary to the view expressed by the RBT, we believe that the US market is unlikely to appreciate this change and will act to reduce investment into Australia, particularly portfolio shareholders. In addition, as timing differences reverse in the future and DCT is not creditable against future tax liabilities, double tax will necessarily arise.

- The RBT has not considered in any detail what transitional provisions will be necessary on the introduction of a DCT and we are particularly concerned about the impact on our members. Significant adverse consequences will arise unless there is a grandfathering of existing unfranked reserves and certain future profits, as the effective tax rate on distributions sourced from these reserves will be increased from 15 to 36%. These are profits which will be untaxed due either to presently existing carried forward losses or to the sale of assets which were held as at 19 September 1985 and hence are exempt from CGT or have a high deemed cost base. We believe that it would be inequitable if relief (in the form of grandfathering) was not provided, given that relief has been proposed for other entities, such as the conversion of tax preferred income in trusts to capital. Without similar relief, our members and other foreign American investors will suffer treatment, which will be unduly biased.

- Under US GAAP, many US companies are required to establish a provision for all future costs (including taxes) of remitting their subsidiaries' reserves back to the US. The introduction of DCT will force US companies to make an immediate additional provision of 21% of the unfranked reserves in their Australian subsidiaries. (ie 36% DCT less the current provision of 15% for withholding tax).

- We are also concerned that DCT will apply to unfranked profits which arise due to income which has been subject to a specifically designated tax concession, such as income of offshore banking units (which is only subject to 10% tax). The effective removal of such concessions by way of a DCT is likely to lead to a significant outflow of US investment capital in the case of OBU's to other regional financial centres such as Singapore.

- The Discussion Paper simply assumes that the DCT will be creditable. We are concerned that the RBT has not taken any advice on the credibility of DCT in foreign jurisdictions. This issue is far from clear in the US and will largely depend on the wording of the legislation. In addition, many U.S. companies have excess foreign tax credits, such that additional Australian tax on profits is a real cost.

- We also note that the above consequences of a DCT are likely to be amplified given that the RBT has also proposed a profits first rule in respect of distributions.

- We believe that as a result of these adverse consequences, Australian subsidiaries of US companies will find it increasingly difficult to attract additional equity capital from their parent companies leading to a likely downturn in the level of new long term productive investment capital injected into the Australian economy from the US.

- In the context of a proposed DCT, we accept that a resident dividend withholding tax ("RDWT") is a best compromise in the circumstances and we support it as such. We note it will be necessary for Australian companies to maintain a separate RDWT account so that upon eventual distribution to non-resident shareholders, a refund of RDWT can be made.

- We applaud the proposal to implement a non-resident investor tax credit ("NRITC") and support this in any event. The benefits to non-resident shareholders should be assessed entirely separately from the substantial negative impact of DCT on the same shareholders. Amcham disagrees with the approach of RBT to combine the two to mitigate the real impact of DCT. However, we note that the RBT has not considered the reaction of the US to such a proposal, particularly given that the Australian/US Double Tax Agreement ("DTA") is in the process of being renegotiated.

B Branch Remittances

There has been insufficient thought given to the calculation of quantum and timing of deemed withholding tax on remittances of Australian branch profits of U.S. companies.

A consistently stated objective of the RBT proposals is to achieve the tax neutrality of investment, irrespective of the entity through which the investment is made. It is suggested that a move towards taxing branches as separate entities would be consistent with achieving this objective.

When coupled with certain of the RBT proposals for taxing entities, it is apparent that the peculiarities of branch operations have not been fully considered in the context of the proposed equality of treatment.

Specifically we refer to the following issues of concern for non-residents operating in Australia through branches.

- Determining the amount and timing of the dividend equivalent

- Under each of the alternatives for taxing entity distributions, remittances of untaxed profits by a branch to its head office are proposed to be treated as "dividend equivalents" and will suffer the tax applicable under each of the alternative regimes.
- The amount of the dividend equivalent is to be derived from the accounting relationship represented by the change in assets of the branch during a particular year. By this mechanism, branches will be deprived of the capacity to control/manage the distributions it is taken to make to its head office in the manner that a subsidiary would be able to. The proposals are silent with respect to issues affecting the timing of the dividend equivalent payment.

- To achieve neutrality in this respect, branches must have the ability to control/manage the amount and timing of the dividend equivalents taken to be remitted to head office. Otherwise, branch operations are likely to suffer double taxation, especially in respect of timing differences.

• The treatment of accumulated profits at the date of commencement of RBT

  - In amplification of the previous point, businesses carried on by a non-resident through an Australian branch prior to introduction of the new regime will not have generated franking credits for income tax paid on its profits. Specific measures are required to deem a branch to have generated franking credits on its accumulated profit balance at the date of commencement of the new regime. Otherwise, the entire balance of such profits will be taken to be untaxed and will suffer further tax upon payment of the dividend equivalent to head office.

• Excess of treaty jurisdiction

  - Notwithstanding the fact that it is proposed to treat a branch as a separate entity from its head office, Article 10 of the Australia/United States does not give Australia the ability to impose tax on branch remittances, as dividends. The Article only provides Australia with the power to impose withholding tax on dividends paid by a resident company. Under the separate entity approach, branch operations will still be non-residents of Australia.

  - It is suggested that the proposals for taxing inter-entity distributions do not require Australia to renegotiate its tax treaties. This assertion must be seriously doubted with respect to the application of the proposals to branch operations of United States resident companies.

