SUBMISSION TO THE REVIEW OF BUSINESS TAXATION

SOUTHCORP LIMITED

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ABOUT SOUTHCORP

Southcorp Limited ("Southcorp") is a diversified Australian company listed on the Australian Stock Exchange. Its market capitalisation is approximately $4 billion making it one of Australia's top fifty companies.

Southcorp manufactures packaging products, wine, water heaters, heating and cooling appliances and air pollution control devices. It has significant manufacturing operations in Australia, USA, New Zealand, China, Malaysia, Italy, Papua New Guinea, and Vietnam. It also exports significant quantities of goods manufactured in Australia to many other countries. During the year ended 30 June 1998, export sales totalled $371 million. Total international sales were $1.176 billion, accounting for approximately 43% of Southcorp's turnover and this is expected to exceed 50% in the next financial year.

Southcorp employs more than 10,000 people worldwide with nearly 30% of our employees outside Australia.

The industries in which Southcorp operates are capital intensive. Over the last ten years, Southcorp's operating profits have grown at an average compound rate of 14% per annum. Much of this growth has occurred through investment in export oriented Australian manufacturing funded principally by Australian shareholders and financial institutions. However, the high level of capital investment required, together with significant lead times, the relatively small size of Australia's population and Australia's geographical isolation from the large population centres of Asia, Europe and North America means that Southcorp is reliant on international investment for growth opportunities. This will also mean an increasing reliance on international sources of debt and equity capital to fund sustained growth and to build global business.

As Southcorp has become more international, so has its attraction to international investors. Southcorp has 56,000 shareholders with the largest holding, by a US investor, being 5%. Total overseas shareholding has grown from 8% to approximately 18% over the last 4 years and is expected to grow to 25% as the company becomes more international.

WHY IS SOUTHCORP MAKING A SUBMISSION

Many of the issues confronting Southcorp are common to a number of other Australian companies:

- a need to look beyond Australia for investment opportunities to build globally competitive growth businesses;
- an increasing reliance on access to international capital markets for funding;
- increasing competition from foreign manufacturers in both international and domestic markets, including competition for investments and capital;
- an increasing focus on capital management to maximise returns to shareholders.

Southcorp believes that the design of Australia's business tax system is a key element in allowing it and other Australian companies to compete in global markets. Southcorp endorses the national objectives and supporting principles for the design and operation of Australia's business tax system as set out in *A Strong Foundation*. However, Southcorp believes that saving and international competitiveness should be included as objectives in their own right.

Amongst other things, Australia's tax system should:

- reduce bias of Australian resident shareholders to investment within Australia rather than companies with operations offshore;
- reduce bias against Australian companies raising Australian capital for offshore investment;
- encourage foreign investors to acquire shares in Australian companies;
- not impede Australian companies' ability to compete with foreign investors for investments - either within Australia or internationally;
- not impede activities which increase Australian shareholders' wealth;
- not penalise Australian companies seeking to repatriate foreign sourced profits to Australia;
- provide certainty as to interpretation of the tax law;
- not impose undue compliance costs on Australian companies.

Southcorp endorses the view of the Business Coalition for Tax Reform ("BCTR") that Australia's present tax system has a number of major faults and is in need of substantial reform. Australia's present tax system does not achieve any of the objectives set out above.

Specifically:

- The present tax system has an inherent bias towards resident shareholders investing in companies that frank dividends and therefore operate predominantly in Australia. Whilst the current dividend imputation and superannuation arrangements have been very successful in promoting community wide investment in shares in Australian companies, an increasing number of those companies are now part of the global capital market.

There is also a bias against Australian companies raising equity in Australia to fund offshore growth. The after-tax return to the ultimate Australian shareholders will be considerably lower from an investment by an Australian company in an offshore project than would be the case from an investment in an Australian project (assuming both projects offered the same pre-tax profitability). This is due to the combined effects of foreign income tax, foreign dividend withholding tax usually at 15%, and the full impact of personal income tax rates due to the absence of franking credits and the inability of the shareholder to claim credit for foreign taxes.

