ARTHUR ANDERSEN

4 May 1999

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

Dear Sir

Business Tax Reform
Australian Based Multinationals

Find attached our detailed submission on some of the issues raised in “A Platform for Consultation”.

This submission focuses on those issues that specifically relate to Australian based multinational companies.

The importance to Australia of the ongoing success of these companies in the global marketplace cannot be understated. Moreover, the complex and specific issues faced by these companies - and their shareholders - as a result of Australia’s taxation regime, require careful and considered attention as we seek to set the blueprint for Australia’s taxation regime for decades to come.

In the course of preparing this submission, we have worked closely with a number of major Australian multinationals that are significantly impacted by the issues raised in “A Platform for Consultation”.

These companies include Brambles, Coca-Cola Amatil, Goodman Fielder and Pioneer International. These and the other companies we have worked closely with on this submission fully support the recommendations made herein.

We would welcome the opportunity to meet with members of the Review Team to discuss the issues raised herein.

If you have any queries, please do not hesitate to contact Alf Capito of Arthur Andersen on (02) 9964-6000.

Yours faithfully

Review of Business Taxation
"A Platform for Consultation"

Issues for Australian Based Multinational Companies

April 1999

Contents

Executive Summary

We welcome the opportunity to make submissions on the specific options set out in *A Platform for Consultation* ("the Discussion Paper").

While our submission deals directly with some of the specific issues raised in the Discussion Paper, our primary concern is that the reform process to date has given inadequate attention to the fundamental structural issues in the tax system that impede the international competitiveness of Australian based multinational companies.

We fully appreciate the difficulty in addressing these issues. The review has necessarily canvassed a broad range of issues. International tax issues are invariably the most complex tax policy issues facing Governments. **However, inadequate consideration of the position of multinational companies over past years has resulted in an Australian tax system that impedes the offshore expansion of these companies. Unfortunately, certain options in the Discussion Paper have the potential to additionally, and severely, disadvantage these companies.**

A further fundamental concern is that the timeframe for the reform process is insufficient to adequately address the issues and we submit that this needs to be emphasised to the Government. In particular, we believe it is first necessary to firmly establish the key policy principles for the development of international tax policy as it relates to outbound investment and to then vigorously test against these principles future legislative proposals.

A System that Encourages the Growth of Multinational Companies

Multinational companies must directly compete in the international arena. A review of Australia's taxation system must ensure that to the maximum extent possible the tax system does not contain an inherent bias against the ability of multinational companies to do so.

These companies not only provide significant job opportunities for Australians but they also provide immense indirect benefits for the country. Amongst other benefits, their head office presence in Australia leads to a much more robust and globally attuned Australian debt and equity market; it supports a significant head office services support sector (which also encourages foreign regional centres) and clearly results in more significant direct investment into Australia than if these multinationals had been located elsewhere. It also provides the opportunity for Australian resident investors - both large and small - to invest in global growth by investing in Australian companies rather than foreign ones. Moreover, the presence of only a few of these multinationals on our local Australian Stock Exchange can have a significant impact on the movement of the Australian All Ordinaries Index and stock market movements generally.

In our view, three key policy principles need to be enshrined in the design of our future taxation system to cater for the interests of both existing and aspiring globally competitive companies.

These are as follows:

- **Australia needs an internationally competitive tax rate for equity providers.** When looking at the effective tax rate applied to equity holders, the interaction of a domestic based imputation system, a comparatively inefficient set of tax treaties and the foreign tax credit system differences that arise for a resident shareholder investing directly offshore as opposed to indirectly via an Australian based multinational, must all be taken into account.

- **Australia also needs an internationally competitive holding company regime.** The attractiveness of Australia as a location for Australian companies expanding is adversely and unnecessarily affected by the controlled foreign company measures, which have become intractable and prevent companies from entering into commercially motivated corporate reorganisations or co-venture arrangements. Further the historical inefficiencies of our double tax treaty network creates serious inefficiencies for having Australia remain as the structural base for multinationals.

- **Australia also needs to develop an internationally competitive debt and equity funding regime** – one which looks to the substance rather than the form of instruments, while still providing both a high degree of certainty as well as choice in tailoring techniques to suit the individual circumstances of the company and the shareholder base. This last policy issue is considered in a separate Arthur Andersen submission.