• The credibility of tax imposed on the dividend equivalent payment

  - Much of the consultation paper operates on the assumption that the credit will be available in the foreign jurisdiction for tax imposed on inter-entity distributions. With respect to branch operations, it would be completely unsatisfactory for the separate entity approach to be endorsed without that assumption being fully tested and confirmed by the foreign revenue authorities in the United States.

– In this regard, although Australian law may deem branch remittances to head office as a dividend, the law of the relevant foreign jurisdiction (in this case the United States) is unlikely to take the same approach and may not recognise an entirely "notional" transaction between parts of the same legal entity. Accordingly, the creditability in the United States of tax imposed on branch remittances must be seriously doubted.

- Capital attributed to branches

  – The ability to identify the capital of an entity is an important aspect in a number of areas of the consultative document. For example, in applying the "slice rule" to certain corporate distributions or ascertaining compliance with thin capitalisation limits.

  – In the context of branch operations, it is proposed that they be treated as being capitalised in an arm's length manner. There is no guidance on the determination of an arm's length amount of capital. This has been an area of significant debate in the context of branch banking in recent times and requires clarification before any proposals are adopted.

C Capital Gains Tax

CGT deferral on share for share mergers (and possibly demergers) appears limited to circumstances where the offering company is Australian, causing U.S. offerors to suffer a disadvantage.

- We applaud the recommendation of introducing script for script rollover relief, however, we believe that this relief should be extended to shares in overseas listed companies and not just Australian listed companies either in circumstances where the overseas company is the bidder or the target.

- This is of particular concern to many of our members operating in Australia, as their Australian employees often hold shares in the overseas parent company. As a result, these employees will not have access to any rollover relief where there is a transaction that affects the parent company in which they have shares. We believe that this exclusion will potentially make it more difficult for US companies operating in Australia to attract talented employees.

- We also believe that script for script rollover relief should be extended to the situation where a US company receives shares in a foreign company in return for its shares in an Australian company. To do otherwise would put US companies at a significant disadvantage compared to resident companies and will likely impact on the level of US portfolio investment into Australia.

- As previously proposed, a share for share offer by a foreign company will not entitle Australian shareholders to claim GST deferral. In contrast, the same offer by an Australian company would entitle the accepting shareholders to enjoy CGT deferral. CGT deferral should be granted on a share offer by a foreign company so long as the shareholder is a resident or holds shares that have a necessary connection with Australia.

- We are disappointed that the RBT has failed to address various CGT issues currently facing US investors arising from the present Double Taxation Treaty with Australia. One critical issue is that the Australian Taxation Office assesses tax on capital gains made by US companies on the disposal of shares in Australian companies contrary to the terms of the treaty as interpreted by the IRS. Hence, the IRS considers the tax to have been voluntarily paid and therefore not creditable. These issues must be resolved and we believe that the RBT is an appropriate forum for this.

- The proposal to tax the sale of shares of foreign companies which hold predominantly Australian assets will lead to double taxation as such tax is very unlikely to be creditable in the US under the present treaty or US domestic law. Such a proposal, which clearly is motivated by anti-avoidance concerns, should not apply to ordinary commercial transactions or other circumstances where the sale is incidental to a larger worldwide transaction. The rule should have a threshold test of 75% of the company's assets being Australian.

D Tax Consolidation

It is proposed that the sole form of group tax relief will be by way of tax consolidation of companies with a common Australian parent. This precludes Australian companies that solely have a common U.S. parent, causing a major disadvantage to some U.S. owned groups compared with Australian owned groups.

- Whilst we generally applaud the move to a consolidated tax regime, we are concerned that the RBT has adopted this approach for reasons of tax avoidance rather than minimisation of compliance. Accordingly, it is likely that the end result will be an increase in compliance.

- We believe that a branch should be included in a consolidated group given that it will be taxed as an entity and therefore no different to other entities, such as trusts or companies.

- We are also concerned that problems may arise where there is no common parent in Australia for a group of companies. This group would be able to avail itself of the current arrangements, such as loss transfers, rebateable dividends and asset rollovers, though will lose this ability under the proposals as they will not be able to consolidate.

It is therefore critical to allow such a group to consolidate by nominating a head company

- An alternative approach is for the option of adopting present grouping rules to remain where the sole reason for not using tax consolidation is due to the common parent company being a non-resident.

E Thin Capitalisation

These proposals will deny interest on debt of U.S. owned Australian businesses which complies with present rules but exceeds newly proposed narrower rules. There must be grandfathering of the existing debt levels for a substantial period and several important commercial exclusions to minimise the disadvantage U.S. investors will suffer compared with Australian owned businesses that are not subject to such rules.

- We are concerned that the proposals for amending the thin capitalisation provisions place US owned Australian companies at a significant disadvantage as compared to Australian companies with only domestic operations. This disparity has no regard to commercial factors and arises because the Australian company has no restrictions on its level of gearing.

- Accordingly, whilst we accept that a safe harbour limit will be imposed, we believe that the following carve-outs are necessary to ensure that foreign investment into Australia is not curtailed:
  - A carve-out for project financing activities, which by their nature are usually highly geared (for commercial not tax reasons);

  - A carve-out for third party stand alone financing (ie no parental guarantees) on wholly commercial terms.

- Many substantial investments have been made in Australia by U.S. investors in recent years with third party financing that complies with existing thin capitalisation rules. Any change of the rules must include a substantial period of grandfathering of such arrangements (say five years) to protect such investors from the obvious tax disadvantage solely attributable to being non-Australian.

F Trusts

In seeking to tax trusts as companies, many financial arrangements of banks, many U.S. owned, may be adversely affected leading to a higher cost of funds for Australian borrowers.