- Relatively high corporate income and capital gains tax rates, coupled with an inefficient tax treaty network with respect to dividend withholding taxes and limited scope to stream foreign earnings to foreign shareholders discourages foreign investment in Australian companies.

- The absence of scrip for scrip rollover relief for CGT purposes acts as a constraint on takeover activity and thus prevents Australian shareholders from realising the maximum value from their investments.

- High foreign dividend withholding taxes applicable under Australia's double tax treaties are a permanent charge against profits and actively discourage Australian companies from repatriating foreign sourced profits.

- Australia's comprehensive Controlled Foreign Company rules cause substantial compliance costs and often operate to impose tax barriers on Australian companies seeking to merge or joint venture with foreign companies. Such restrictions can put Australian companies at a comparative disadvantage when competing for investments against companies from countries such as the US and much of Europe which allow mergers and joint ventures without an immediate tax cost.

- Australia does not allow tax deductions for writing off the cost of acquired goodwill. Thus Australian companies are at a competitive disadvantage to competitors from countries such as the US which does allow tax deductions for writing off goodwill.

ENDORSEMENT OF BCA/CTA AND BCTR SUBMISSIONS

A Platform For Consultation raised a wide range of proposals for a possible reform of the business tax system. Many of these proposals would affect Southcorp in the same or similar way they would affect the majority of Australia's corporate taxpaying population. Southcorp wholly endorses the submissions made jointly by the Business Council of Australia and the Corporate Tax Association.

Southcorp also endorses the submissions made by the BCTR to the extent its submissions are not inconsistent with the joint BCA/CTA submissions.

PURPOSE OF SOUTHCORP'S SUBMISSIONS

Southcorp's purpose in making a submission separate from the BCA and CTA is to supplement the comments made by those bodies about a few of the proposals which, in Southcorp's view, are of particular significance to Australian companies seeking international growth.

The areas on which Southcorp proposes to comment are:

- tax rate vs tax base;
- reforms to dividend imputation;
- interest deductibility;
- capital gains tax scrip for scrip rollover;
- double tax treaty renegotiation;
- conduit investment through Australia;
- certainty and the role of anti-avoidance provisions.

TAX RATE VS TAX BASE

General

Southcorp supports the proposal which would reduce the company tax rate to 30%, but broaden the tax base by reducing tax preferences such as accelerated depreciation. The reported after tax profits of many Australian companies would increase as a result of a reduction in the company tax rate. This should be a factor which will increase the attraction of Australian companies to foreign investors, and increase the value of the companies' shares.

An Exception for Expenditure on R&D

The tax law presently allows a deduction equal to 125% of the amount expended by a company on qualifying R&D activities. Until 20 August 1996 the allowable deduction was 150% of the R&D expenditure. For most manufacturing companies, the effect of the R&D concession is to increase the allowable deduction by 25% (previously 50%).

At a 36% corporate tax rate, the R&D concession reduces the after tax cost of every dollar of R&D expenditure from 64 cents to 55 cents. When the concession was provided at 150% the after tax cost of R&D expenditure was 46 cents.

Southcorp submits that the R&D concession should not be included in the package of tax preferences which are to be removed to fund a reduction in the corporate tax rate. As the table below shows, removal of the R&D concession - when coupled with a reduction in the corporate tax rate to 30% - would increase the after tax cost of R&D to 70 cents, an increase of more than 27% from the current position and more than 52% up on the position which existed when the concession was at 150%.

The table also shows that, at a 30% tax rate, the R&D concession should be restored to 150% to maintain the current after tax cost of R&D.

	No Concession	**125%**	**150%**	**180%**
36% Tax Rate	64 cents	55 cents	46 cents	
30% Tax Rate	70 cents	63 cents	55 cents	46 cents

Southcorp believes that restoration of the concession to 150% would:

- signal a strong commitment by Australia to investment in R&D as a key driver of innovation and longer term competitive advantage;
- increase the commitment by Australian companies to R&D thus enhancing opportunities for new products and/or processes to be sold internationally; and
- provide an internationally competitive regime which would attract new international R&D investment in Australia.