Deferred Company Tax

The proposal in *A New Tax System* to implement a deferred company tax is unnecessary and introduces an unacceptable bias into the tax system. In particular, the discussion surrounding deferred company tax appears to have been primarily directed at tax preferred income arising in respect of Australian source profits. It does not seem to fully contemplate the likely effect of the impact of deferred company tax on distributions by companies of exempt foreign income (and to a lesser extent foreign income subject to a foreign tax credit). Put another way, the discussion does not focus on specific issues faced by Australian multinational companies.

For multinational companies the most significant "tax preference" is generated from the permanent difference that arises from the receipt of exempt dividends. Other tax preferences are less significant in comparison. Further, these less significant tax preferences will decline even further over time (although they are unlikely to be completely removed) if timing differences are substantially removed. We assume that a deferred company tax would be complemented by conduit tax relief. In this case, a deferred company tax impost in respect of a dividend paid to a foreign shareholder will generally not arise. On the other hand, where franking credits are insufficient to fully frank a dividend to a resident shareholder because of tax preferences arising from exempt foreign dividends, deferred company tax would be imposed. These shareholders might adjust their behaviour to take account of the deferred company tax and no serious detriment from the reduction in corporate profits may arise (at least this is the suggestion in the Discussion Paper). Even if this is true, which in many cases we doubt, there will never be a benefit to the foreign shareholder from the deferred company tax imposed on dividends paid to the resident shareholder. The liability imposed on the company, reflected in reduced profits, is borne equally by all shareholders but is wholly refunded only to the resident shareholders.

This is the equivalent of the company preferentially distributing profits to one shareholder to the detriment of another shareholder, and introduces a bias against non-resident shareholders that does not currently exist. Two likely consequences arise. The company will be disadvantaged in raising capital from non-residents and it may also will respond by actively seeking to exclude resident shareholders from its capital base.

This aspect alone militates against the introduction of a deferred company tax.

Removing the Existing Bias

Leaving aside any consideration of deferred company tax, it is deceptive to look at solely the corporate tax rate in assessing international competitiveness when focussing on business income tax rates. Reference to the corporate tax rate is only a starting point to international tax competitiveness. Instead, for multinationals that derive an ever decreasing percentage of their earnings from Australia, the corporate tax rate is of reducing significance. The existing national debate over whether our tax rate should be 36%, 30% or something in between, though still relevant, is therefore not as important an issue for many multinationals. The Australian tax rate will be of particular significance only if it has the effect of adding significant additional tax to the Group's foreign earnings, which have typically already been taxed offshore.

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

The inherent bias under the imputation system towards investment in Australia by Australians, resulting from the failure to provide an imputation credit for underlying foreign taxes, needs to be removed or reduced. In our view, the most effective means of removing the bias would be to allow, in whole or in part, an imputation credit (or, more practically, a notional imputation credit) for foreign taxes paid.

Alternatively, the existing bias could be partially ameliorated if it were possible to stream in a tax effective manner foreign profits to foreign shareholders and domestic profits to resident investors both directly and via the foreign dividend account mechanism.

A Trade off Between Streaming and Deferred Company Tax

We understand that during the course of the consultation process the option for dividend steaming has been represented as a potential "trade off" for acceptance of a deferred company tax. We strongly submit that any such trade off is unacceptable. **We believe that a proposal for such "trade off" illustrates a misunderstanding of both the nature and extent of the existing bias against capital raising from residents and the operation of the deferred company tax in such circumstances.**

If both deferred company tax and streaming were to be introduced, some multinational companies may be placed in the same position as would be the case if deferred company tax were not introduced and streaming were allowed. That is, provided that Australian tax paid profits were sufficient to satisfy the dividends paid to the resident shareholder base, no deferred company tax impost would arise. Further, no Australian tax would arise in respect of the dividends paid to the non-resident investor.

However, if the level of domestic profits were to be insufficient to satisfy the dividends paid to the resident shareholder base (that is, foreign income was required to satisfy the domestic shareholders) deferred company tax would be imposed in respect of dividends paid to resident shareholders. This would introduce the same bias that militates against the introduction of a deferred company tax without streaming.

Comments on Specific Options

Our specific comments on the options set out in the Discussion Paper are as follows:

- As discussed above, we are implacably against the introduction of a deferred company tax regime in any form and regardless of any trade off or modifications whether coupled with dividend streaming or not.