- Chapter 22 of Discussion Paper 2 contains a proposal to tax most trusts as if they were companies. It is intended that a variety of trusts would be excluded and the existing flow through regime would continue to apply to them. The rationale behind this proposal is to establish equivalent taxation regimes for companies, trusts, limited partnerships and co-operatives in order to reduce complexity and compliance costs.

- Chapter 16 of the Discussion Paper proposes the continuation of the "flow through" taxation method for collective investment vehicles such as widely held unit trusts and cash management trusts. The Federal Treasurer has indicated that such vehicles should continue to be taxed under the flow through method.

- The proposal, as it stands, has some significant unintended consequences such as taxing wholesale unit trusts and securitisation trusts. Wholesale unit trusts are a product of the maturity and efficiency of Australia's funds management industry. However, most wholesale unit trusts are not widely held as defined. Instead, they have a small number of investors, usually retail unit trusts, which are widely held. To subject wholesale unit trusts to corporate tax and then allow the continuation of the flow through method to retail trusts would be nonsensical and would instantly create inefficiency in a competitive and dynamic industry.

- Securitisation trusts are arrangements whereby funding for mortgages, typically, is obtained from the wider investment community rather than just the funds available to the financier/mortgagee. Without any risk of exaggeration, it can be said that the use of securitisation in the last decade has lowered the Australian standard home mortgage interest rate by approximately two per cent per annum. The proposal to tax trusts, as it currently stands, will almost certainly lead to the demise of securitisation and a reduction in competition in the home mortgage area. This is because investors in securitised trusts will now receive net income rather than gross, and, in the case of investors such as superannuation funds, it will be necessary to recover excess tax from the Australian Taxation Office (we are enormously sceptical of the Australian Taxation Office's ability and willingness to operate accelerated recovery procedures as suggested in the discussion paper).

- We believe that the Review has approached the issue of equity between entities from the wrong direction. Rather than subjecting all trusts to tax and then exempting some we believe that the Review should state the type of trust operation it wishes to tax and leave all others unaffected. It is acknowledged that such an approach is the antithesis of that normally adopted by the Australian Taxation Office. However the advantages of such an approach are manifold. Firstly, the unintended consequences could be avoided. Secondly, it is much easier to implement a regime which merely targets the carrying on of business by trusts.

- Specifically, it would be possible to implement this proposal by simply repealing Section 102R(1) a (ii) and b (ii) of the Income Tax Assessment Act and repealing the word "unit" from relevant places within Division 6C. The result would be consistent with the Review's goal of consistency, unintended consequences would be eliminated and the legislative effort involved would be minimised.

- The new rules should confirm present treatment under Sections 106-50, 104-10 and 109-15 of the 1997 Act whereby assets and income of trusts to which a beneficiary has an absolute vested and indefeasible interest is treated as owned directly by the beneficiary.

G Individual Taxation

The present regime of taxation of U.S. citizens temporarily based in Australia leads to manifold tax anomalies often leading to double taxation or taxation of unearned income. Hence, Amcham recommends that foreign citizens (including U.S. citizens) temporarily based in Australia on a visa for a term of no longer than 5 years should be treated as non-residents.

A separate paper (Appendix 2) is attached expanding on this important issue.

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THE AMERICAN CHAMBER OF COMMERCE IN AUSTRALIA

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APPENDIX I

THE AMERICAN CHAMBER OF COMMERCE IN AUSTRALIA

AMCHAM SUBMISSION TO THE FEDERAL GOVERNMENT

ON THE PROPOSAL

DEFERRED COMPANY TAX

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1 December 1998

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EXECUTIVE SUMMARY

The Proposal

Business Tax Reform announcements by the Government included full franking of all dividends. For dividends that are presently unfranked, an Australian company will be required to pay deferred company tax (DCT) of $36 for every $64 of unfranked dividend paid. The tax is paid by the company as a company tax. The Proposal Document suggests it is paid as compensation for tax not previously paid on profits available for distribution to shareholders.

The Perceived Advantages

It is understood the proposal is considered by Treasury to have merit because:

(a) taxation of shareholders will be simpler as all dividends will be taxed in the same way (i.e. there will no longer be the substantial distinction between franked and unfranked dividends);

(b) the potential cost to the Revenue of non-disclosure by shareholders of unfranked dividends will be largely resolved by the effective payment of the tax by the company instead; and

(c) taxation of non-residents' unfranked dividends will be increased from 15% (under double tax agreements) to 36%.

The Real Problems

The proposal suffers from several fundamental problems that will have the effect of:

(a) reducing profits and therefore the share price of Australian public companies earning largely foreign profits;

(b) creating a very substantial outflow of funds from Australian subsidiaries and domestic branches of foreign companies;

(c) diminishing the benefit of tax concessions of companies, which will effectively be reversed upon distribution to shareholders; and

(d) taxing twice any distribution of profits, the taxation of which has merely been deferred.

A Workable Solution

The most appropriate means of achieving the first two objectives of DCT is merely to introduce a withholding tax at the rate of 36% payable by companies upon the payment of unfranked dividends to residents at the rate of 36% (subject to limited exceptions). Australian companies already withhold tax (at the rate of 15% or 30%) on unfranked dividends to non-residents; hence the administrative aspects of this proposal would be minor.

DEFERRED COMPANY TAX

1 The Proposal

1.1 The Tax Reform Package of the Government dated August 1998 included a proposal (at page 116) to require all dividends to be franked. To the extent that the company does not have a franking balance, the dividend payment would give rise to a tax liability to the company at the normal company tax rate on the grossed up amount of the dividend. For example, an unfranked dividend of $64 will attract DCT of $36.