In the context of a reformed business tax system with improved integrity, it should be apparent that any concession afforded expenditure on R&D should only be available for genuine R&D activities and only available to the person or entity who genuinely bears the economic cost of the activities.

REFORMS TO DIVIDEND IMPUTATION

Comments on the Need For Change

A Platform For Consultation proposes changes to the dividend imputation system to ensure that profits distributed by a company are fully franked. This is proposed to be achieved by the adoption of one of three options viz:

- deferred company tax ("DCT");
- resident dividend withholding tax ("RDWT"); or
- taxing unfranked inter-entity distributions.

In proposing the three options, *A Platform For Consultation* makes assertions about the complexity of the current imputation system and the potential for companies to stream franked and unfranked dividends as justification of the need for change.

In Southcorp's opinion, the assertions made about the "failings" of the current system do not stand up to scrutiny.

Specifically:

- the complexity of the core provisions of the current system is exaggerated. Australian companies are well used to the mechanics of maintaining franking accounts. Complexity has been added by anti-avoidance provisions to prevent streaming and by measures designed to limit the scope for companies to overfrank dividends.

- the proposal to make surplus imputation credits refundable to Australian resident shareholders will substantially reduce the incentive for "onshore" streaming. Incentives to stream unfranked dividends to non-residents would remain largely because of:

    - Australia's unilateral decision to not impose dividend withholding tax on the franked component of dividends paid to non-residents; and

    - Australia's double tax treaty network which typically provide for dividend withholding tax at 15%, compared with a 5% rate now being adopted by many other countries in their treaty arrangements.

- regardless of the incentive, the potential for a company to participate in streaming has been virtually eliminated by the anti-avoidance provisions now in place. Whilst these provisions are complex, they are - in practical terms - irrelevant for most companies since most companies now believe that streaming opportunities no longer exist.

A Platform For Consultation also ignores the advantages of the current system relative to the three options for change. Under the current imputation system, companies have the advantage of being able to use the franking deficit tax payment and offset rules to overfrank dividends. This partially mitigates the impact of double tax on temporary tax preferences. In fact, ignoring the imposition of franking additional tax, the effective overall tax rate under the current system as applied to the example in Table 15.2 of *A Platform For Consultation* would be 47% - the shareholder's marginal tax rate - if the company overfranked the dividend in year 1 and paid franking deficit tax (which could be offset against year 2 tax).

Southcorp is strongly of the view that the present imputation system should be retained in preference to any of the three options considered in *A Platform For Consultation*.

Deferred Company Tax

DCT is unacceptable to Australian companies which either have existing foreign shareholders or which are looking to encourage foreign investors to acquire shares. The main reasons a DCT is unacceptable are:

- A DCT converts what is the individual tax liability of a shareholder into a charge against the company's profits thus reducing earnings per share. This will reduce the value of the company and raise the cost of raising new capital.

- The effect of DCT is to increase the tax on unfranked distributions to non-residents from a 15% withholding tax to a 36% company tax. Furthermore, unlike a dividend withholding tax, the DCT is unlikely to give rise to a credit for foreign taxes in the foreign shareholder's home country. DCT would significantly reduce the dividend return to foreign shareholders generally and reduce foreign demand for shares in Australian companies. The consequent reduction in share prices of Australian companies will reduce the capital gains made by Australian shareholders on eventual disposal of their shares. A reduction in the company tax rate will only partly mitigate the impact for foreign shareholders.

- The DCT does not accord with the spirit of Australia's double tax treaties which allow for the imposition of a 15% withholding tax rather than a 36% company tax. Nor does the proposal to "switch" part of the DCT to a creditable dividend withholding tax by means of the Non-Resident Investor Tax Credit proposed in Chapter 30 of *A Platform For Consultation*.