- In fact, we do not see any strong reasons to change the existing corporate imputation system. Neither a resident dividend withholding tax nor the taxation of inter-company dividends should be implemented. We see no basis for the policy of removing tax preferences between non-wholly owned companies, particularly where the underlying operations of the payer are essentially an extension of the shareholder's operations rather than a passive investment.

- However, if these measures are to be implemented, care needs to be taken to ensure that Australian holding companies owned by non-residents that, in turn, hold shares in Australian companies are treated as flow through vehicles. In particular, it is important that foreign income be wholly unaffected as the amount flows through the corporate chain.

- We are strongly in favour of introducing a system that provides for the allocation of franking credits in respect of foreign withholding and underlying taxes. In our view this should be achieved by a notional allocation of the foreign taxes rather that an exact imputation of the foreign taxes.

- As an alternative to the provision of a franking credit for foreign taxes, we recommend that "streaming" of profits between shareholders be allowed. This could be achieved by allowing both direct streaming of foreign income to foreign shareholders without any effect on franking credits; and allowing the preferential allocation of franking credits to resident shareholders and foreign dividend account credits to foreign shareholders.

- The cost on Australian multinationals of foreign taxes on cross border dividend flows requires urgent attention. This can only be achieved through a concerted programme of bilateral action to renegotiate Australia's double tax agreements.

- The proposal to introduce restrictions on interest deductibility are misconceived, impractical and should be abandoned.

- If restrictions on interest deductibility are to be introduced, the rules need to be simple to administer while still providing adequate leeway to ensure that only cases of extreme "mis-allocation" of expenses are affected. We submit that the introduction of an adequate safe harbour gearing ratio, with resort to world wide gearing and ultimately arm's length methodologies only where the safe harbour test is not satisfied. However, considerable additional consultation on these measures is necessary once further details of the proposal are known if (contrary to our submission) such rules are to be implemented.

- The proposals for the extension of rollover relief for scrip-for-scrip transactions should be extended.

- The existing rollover relief under the CFC measures should not be denied or curtailed. Instead, existing rollover relief should be extended to allow mergers and reconstructions in foreign countries. As a minimum, where the foreign country has a capital gains tax regime, rollover relief should be granted on the same basis as provided in that foreign country.

- Contrary to the assertion in the Discussion Paper, in our view the recent changes to the CFC measures were misconceived and were not the subject of properly considered consultation. We submit that the CFC measures must be independently reviewed as a matter of priority to ensure that, consistent with the broad policy of the CFC measures, they are only applicable to cases of potential avoidance and do not impede genuine business operations.

Specific Submissions

Our submissions on the specific issues raised in the Discussion Paper are as follows.

- None of the options for changes to the current corporate imputation system should be implemented. Although unclear, the net revenue cost at a 30% tax rate arising from the rejection of all options would appear to be $210 million in 2003/2004.[1]

- The option for the introduction of a deferred company tax regime is particularly undesirable and should be abandoned in its entirety. If implemented, the proposal would adversely affect the corporate profits of Australian multinational companies. Depending on the circumstances of a particular company, this may or may not affect the after tax returns of the shareholders. However, the reduction in profits would be sufficient to adversely affect a company's ability to raise capital in foreign markets. The revenue effect from the increase in tax on these categories on foreign shareholders and exempt bodies would appear to be in the order of $90 million in 2003/2004.[2]

  A deferred company tax may not affect the after tax returns of non-resident investors because the main tax preferred income will be exempt foreign dividend income which carries with it a foreign dividend account credit. That is, the dividends may in any event be exempt from deferred company tax. However, deferred company tax will still be imposed on dividends paid to resident shareholders, impacting corporate profits.

- The option for a resident withholding tax is unnecessary and will retrospectively affect the returns on investment decisions made prior to commencement of the business tax reform in 2000/2001. The revenue to be raised from publicly listed companies appears to be in the order of $90 million in 2003/2004.[3]

  Further, coupled with the current operation of the foreign dividend account system (see below) the option will affect the structure of foreign investment in Australia.

  The other main effect of the resident withholding tax option would be to increase revenue from the avoidance of tax at the individual

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1 Based on the amount estimated in A New Tax System of $420 million less the negative impact of change to 30% of $210 million in Table 39.1.

2 Resident dividend withholding tax at 30% represents a negative impact on revenue of $90 million, which would appear to arise mainly from reduction in the revenue raised from the taxation of unfranked dividends of non-residents. That is, deferred company tax raises $90 million in respect of non-residents.