1.2 The proposal also includes a refund of tax to a shareholder to the extent that the tax payable on franked dividends is less than the underlying imputation credit. Only individuals and superannuation funds will be eligible for the cash refund of an imputation credit. Private companies, trusts and non-residents would not be entitled to the refund.

1.3 The proposal is generally to extend to all dividends paid, whether to individuals, companies, residents or non-residents. The proposal seeks to ensure that the distribution of untaxed profits is taxed at the company level, rather than solely at the shareholder level, which was the case when unfranked dividends were paid out of untaxed profits.

1.4 The Government proposal forecasts that the additional tax revenue will commence from 1 July 1999 and identifies an element that will be as a result of additional tax on payments of previously unfranked dividends to non-residents. Revenue from the proposal in relation to unfranked dividends to both residents (less imputation credit refunds) and non-residents is forecast at $70 million in the year 2000, increasing to $400 million by the year 2002.

1.5 In the case of individuals and private companies, the proposal in relation to unfranked dividends does not change the tax collection, only the timing. Hence, the real source of revenue is the public investment companies (such as general insurers) previously not taxed (due to dividend rebate) and non-residents (previously subject to 15% dividend withholding tax).

Set out below are some of the key issues relating to the proposed DCT:

2 Company Tax – Credit for DCT

2.1 Various sources have been conflicting as to the exact nature of the concept of DCT, particularly as to whether DCT is creditable against the future tax liability of the company. If the consistent policy theme is the imposition of a single level of tax on distributed profits, it would be appropriate to assume the outcome will be that DCT is creditable. However, the concern is that such tax is normally described as Advance Company Tax (ACT) as is the case in the U.K. up to April 1999.

2.2 If the DCT is not creditable against future company tax, then distributions on profits, which enjoy merely tax deferral, will be taxed twice viz. firstly upon distribution to shareholders and secondly when deemed derived by the company for tax purposes.

2.3 Attachment 1, Part A, shows the outcome for a company with a regular dividend payment policy, but enjoying accelerated deductions on expenditure (mining expenses, R&D, depreciation or financing costs) which are expensed in the financial statements over a longer period. It shows that the double taxation occurs at the company level, such that the effective rate increases to 46.5% in the example shown. This cost would be even higher if a 100% dividend policy was adopted.

2.4 In contrast, if the DCT is creditable against company tax, Appendix 1 Part B shows that the effective tax cost to the company is not increased. This is because any DCT paid is merely a prepayment of the company tax deferred by the accelerated deductions.

2.5 A means of achieving credit for DCT within existing law may involve merely requiring all dividends to be franked and requiring franking deficit tax to be paid on the franking deficit. Franking Additional Tax would be abolished. This is the mechanism described to me by a senior member of the ATO.

2.6 In the U.K., the ACT paid by a company is creditable against future company tax liabilities and indeed is creditable against U.K. tax paid in the prior six years. There is no sound basis for DCT not being creditable against company tax.

3 **Non-Residents**

3.1 Unfranked dividends paid to residents of countries with which Australia has a double tax agreement presently are taxed at 15%. The effect of the proposal is that such dividends will be taxed at 36%, on the grossed up amount of the unfranked dividend. Hence, the actual tax rate will be 56.25% (36/64 x 100%). This is a huge increase in the tax rate for non-residents of more than 350%.

3.2 Another element of proposed business tax reform will result in branches of non-residents being taxed as a stand-alone company. At present, Australian branch profits repatriated to the foreign head office are not subject to dividend withholding tax. A combined result of the DCT proposals and the taxation of branches is that the taxation of the repatriation of untaxed profits will increase from nil to 36%.

3.3 In both cases, the DCT cannot be imposed on the shareholder under present law as most double tax agreements (DTA) limit such tax to 15%. The proposal (page 118) states:

"Consequential changes to international taxation arrangements would therefore be necessary"

3.4 The imposition of tax on the company in relation to dividends paid, rather than on the shareholder may facilitate reform without amendment to present DTAs, but will almost certainly render impossible a claim for a foreign tax credit by the foreign shareholder in its home country (eg U.S.A. and U.K.)

3.5 The consequence of this is highly anomalous. The DCT (as presently proposed), on distribution of Australian profits that have not been taxed due to an Australian tax concession, would be imposed at the rate of 56.25% (being 36% of the pre-tax amount) and is not creditable against foreign tax payable on dividends received by a foreign shareholder in his own jurisdiction. Assuming a foreign tax rate of 35% (eg USA), the total tax on the Australian profit is between 58% and 71%. In contrast, if the Australian profit is subject to normal Australian tax (which is creditable in the foreign jurisdiction), the total tax is only 36%.

3.6 The extent of the potential cost is very broad as unfranked profits would include:

(a) pre-1987 profits (pre-imputation)

(b) profits from pre-CGT asset sales

(c) profits sheltered by prior allowances (R&D 150% deduction, investment allowance, dividend rebates on unfranked dividends, foreign income, CGT indexation)

(d) profit from future sales of pre and post CGT assets (revaluations, group reorganisations with rollover)

3.7 There is no mention in the relevant public information of existing unfranked profits being exempted from the proposal.

3.8 Distributed profits sheltered from tax by tax concessions such as 125% R&D deductions will be taxed to the company as if no concession had been granted. This is counter to the original purpose of the tax concession offered.

4 Australian Residents

4.1 The principal concern for the companies paying the DCT is whether it constitutes a distribution of profit or an expense of the company. If the tax is a liability of the company and not paid for and on behalf of shareholders, it will be expensed by the company, unless the tax is creditable against future company tax and is virtually certain of utilisation.