It might be argued that concerns about the increase in tax on unfranked profits distributed to non-residents that would arise under a DCT regime could be mitigated by, for example, allowing dividend streaming arrangements under which an Australian company's foreign earnings were able to be streamed to foreign shareholders.

However, it is clear that any such benefit falls well short of satisfactorily addressing the main concerns about a DCT raised above. The effective tax on distributions to non-residents will continue to be higher in situations where the company's foreign profits as a proportion of total profits is lower than the proportion of foreign shareholders. DCT imposed on unfranked distributions to resident shareholders will continue to have negative impacts on reported profits and the cost of raising new capital.

As argued elsewhere in this submission, Southcorp supports the concept of streaming foreign profits to foreign shareholders - but as a means of overcoming existing defects in the tax law and not as a means of only partially overcoming the substantial adverse effects of a DCT.

Southcorp believes that the majority of Australia's multinationals will find the notion of a DCT, in any form, unacceptable.

Resident Dividend Withholding Tax ("RDWT")

If changes to the dividend imputation system are to be made, then RDWT will overcome most of the problems associated with a DCT outlined above. However, RDWT applied to unfranked dividends paid within a wholly-owned Australian company group would result in a charge against the profits of the company receiving the dividend and a charge against the reported profits in the consolidated accounts of the Australian company group.

A Platform For Consultation indicates that RDWT would not apply to unfranked dividends flowing between companies which were members of a Consolidated Group for tax purposes under the Consolidation proposals contained in Chapter 25 et seq. Consequently, the problem referred to above will be avoided **<u>provided the Consolidation proposals commence at the same time as the introduction of RDWT</u>**.

We note the comments of the RBT team at a consultation seminar held at the Hilton Hotel, Melbourne on 24 March 1999 which intimated that Consolidation might be one of the proposals with a start date later than 1 July 2000. If the start date of Consolidation is deferred, Southcorp submits that it would be appropriate to also put in place transitional arrangements which excluded the application of RDWT to unfranked dividends paid within a wholly-owned Australian group. Reasons for this view are:

- A significant cause of unfranked profits within individual companies forming part of the wholly-owned group are:

    - utilisation of tax losses transferred from other group members; and

    - utilisation of CGT rollover relief in relation to intra-group transfers of assets, the effect of which is to shift the CGT liability from the transferor to the transferee whilst allowing the transferor to recognise an accounting profit (value shifting rules generally ensure the assets are transferred at market value rather than book value).

  The imposition of RDWT to distributions of unfranked profits within a wholly-owned company group would undermine the purpose for allowing tax loss transfers and CGT rollover relief.

- The imposition of RDWT on unfranked distributions within the wholly-owned company group would create a tax bias determined largely by the complexity of the group structure. Complex company group structures are often an inescapable outcome of growth by acquisition. Company groups face significant stamp duty and CGT issues in attempting to simplify a group structure notwithstanding that any restructure will not result in any change in the ultimate ownership of the underlying assets.

- Unfranked dividends are often paid up a corporate chain to maximise utilisation of franking credits trapped within a higher tier company in the group.

Summary

The current imputation system is preferable to any of the options proposed in *A Platform For Consultation*.

Of the three options proposed in *A Platform For Consultation*, only RDWT is considered viable.

If RDWT is to be introduced, either:

- the commencement date should not be any earlier than the commencement of the Consolidation regime; or
- RDWT should not apply to the unfranked portion of dividends flowing within a wholly owned Australian company group.

INTEREST DEDUCTIBILITY

Under the existing law, deductions are generally not available for the cost of servicing Australian debt to fund offshore growth. This is because dividends repatriated from non-portfolio investments in foreign countries are exempt from Australian tax when received by the Australian company. The combination of the Consolidation proposals in Chapter 25 et seq and the Domestic Thin Capitalisation proposals in Chapter 33 will mean that many companies will be denied interest deductions on domestic debt that is notionally attributable to offshore growth. This is a highly unsatisfactory outcome for companies which are, or aim to be, truly global. This is particularly so in a tax environment which already has a bias against providing such companies with domestic sourced equity.