3 Taxation of inter-company dividends at 30% represents a negative impact on revenue of $120 million, indicating an estimate of the revenue raised from removal of tax preferences of $90 million.

shareholder level. The revenue to be raised from minimisation of evasion appears to be in the order of $30 million.[4]

- As with the option to impose a resident dividend withholding tax, the option for the taxation of inter-company dividends is unnecessary and will retrospectively affect investment decisions made in the past. The revenue to be raised from companies appears to be in the order of $90 million. Further, coupled with the effect of the current operation of the foreign dividend account system both of the options will affect the structure of foreign investment.

- In theory an imputation credit should also be provided for underlying foreign taxes in respect of branch income and non-portfolio dividends, subject to a maximum credit equal to the company tax rate. However, given the complexity of this approach and the inherent administrative burden, a notional credit should be provided equal to the corporate tax rate (in the case of exempt foreign income) or the actual foreign tax credit allowed (in the case of assessable foreign income).

- In the absence of the implementation of a system for the allowance of imputation credits for both foreign withholding taxes and foreign underlying taxes, we agree that the system for passing foreign income of Australian companies to the foreign shareholders of Australian companies should be retained. However, in our view foreign income should be allowed to be "streamed" to foreign shareholders. This approach is an appropriate policy response to the increasing problems faced by Australian based multinationals as they attempt to expand their business and shareholding on a global basis. This option does not represent a favoured treatment of Australian shareholders relative to shareholders in Australian companies which do not have foreign source income and foreign shareholders. Australian shareholders will effectively pay tax at their marginal tax rate on all dividends received but will not pay double tax as under the present treatment.

- Australia's double tax agreements need to be urgently revised. No matter what other policy is introduced, cross border withholding taxes will continue to limit the free flow of capital. Given that Australia has unilaterally removed dividend withholding tax on fully franked dividends, it is likely that net economic benefits of bilaterally reducing withholding taxes will accrue to Australia.

- The proposal for attempting to allocate the foreign income in proportion to the foreign shareholders at the time the foreign income is derived should be abandoned. This proposal would appear to have little practical benefit and is not estimated to have any significant revenue impact. Against this, if implemented, the change would significantly increase compliance costs.

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4 Resident dividend withholding tax at 30% represents a negative impact on revenue of $90 million, indicating an estimate of the revenue raised to be $120 million. Given the estimate of the revenue raised from removal of tax preferences of $90 million, the remaining impact of resident withholding tax appears to represent tax raised from evasion.

- All foreign income derived by a company that is 100% owned by non-residents should be allowed to flow through to non-resident shareholders without any "top up" tax in Australia. This will allow for the continued development of Australia as a regional holding company location. In any other case, there may be considerable difficulties in integrating this approach with either of our recommendations for allowing franking credits for foreign taxes or with the proposal for "streaming", and this would need to be further explored in the context of developing these rules.

- The current exclusion of foreign branch income from the foreign dividend account system is not warranted. Even though, in revenue terms, for the majority of taxpayers this is not likely to be a significant issue outside of the broad-exemption listed countries, there seems little basis to discriminate merely on the basis of perceived avoidance possibilities that cannot be demonstrated.

- The existing anomaly whereby a foreign dividend account credit is not granted for foreign tax credits in respect of amounts attributed under the CFC measures is unwarranted and should be corrected. The practical effect of the anomaly has been exacerbated by the recent extension of the CFC measures to encompass income that has been subject to significant levels of foreign tax, in many cases tax rates in excess of that imposed by Australia. It is unlikely that this matter will have a significant revenue impact.

- The existing restriction that prevents the flow through of foreign dividend account credits between Australian companies that are not wholly owned should be removed. This restriction has no theoretical basis and creates anomalies for joint ventures and Australian holding companies with substantial investments in Australian companies that have foreign source income.

- The policy of interest quarantining and the subsequent policy of disallowing interest expenses in respect of exempt income are fundamentally flawed. Therefore, it is inappropriate to introduce rules for the allocation of interest unless the underlying policy giving rise to the necessity for the allocation is re-examined. On a conceptual basis, we believe that interest incurred for the purpose of deriving foreign income should be allowed as a deduction, irrespective of whether or not the investment yields assessable or exempt income. Again, on a conceptual basis, the deduction should not be subject to quarantining. Instead, the deduction should be effectively clawed back on receipt of foreign income, either through credit quarantining (in the case of assessable dividends) or through a deduction claw back (in the case of exempt dividends).