4.2 Australian companies may not be able to frank dividends for a combination of reasons including principally:

(a) receipt of foreign income previously taxed in a foreign country;

(b) recoupment of tax losses; and

(c) entitlement to tax concessions (e.g. R&D, mining expenditure allowances and accelerated depreciation)

4.3 For many Australian companies which no longer can pay fully franked dividends, DCT could well cause reported profits to drop with potential impact on their share prices as the industry price earnings multiple is applied to a lower profit.

4.4 Appendix 2 shows that an Australian public company may drop its reported profits by 20% as a result of DCT which will have an immense impact on shareholder value and ability to raise new capital.

4.5 While dividends (subject to DCT) would carry franking credits, the value ascribed to such a dividend is dependent upon the recipient. Hence, the small benefit to some shareholders of payment of a franked dividend would not compensate for the loss of shareholder worth.

4.6 The high cost of capital for Australian companies relative to international standards is a very real limit to the growth of Australian business. Hence, the proposal could render Australian business less competitive.

5 **Economy Generally**

5.1 The impact of the proposal on foreign owned companies will be:

(a) force early repatriation of unfranked profits

(b) convert equity to non-deductible interest bearing loans (thin capitalisation or debt creation) which at least only suffer 10% withholding tax

(c) reconsider their investment in Australia

5.2 The adverse impact on reported profits of Australian listed entities that do not pay fully franked dividends is fundamental to Australian business competitiveness in international markets. The imposition of 36% tax on the distribution of foreign profits, which have already been taxed offshore, will cause more Australian companies to reconsider relocating to another location. This will have a severe impact on employment and the balance of payments.

5.3 The impact of the proposed DCT is to create an even greater disincentive for Australian companies to pursue successful business opportunities outside Australia.

5.4 The potential impact is so disproportionate to the minor benefits sought that common sense should prevail to cause a complete review.

6 Potential Solutions

6.1 The most appropriate response for Government is to withdraw the proposal entirely. This would partially impact upon revenue forecasts which assume $400m by the year 2002 from additional taxation of non-residents.

6.2 It is noted that the franking credit refund proposed has been forecast to cost $500m by the year 2002 in relation to dividends presently franked. It may be possible to simply drop both proposals at little net impact to Revenue.

6.3 The most appropriate solution is to introduce a withholding tax of 36% on unfranked dividends paid to residents, while continuing to allow a rebate to all public companies. This would ensure the same outcome to individuals and super funds as with full franking via a DCT. For non-residents, the 15% DTA rate would continue to apply. This would ensure massive capital outflow does not occur.

6.4 As the withholding cost is a shareholder cost, Australian public companies' reported profits would not be adversely effected. The dividend payment by a company would simply be applied partly to pay cash to shareholders and partly to remit tax to the Australian Taxation Office.

6.5 An alternative approach is to provide for grandfathering from DCT, dividends from presently existing unfranked profits. This would render the proposal largely inoperative for many years and hence is unlikely to be acceptable.

6.6 Given the potential difficulties with the operation of the DCT proposal under present DTAs, a potential solution is to exempt DCT for non-resident owned entities which no longer have franking credit balances in any event (by virtue of proposed exempting account rules). This would largely solve the problem for non-resident owned companies, while keeping the full franking system intact for Australian owned companies.

6.7 The solution of excluding foreign owned entities does not solve the problem for Australian listed entities. To the extent that such companies have foreign dividend accounts (FDA) (arising from foreign profits), it should be possible to amend the law to allow partially unfranked dividends to be paid from taxed profits and the balance to be paid unfranked from the FDA.

7 International Precedent

7.1 From April 1999, the U.K. will fully withdraw the ACT system which has highlighted over many years the problems similar to those raised in this paper in regard to the proposed DCT.

7.2 Several countries such as Germany, France and Singapore have an imputation system that requires all dividends to be franked. However, such regimes have many relieving provisions and tend to follow the accounting profits to calculate taxable income.

7.3 A brief paper of foreign jurisdictions could be prepared to add authority to the arguments for withdrawal of the DCT proposal in the present embryonic form.

A.E. Clemens
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1 December 1998

Appendix 1

Part A

Impact on Company with Accelerated Deductions
if DCT not creditable against company tax

	Year 1	Year 2	Total
Profit	100	100	200
Accelerated Deduction	(80)	80	-
	----	----	---
Tax Income	20	180	200
	===	===	===
Income Tax	7	65	72
DCT on 50% dividend in each year	21	-	21
	----	----	---
	28	65	93
	===	===	===
Net Profit	72	35	107
	===	===	===
Effective Rate	**46.5%**		

Part B

Impact on Company with Accelerated Deductions if DCT
creditable against company tax

	Year 1	Year 2	Total
Profit	100	100	200
Accelerated Deduction	(80)	80	-
	----	----	----
Tax Income	20	180	200
	===	===	===
Income Tax	7	65	72
DCT (Prepaid company tax)	21	(21)	-
	----	----	----

Tax	28	44	72
	==	==	==
Net Profit	72	56	128
	===	===	===
Effective Rate	**36%**		

Appendix 2

Impact on Australian Public Company paying unfranked dividends

Assumption

Australian company earns profits on a long-term basis as follows:

		Tax Rate	Tax	Net Profit	Franking
Australian Source	33	36%	12	21	21
Foreign Source	67	33%	22	45	-
	---		---	---	---
	100		34	66	21
	===		==	==	==

Dividend payout is 67% of profit i.e. 44

Hence Franked Dividend is 21 and Unfranked Dividend is 23

Impact of DCT

The unfranked dividend of 23 will be subject to DCT. Hence either (a) the cash dividend will fall or (b) the company will maintain the cash dividend and bear the cost itself.