In Southcorp's view:

- Australian companies should not be penalised by a loss of interest deductions on money borrowed to fund international growth. Successful international growth will increase the profits available for distribution and any tax preferences will be washed out on eventual distribution to shareholders. Southcorp notes that other countries including New Zealand and the US allow interest deductions in relation to offshore investments.

- If there are to be restrictions on interest deductions, then such restrictions should:

    - be applied only on the basis of specific provisions which compare Australian gearing with worldwide gearing and then only if Australian gearing is significantly out of line with worldwide gearing over a sustained period of time; and

    - at worst, result in a deferral of the deduction rather than be a permanent denial. Southcorp notes that this is the position which would have arisen under the Foreign Tax Credit System which applied to offshore non-portfolio investments prior to 1 July 1990. The change to an exemption system was largely justified as a compliance cost saving measure for companies because of the difficulties in undertaking calculations of foreign tax credit entitlements for relatively little impact on the amount of Australian tax paid.

CAPITAL GAINS TAX SCRIP FOR SCRIP ROLLOVER

A Platform For Consultation raises the prospect of allowing CGT rollover relief in relation to scrip for scrip takeovers and deconsolidations.

Southcorp believes that the absence of such rollover relief has been a significant impediment to takeovers and deconsolidations, both of which are activities that have the potential to add substantial value to shareholders. Consequently, Southcorp endorses any proposal to allow rollover relief in these circumstances.

Southcorp believes that allowing scrip for scrip rollover relief is likely to lead to increased tax revenue in the longer term because of:

- an increase in the level of takeover and deconsolidation activity; and
- the effect of the increase in value on CGT revenue when the “new” shares are eventually sold.

DOUBLE TAX TREATY RENEGOTIATION

Elsewhere in this submission, Southcorp has referred to the inefficiency of Australia's double tax treaties in respect of dividend withholding taxes. Most of Australia's treaty partners are able to, and do in fact, impose a 15% withholding tax on profits repatriated to Australia by way of dividend. By contrast, Australia has decided not to impose dividend withholding tax on franked dividends, notwithstanding that the tax treaties would allow for a 15% withholding tax. Australia should have received lower dividend withholding tax rates from its treaty partners as a pre-condition to foregoing its right to impose dividend withholding tax.

Many other countries have tax treaty networks which provide for substantially lower rates of withholding tax on dividend flows. Consequently, Australian based multinationals are at a competitive disadvantage relative to multinationals domiciled in other countries.

Southcorp believes that the Review of Business Taxation should highlight the urgent need to renegotiate Australia's tax treaties and recommend a process by which progress in this area is widely publicised.

CONDUIT INVESTMENT THROUGH AUSTRALIA

The high cost of foreign withholding taxes would be reduced by allowing Australian companies to stream foreign sourced profits directly to foreign shareholders.

This would increase the franking credits available for use by Australian shareholders. The net effect is that both foreign and Australian shareholders would be better off since the overall tax burden on the underlying profits generated by the company would be reduced. This should increase the value of the shares in the company.

Whilst there would be a revenue cost because of an increase in the franking credits being used to reduce tax payable by Australian shareholders, this could be expected to be partly offset by the increase in CGT revenue because of the increase in the value of the shares in the Australian company.

CERTAINTY AND THE ROLE OF ANTI-AVOIDANCE PROVISIONS

A Strong Foundation includes simplicity as one of its principles supporting the national objectives of a business tax system. Southcorp agrees that ***simplicity*** is an appropriate principle but that it should not be achieved at the expense of ***certainty*** which is even more important for corporate taxpayers.

Chapter 24 of *A Platform For Consultation* contemplates the introduction of a “very robust general anti-avoidance rule” which would eliminate the need for many specific anti-avoidance measures. Para 24-23 acknowledges, however, that an excessively broad general anti-avoidance provision (“GAAP”) would reduce taxpayer certainty.