- In any event, the strict tracing of expenses is preferable to the proposal to allocate expenses by formula allocation or by arm's length rules. This will be at an estimated revenue cost of $100 million. However, we note that this revenue estimate is inexact.

- If interest allocation rules are to be introduced, the primary test should be to allow a statutory ratio of debt to equity, such that domestic investment may be subject to greater gearing than foreign investment. An overriding test should be included to ensure that no interest will be disallowed if it is established that the gearing of the Australian investment does not exceed arm's length gearing ratios. We are particularly concerned that the statutory gearing test be set at a reasonable level. We are further concerned that the measurement of equity be reasonable to ensure that the ratio maintains its relevance and that the compliance burden is not onerous.

- The current capital gains tax rollover relief provisions should be extended to ensure that businesses can enter joint ventures, or alternatively undertake group reorganisations on a scrip for scrip or an asset for scrip basis without suffering major tax imposts. This is consistent with the objectives of achieving international competitiveness by ensuring that the tax flexibility of entering into commercial transactions and offered by other countries is, as a minimum, matched by Australia.

- The current rollover of assets under the CFC measures should not be constrained in the manner suggested in the Discussion Paper. Abandoning this option is revenue neutral. Instead, the current range of rollover provisions should be extended to ensure that in all cases rollover relief is consistent with that provided in the jurisdiction in which the CFC is resident. Given that the current restrictions would generally have prevented restructures and mergers, this option is likely to be revenue neutral. Further, the current rollover relief should be available for transactions by CFCs consistent with any extension of rollover relief provided for scrip for scrip transactions. These options are also likely to be revenue neutral.

- We are disappointed with the omission from the Review of any re-consideration of the policy and operation of the CFC measures. We believe that the Review has underestimated the problems and inequities that multinational companies face under the CFC measures, particularly exacerbated by the 1997 changes to the rules. These rules require urgent reconsideration.

Treatment of Foreign Taxes under an Integrated Tax System

Submission

We submit that all resident companies should be provided with an imputation credit for foreign withholding taxes paid in respect of foreign dividends. This credit should be provided irrespective of whether the dividend is a portfolio or non-portfolio dividend and irrespective of whether or not the dividend is assessable income at the corporate level or is exempt income. Further, the provision of an imputation credit should not be dependent on the outcome of the treatment of collective investment vehicles.

In our view, in the interests of removing economic distortions, an imputation credit should also be provided for underlying foreign taxes. We accept that the cost to the Revenue would be considerable, but should not be dismissed. We have conducted no independent estimate of the cost. Irrespective of the exact figure, there is little reason to doubt that amount would be significant. Nevertheless, we have set out the conceptual basis for the extension on the basis that the Discussion Paper firmly suggests that conceptual purity should always be a starting point for any discussion of options.

Background

The Discussion Paper proposes options for the treatment of investment vehicles whereby the impact of entity taxation will be alleviated. One of these options provides that foreign withholding taxes would generate an imputation credit for trusts treated as companies, with the effect that income which has been subject to a credit for foreign withholding tax will, via the imputation system, be entitled to pass that credit on to the investors in the investment vehicle without any "top up" to the beneficiary.

The option canvasses the possibility that this treatment would, on neutrality grounds, be extended to shareholders in corporate investment vehicles. The option further canvasses the possibility that the treatment would be extended to all dividend income derived by the entity, irrespective of whether the dividend was a portfolio or non-portfolio dividend.

The basis for this proposal would appear to be that investment vehicles are apt to be mobile in their choice of locations and any treatment that denied a pass through treatment would tend to have the effect that the vehicle would become uncompetitive with similar vehicles located offshore; would themselves relocate; or would encourage investors to invest directly in foreign stocks rather than investing via the investment vehicle.

Each of these concerns is also applicable to Australian based multinationals.

Nature of the Problem

For Australian companies looking for rapid growth, it is inevitable that significant expansion will occur in offshore markets. The relatively small size of the Australian market and the tendency towards specialisation by major companies both mean that there are limited growth prospects in the Australian market. Any Australian company with income from a foreign source will, to varying degrees, suffer foreign tax. However, imputation credits are provided only for Australian tax paid. As a result, although foreign earnings at the level of the Australian company will be subject to worldwide taxation at approximately the Australian tax rate, to the extent that foreign tax has been paid rather than Australian tax a distribution to a resident shareholder will be taxed with no regard to the foreign tax paid. The effect is that the Australian shareholder gains (vicariously) only a deduction for foreign taxes. Where the foreign earnings are subject to tax at a rate of 35% (comparable to Australia's corporate tax rate), the world-wide tax paid by a shareholder on the top marginal tax rate is in excess of 66%. This will not be reduced under the proposal to reduce the rate of corporate tax.