	At Present		Reduced Cash		Same Cash
Profit before Tax	100		100		100
Income Tax on Profit	34	34		34	
DCT on Unfranked Dividend (Note)	-	8 (a)		13 (b)	
	---	---		---	
	34		42		47
	---		---		---
Net Profit	66		58		53
	==		==		==
Franked Dividend	21		36		44
Unfranked Dividend	23		-		-
	---		---		---
	44		36		44
	==		==		==
Reduction in Profit			**12%**		**20%**
Reduction in Dividend Yield			**18%**		**Nil**

(a) Unfranked 15 x 36/64 = 8 [Total Cost 23]

(b) Unfranked 23 x 36/64 = 13 [Total Cost 36]

APPENDIX II

II THE AMERICAN CHAMBER OF COMMERCE IN AUSTRALIA

AmCham Submission to The Federal Government

III ON

Expatriate Taxation Problems

"The complex, inconsistent, confusing and expensive Australian taxation regime for expatriate employees of foreign investors is a significant disincentive to investment or the expansion of existing operations."

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VII MAXIMISING AUSTRALIA'S REGIONAL FINANCIAL CENTRE POTENTIAL

- TACKLING EXPATRIATE TAXATION PROBLEMS

1 EXECUTIVE SUMMARY

- There are a number of flaws in the existing tax arrangements for expatriates that discourage them from accepting appointments in Australia and, thus, are a disincentive to the location of business depending upon them in Australia. The most important changes to the tax arrangements for expatriate individuals that are necessary to rectify this situation are:

  (a) The exclusion from the Australian tax net of foreign sourced income derived by executives and other employees transferred to Australia on a temporary basis; and

  (b) Simplification of the existing tax rules, including coordination of various threshold tests.

- There is no consistency between the various threshold tests currently imposed by different provisions of Australian tax law in the taxation of expatriates.

- Expatriate taxation arrangements would be significantly simplified and Australia would be immediately more competitive as a destination for foreign investment, if expatriates' foreign source income was not subject to Australian tax and the complex and inconsistent threshold rules were simplified and made consistent.

- For the purposes of Sections 6-5 and 6-10 of the *1997 Income Tax Assessment Act*, we recommend that individuals who enter Australia on a temporary visa of any kind should be treated as non-residents, where the entry permit is for no longer than 5 years.

- We also recommend that the suggested 5-year rule be applied for the following purposes:

  (a) The requirement for the employer to make compulsory superannuation contributions for expatriates, if it is not abolished (see below);

  (b) The definition of "resident" for tax purposes;

  (c) The definition of "living away from home" for FBT purposes;

  (d) Determination of liability for capital gains tax on foreign assets;

  (e) The application of the foreign investment fund and CFC/CFT provisions;

  (f) The requirement for expatriates to withhold Australian tax from interest paid to foreign lenders, if the obligation is not otherwise eliminated (which would be preferable).

- The Government should remove the Superannuation Guarantee obligation of employers in respect of their expatriate employees.

- The Government should cease collection the Medicare Levy from expatriates who are ineligible for Medicare benefits.

2 INTRODUCTION

AmCham welcomes the initiative of the Howard Government to develop Australia as a regional and global financial centre. We believe this to be an excellent initiative.

We have noted the Government initiatives to encourage financial centre status include:

- Measures to encourage offshore banking and the international expansion of the Australian bond market in the *Investing for Growth* package, released in December 1997;
- The establishment of a Financial Services Advisory Council taskforce to report on further measures that could be taken to make Australia more attractive as a financial centre; and
- The appointment of a Minister for Financial Services and Regulation, with a particular responsibility for regional financial centre development.

However, a number of difficulties exist in Australian tax rules which cause major problems for expatriate employees and their employers. These problems cause a significant increase in costs and difficulties for employers.

It is important to note that while the Financial Services Sector is significant and represents a major potential growth area with strong US participation, American companies operate in a broad range of industry sectors. US investment is significant and in many cases, encounters the same difficulties and costs with expatriate employees in the Financial Services Sector.

The need to rationalise the regulatory regime is important if the Government's objective of making Australia a financial services centre is to be achieved. When the negative impact of this difficult and expensive regulatory regime on all American (and other foreign) investors is appreciated. The need for urgent action becomes obvious.

High priority must be given to actions to eliminate these taxation difficulties faced by expatriate employees.

This action falls into two main areas.

(a) The exclusion from the Australian tax net of foreign sourced income derived by executives and other employees transferred to Australia on a temporary basis; and

(b) Simplification of existing tax rules, including coordination of various threshold tests. A standard 5-year rule for determining residency and the application of various other provisions, like FBT and capital gains tax, should be adopted.

These measures would improve the competitiveness of Australia as a destination for foreign investment. Though the expatriate tax regimes in some other jurisdictions would still be more attractive, the differences would be much less substantive. The economic benefits from these measures should far outweigh the cost, given the amount of existing regional business conducted in Australia.

We request the Government give serious consideration to the following issues.

3 INDIVIDUAL TAX ISSUES

US companies are the leading source of foreign investment in Australia; making substantial contributions to Australia's Gross Domestic Product (GDP), export income and creators of a significant number of jobs. The management of substantial businesses often requires the relocation of senior and technically skilled managers, particularly for industries based on technology. These employees are critical but only a small fraction of total employees.