Southcorp endorses the need for a robust GAAP. However, the necessary robustness should be achieved by an appropriately wide concept of *scheme* and *tax benefit* and not by diluting any test as to a taxpayer’s purpose in entering into an arrangement before the GAAP would apply. For many years, the tax law has required the application of a “sole or dominant” purpose test before a GAAP could apply. More recently, new legislation has sought to substantially reduce this threshhold - firstly, by adopting a “not incidental” purpose test and, ultimately, in the GST Bills, by completely removing any test as to purpose if a “principal effect” of a scheme is to obtain a tax benefit.

The nature of a GAAP is that it is necessarily very broad in the possible scope of its operation. Consequently, it has the potential to apply to virtually every type of transaction entered into by a taxpayer. An overly broad GAAP therefore has the potential to constantly divert the focus of a taxpayer’s business activity to the tax consequences of each transaction entered into.

By contrast, specific anti-avoidance provisions are targetted at specific types of transactions. In the main, the purpose of enacting such provisions is to discourage taxpayers from entering into particular kinds of transaction. Whilst often complex in design, the nature and purpose of specific anti-avoidance provisions is such that they are of little or no relevance to the way a taxpayer conducts its principal business activities. A taxpayer achieves certainty as to application of the specific anti-avoidance provision by not entering into the type of transaction the subject of the provision.

The end product of the business tax reform process should be a better designed business tax system. Consequently, there should be no need for any test other than a “sole or dominant” purpose test in the design of a GAAP.

IMPLEMENTATION AND ONGOING MAINTENANCE OF THE NEW BUSINESS TAX SYSTEM

The case for a comprehensive review of Australia's business tax system is compelling. A well designed and efficient tax system is a key element in promoting the international competitiveness of Australian business.

It is a matter of critical importance that the opportunity for reform is not wasted by repeating the mistakes of the past. Therefore, there must be in place an appropriate structure for implementing the redesigned tax system and for ensuring that it continues to meet the national objectives in the future.

Much of the discussion in *A Platform For Consultation* is in the context of a high level analysis of policy issues. This is entirely appropriate for purposes of developing the broad framework of a revised tax system. However, if the broad policy framework is not properly translated into the detail of tax legislation, much of the value of the tax reform process will be lost.

The Review is aiming for full implementation of changes to the tax law by 1 July 2000. This is an ambitious timetable, particularly given the likely volume of detailed legislation that will be required. As a general principle, Southcorp supports the aim of implementing change within this timeframe. The tax reform process has marshalled the resources of Treasury, the Australian Taxation Office and the business community at large and the momentum for reform should not be dissipated by unduly delaying implementation. However, the objective of ensuring that all changes to the tax law arising from the tax reform process should not be allowed to become an end in itself. Getting the changes right is much more important than ensuring the 1 July 2000 start date target is met.

Southcorp believes that it is possible to implement effective reform by 1 July 2000 but only if:

- there is sustained genuine consultation throughout the process of drafting detailed legislation;

- the legitimate concerns of the business community are addressed in a way satisfactory to the business community;

- those responsible for drafting the legislation resist the temptation to place undue emphasis on anti-avoidance measures which are targetted at a few taxpayers but which impact on all taxpayers - either by increasing compliance costs or by creating uncertainty as to application of the law.

Similarly, it is imperative that future changes to the tax law not undermine the purpose or effect of the tax reform process. Southcorp submits that three key elements to ensure that this does not happen are:

- as a general principle, future announcements of changes to tax law on policy grounds only proceed after business groups have been genuinely consulted. The only exception to this should be in circumstances where significant amounts of tax revenue are at immediate risk;

- that any changes to the tax law on policy grounds be justified by express reference to the national objectives and the supporting principles outlined in *A Strong Foundation*; and

- a well managed and publicly accountable administration of the tax law. In this regard, Southcorp supports proposals to introduce an Advisory Board along the lines discussed in Chapter 7 of *A Strong Foundation*.