The effect of this policy approach is that Australian multinational companies are disadvantaged in their efforts to expand globally by the cost of raising capital from residents of Australia, because these investors require a significantly greater pre tax return on foreign investments than would be the case for an investment in Australia. This distorts investment decisions.

Alternatively, the company may seek capital from foreign investors, for whom the inherent bias under the imputation system has less impact. The disadvantages of seeking capital offshore is that Australian companies are less well known. That is, tax bias disadvantages the company in the domestic market, in which the company is well known, and commercial features make capital raising more difficult in the foreign market.

This problem does not arise specifically because of Australia's corporate tax rate. Instead it arises because of the multiple layers of taxation.

Economic Neutrality

A Strong Foundation proposed the policy of balanced taxation of international investment, requiring that taxation of income generated by inbound and outbound investment and other cross border business activities should be consistent with Australia's national interest including its competitiveness while respecting Australia's international obligations.

With the continued globalisation of the economy, including the movement of many of Australia's companies into a multinational environment, emphasis on the economic policy of neutrality is becoming a major concern in the development or reform of any international tax policy. The extent of this concern is seen from the perspective of enhancing offshore investment; maintaining the Australian based multinationals; and of fostering capital investment into the Australian economy.

Global vs National Neutrality

Global neutrality implies that businesses should pay similar rates of Australian and foreign tax on income derived from investments in Australia or abroad. Under global neutrality the foreign taxes paid by businesses would be credited against Australian taxes owing so that the total rate of foreign and Australian tax on income paid on foreign investments in no greater or less than that on domestic investments. Similarly foreign governments would allow their resident multinationals to credit Australian taxes against the foreign government's taxes owing on income derived from Australia.

National neutrality implies that domestic taxes should apply at statutory rates of the investor country irrespective of the geographic source of the income and that foreign income taxes should only be deductible in the investor country as an expense of doing business in another country rather than being treated as a credit against taxes. With the deductibility however, there is an element of double taxation that results in higher taxes on foreign compared to domestic operations at the level of the individual investor.

Presently, and in broad terms, capital export neutrality is achieved at the company level by the following patterns for taxation of foreign income:

- taxation in the country of source and exemption in Australia as long as the rate of tax in the source country is broadly comparable to that of Australia; or

- taxation in both source and in Australia with a foreign tax credit against the Australian tax liability for source country tax.

The current Australian treatment approximates capital export neutrality but is imperfect in that no refund for excess foreign taxes paid in the source country is allowed. This is consistent with international norms.

However, capital export neutrality for a resident shareholder breaks down when the total world wide tax levied at the shareholder level is taken into account. At this point, the policy mirrors one of national neutrality. In particular, the current taxation system provides that Australian sourced income will be subjected to the imputation system, thereby giving rise to franking credits. Alternatively, foreign sourced may be either exempt or subject to the foreign tax credit system. Accordingly, a locational bias is created from the perspective of the source of the earnings.

Some countries have accepted the concept of global neutrality, either by providing an exemption of dividends paid by a company to an individual or by providing a standard credit at the level of the company's shareholder.

The Options

The Discussion Paper suggests that an imputation credit should be made available in respect of withholding tax paid on foreign dividends and, additionally, for exempt foreign dividends.

Although this section of the Discussion Paper relates specifically to resident trusts, it also outlines that the proposal should be extended to resident companies. It is then suggested that the effect of this option would be the mitigation of the gap between the treatment domestic and foreign sourced income. Accordingly, the above mentioned options seeks to mitigate the capital export non-neutrality that currently exists.

However, in our view this limited approach is insufficient to address the fundamental bias in favour of investment in Australia, or more correctly the bias against foreign investment.

Option 1: Provision of Imputation Flow-through for Underlying and Withholding Taxes

It is the basis of this submission that, conceptually at least, in order to satisfy the requirements of locational neutrality of investment as outlined in *A Strong Foundation* that resident companies should be provided with an imputation credit in respect of both underlying foreign tax paid and any foreign withholding taxes paid.