There are a number of flaws in the existing tax arrangements for expatriates that discourage them from accepting appointments in Australia and, thus, are a disincentive to the location of business depending upon them in Australia. The most important changes to the tax arrangements for expatriate individuals that are necessary to rectify this situation are:

(a) The exclusion from the Australian tax net of foreign sourced income derived by executives and other employees transferred to Australia on a temporary basis; and

(b) Simplification of the existing tax rules, including coordination of various threshold tests.

These recommendations are based on the principle that the normal rate of personal income tax should be levied on the Australian source income of all taxpayers. Accordingly, expatriates would pay tax at the top marginal rates on their income earned in Australia.

3.1 Exclusion of Foreign Sourced Income

The greatest problem for many expatriate employees seconded temporarily to Australia, is the requirement to include foreign sourced income in their Australian taxable income. This liability is often unexpected and can be very costly. **Most countries competing for a share of global financial business, including Singapore, Hong Kong and Ireland, do not tax temporary residents on income arising from sources outside their borders.** *see Schedule I.*

Many foreign employers comprehensively protect their temporary expatriate employees from higher rates of tax than they would pay in their home country. This is known as "tax equalisation". In these cases, this feature of the Australian tax system can significantly increase the cost of transferring an employee to Australia for a temporary assignment. It is a common feature of employment contracts for expatriate employees on short-term assignment.

In other cases, where the employer protects the individual from higher rates of tax only in respect of employment income, this can often impose an unanticipated liability on the transferring employee, particularly having regard to Australia's high rates of personal income tax. This feature of our taxation system can lead to a situation where executives who would otherwise be prepared to take up a temporary assignment in Australia refuse.

3.2 The Complexity of our Existing Rules

There is no consistency between the various threshold tests currently imposed by different provisions of Australian tax law in the taxation of expatriates. The following examples demonstrate the fact that there is no "uniform code" for expatriates:

1 Issue	**Threshold Test**
Compulsory superannuation	Due on all salary and wages (up to a limit) related to the performance of services in Australia from day one. The only exception is for those who enter the country on a class 457 visa and **would** have qualified for the (now defunct) class 413 visa. In this regard, there are inadequate guidelines to assist employers in the classification of employees. The contributions must be made to a complying superannuation fund and must be retained until the person's preservation age (generally 55).
Residence v non residence	The question of whether an expatriate is a resident or a non-resident of Australia for tax purposes is of crucial importance. If a person is a resident, they are required to return for tax purposes their worldwide income. A non-resident is required to bring to account only that income which is sourced in Australia, together with certain "statutory" income. Until recently, residency was generally determined on a rule of thumb basis, with an individual temporarily based in Australia for a period of less than two years being considered to be a non-resident. By virtue of TR98/17, the two-year rule has been replaced by what amounts to a six-month rule. Except in unusual circumstances, an expatriate who is in Australia for more than six months will be considered to be a resident for tax purposes from date of arrival. As such, practically all expatriate employees here temporarily are required to return for Australian tax purposes all of their worldwide income. In many instances, our Double Tax Treaties provide no relief from the imposition of worldwide taxation by Australia. The ruling has increased costs for businesses that provide for expatriate tax equalisation. A brief international comparison of the treatment of foreign source income is provided at *Schedule I.*

2 Issue	**Threshold Test**
Controlled foreign entities	The taxation of worldwide income for resident taxpayers is further complicated by our controlled foreign trust ('CFT') and controlled foreign corporation ('CFC') rules. These apply to residents and seek to tax income accruing in various offshore vehicles, which are controlled by the relevant resident (alone or together with the resident's associates.) This often means that investments structured for family reasons, or to take advantage of certain tax rules in the home jurisdiction, have their income attributed to the resident and fully taxable here from the day that individual becomes resident. These rules are extremely complex and therefore often burdensome to apply. It can also be difficult for the individual to obtain the necessary information to determine their liability to Australian tax under these rules. Finally, in many instances our Double Tax Treaties provide no relief from the operation of our controlled entity rules.
Withholding tax	Resident expatriates have an obligation to deduct withholding tax from their interest payments to foreign financial institutions. For example, expatriate residents with a loan from a bank in their home country to finance the purchase of their home there should remit withholding tax on their mortgage interest payments. Failure to register and regularly withhold tax and remit it results in penalties. In addition, if there is an eligible tax deduction for the interest incurred then this is denied, if the withholding tax obligation is not met. Expatriate borrowers are generally required to bear the cost of the tax, because Australian withholding tax arrangements have no bearing on the setting of retail interest rates in foreign countries. If an employer reimburses this extra cost, it creates a fringe benefit tax liability. The application of withholding tax in the manner advised seems to be somewhat of an anomaly. Section 128F provides a policy precedent for amending the tax law to prevent this unfair outcome.
Capital gains tax on 'foreign' assets.	Where an individual has been a tax resident of Australia for 5 years or more our of the preceding 10 years, there is a deemed

disposal, for CGT purposes, of assets held before arrival in Australia, when the individual becomes a non-resident on leaving Australia. This can adversely affect expatriates who complete two 3-year terms.

Issue	**Threshold Test**
Foreign investment fund taxation	Liability is imposed once the total of all temporary entry permits used to enter Australia exceeds 4 years, or if the individual has **applied** for permanent residence. This tax is imposed on attributed income (as opposed to remitted income, or income on disposal) and can result in particular difficulties for expatriates who have accumulated investments in mutual or similar funds prior to their taking up a temporary position in Australia. Because of the threshold rules, FIF attributed income can be liable to tax in Australia well before the expatriate has physically been in Australia for 4 years.
Income deemed to arise from participation in employee share or option plans	Particular difficulties arise for expatriates who have the opportunity, during their stay in Australia, to participate in any one of a number of ways in an employee share scheme administered by their overseas employer. The relevant legislation has arguably no jurisdictional limit as it applies regardless of the residency status of the individual; nor does it have regard to the country in which the employment was exercised which gave rise to the right to participate in the employee share scheme. There is little formal guidance to assist in the tax assessment of expatriate employees who participate in such schemes.
Fringe benefits tax on various 'expatriate' benefits eg. housing	There are many benefits included in an expatriate's package, which are included in the fringe benefits tax net. Many of these benefits (for example, expatriate housing, education of children) are exempt from FBT if the individual can establish, by reference to a facts and circumstances test, that he is living away from home. This is a different test from the tests applied to determine whether the individual is a resident, whether he is liable to the FIF legislation, or whether superannuation must be set aside in Australia for him. In addition, the expatriate status for migration purposes does not definitively determine the status of the employee for FBT purposes. For example, some expatriates are considered by the tax authorities to be 'citizens of the world' and, therefore, not to be 'living away from their usual place of residence' and not

entitled to living away from home benefits. This approach fails to take account of modern business practice and the business needs of a regional financial centre.

Issue	Threshold Test
Medicare levy and benefits	Expatriates who are temporary residents for tax purposes are not eligible for Medicare benefits, unless there is a reciprocal health care agreement with the country of citizenship or prior residence (of which there are several, including the UK and New Zealand). Ineligible expatriates must pay the Medicare levy and then claim a rebate, after it has been certified that they are not entitled to health care benefits. Certificates must be obtained annually.

4 RECOMMENDATIONS

Expatriate taxation arrangements would be significantly simplified and Australia would be immediately more competitive as a destination for foreign investment, if expatriates' foreign source income was not subject to Australian tax and the complex and inconsistent threshold rules were simplified and made consistent.

In particular, for the purposes of Sections 6-5 and 6-10 of the *1997 Income Tax Assessment Act,* we recommend that individuals who enter Australia on a temporary visa of any kind should be treated as non-residents, where the entry permit is for no longer than 5 years.

This would mean that employment income earned while in Australia and investment income derived from an Australian source while in Australia would be fully taxable here. Typically, income received on assets held prior to entry to Australia would be exempt from Australian tax. For example, if an expatriate acquired shares listed on a foreign exchange, the dividends paid on those shares would not be subject to tax in Australia. However, if the expatriate acquired shares in an Australian company, then dividends flowing from those shares would be taxable in Australia.

To accompany this measure, a clear sourcing rule should be applied to benefits arising under employee share and option plans to limit the jurisdiction of the Australian provisions.

In addition, we recommend that the suggested 5-year rule be applied for the following purposes:

(a) The requirement for the employer to make compulsory superannuation contributions for expatriates, if it is not abolished (see below);

(b) The definition of "resident" for tax purposes;

(c) The definition of "living away from home" for FBT purposes;

(d) Determination of liability for capital gains tax on foreign assets;

(e) The application of the foreign investment fund and CFC/CFT provisions;

(f) The requirement for expatriates to withhold Australian tax from interest paid to foreign lenders, if the obligation is not otherwise eliminated (which would be preferable).

There are over 100 classes of visa on which a foreign national may enter Australia. We recommend that those that are issued for no longer than the agreed period should entitle the individual to the treatment described above.

Provision would need to be made to stop individuals from abusing the proposed 5-year rule, (for example, if 5 years were the agreed period, by entering Australia on a 3½ year visa, leaving Australia for 6 months and then re-entering on another 3½ year visa). Perhaps an absence from this country of 365 days would be needed in order for the test to be applied afresh.

The manner in which the superannuation guarantee and Medicare arrangements operate for expatriates are an unnecessary irritant to expatriates and their employers and deliver no policy benefits. These problems could be rectified without great difficulty.

The Government should remove the Superannuation Guarantee obligation of employers in respect of their expatriate employees. The Government's policy is to ensure that as many Australians as possible have access to superannuation and to provide for higher standards of living in retirement. This is pertinent to expatriate employees, as they are only temporary entrants and cannot become a burden on the Government in their retirement. In practice, the obligation places an extra cost on employers, as the benefit is heavily discounted by their expatriate employees, since it is generally preserved until they reach 55 years of age and the superannuation guarantee is an inefficient investment mechanism for them.

The Government should cease collection the Medicare Levy from expatriates who are ineligible for Medicare benefits. This would eliminate the burden of the rebate process and could be based upon a simple declaration of ineligibility to receive Medicare benefits by an authorised appropriate person; for example, Medicare officer.

5 SCHEDULE I

(i) Taxation of Foreign Visitors in Other Countries

Country	Minimum presence required for tax residence	Taxation on worldwide income?	Length of stay after which taxed on worldwide income
CHINA	12 months	No	5 years
JAPAN	12 months (1)	No	5 years
KOREA	12 months	Yes	-
MALYASIA	6 months	No (2)	-
SINGAPORE	6 months	No (2)	-
TAIWAN	6 months	No	-
IRELAND	6 months	No (2)	(3)
US	6 months	Yes	-
UK	6 months (1)	No (2)	- (3)

Notes:

(1) In some cases, the **intended** duration of the individual's stay is also relevant.

(2) Provided foreign income not remitted.

(3) Taxation of worldwide income may apply if the individual acquires a Ireland/UK domicile of choice.

6 ACKNOWLEDGEMENT

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