The system would operate so that the foreign tax credit associated with foreign income generates a credit to a franking account, and dividends paid could be credited in the same manner as dividends are credited against the franking account. While conceptually straight forward, problems are encountered in the calculation of the credit for foreign taxes since these will inevitably be complicated (as are calculations of the foreign tax credit for underlying foreign taxes). Therefore, though conceptually "pure", we do not envisage that a direct imputation of underlying foreign taxes would be appropriate.

Option 2: Flat Rate of Credit Similar to the United Kingdom

Some countries have developed an integration model that involves a standard tax credit on dividend income received by domestic shareholders from domestic companies. Alternatively, some countries provide that dividends received by domestic shareholders are exempt.

Notably, either of these systems could have the effect of providing integration benefits for foreign underlying taxes, albeit the benefit provided would not directly impute the foreign taxes to the resident shareholder.

For example, the United Kingdom utilises a system where the amount of an imputation credit provided is capped according to the ultimate shareholder's level of taxable income, and the value of the cap is the same irrespective of the source of the income. Accordingly, the United Kingdom system does not differentiate between earnings sourced locally or abroad, therefore the economic benefits attached to dividends of United Kingdom based multinationals is constraint irrespective of the original source of the entities earnings.

The full operation of the system in the United Kingdom is as follows. A company resident in the United Kingdom is subject to tax at 31% on income from all sources, with a credit for any foreign tax paid. The profit after tax may then be distributed but no tracking of the actual tax paid occurs and no form of imputation credit attaches to the dividend. The integration of the corporate tax system with the shareholders tax occurs wholly at the level of the shareholder. The shareholder is then subject to tax depending on the classification of the shareholder as either a low, medium or high rate taxpayer. The taxation rate on the dividend and the amount of the credit provided varies with that classification, as follows.

Classification of taxpayer	*Tax on dividend of $100*	*Tax credit*	*Effective top up*
Low rate	£11.10	£11.10	Nil
Medium rate	£11.10	£11.10	Nil
High rate	£36.10	£11.10	£25.00

For a non-resident shareholder, the notional credit system is inapplicable and no tax is suffered by the non-resident (the United Kingdom does not impose dividend withholding tax).

Under this system, capital export neutrality is retained to the level of the resident shareholder. It is true that there is a "top up" of tax for a high rate taxpayer, but this still ensure that the high rate taxpayer is neutral regarding the choice of investment in the UK a company investing in the United Kingdom or offshore. Where the marginal rate of tax paid by the shareholder is greater than the corporate rate of tax, there is an essential difference between the notional imputation credit system and a system that exempts dividends.

Except to the extent that there is a top up of tax on foreign source income at the level of the UK resident company, no disadvantage occurs for a non-resident investing in a UK resident company which in turn has foreign investments, *vis a vis* direct interest in the foreign investment. The effect is that the UK company suffers only minimal disadvantage between raising capital in the domestic market (neutrality is achieved for the resident shareholder) and raising capital from foreign shareholders (except for investment by the UK company in low tax jurisdictions, neutrality is achieved for the foreign investor).

The system clearly operates more efficiently where there are minimal timing differences, and any permanent differences arise only as a substitute for a full credit for foreign taxes. However, because the credit provided at the level of the shareholder is not strictly tied to the level of taxes paid, the model may be more difficult to integrate with a model that seeks to provide refunds of tax payable to low rate taxpayers. Nevertheless, the system is illustrative of an approach that uses a notional credit system. However, if implemented in Australia, the UK system would involve a cost to the Revenue. To gain increased neutrality at a lesser cost, a partial flat credit could be provided for foreign income distributed.

Option 3: Streaming of Foreign Source Income

A reduction of the bias against foreign investors (which would not necessarily achieve full capital export for resident shareholders) can be achieved if Australian based multinationals were allowed to stream dividends from foreign sourced income to foreign shareholders (and implicitly dividends from domestic source income to domestic shareholders) in a tax efficient manner. This option is examined in greater detail in the following section of this submission.

Option 4: Classical System

It is speculated in Chapter 1 of the Discussion Paper that an alternative to the current imputation system would be to abandon an integration model for the taxation of dividends and re-introduce a classical system for the taxation of dividends. The perceived benefits of the classical system in this respect are:

- The removal of an imputation system and the movement back to a classical system would eliminate the locational bias that is evident in an imputation system. That is, under the classical system the shareholder does not receive credit for taxes paid at the corporate level. Accordingly, where no credit is provided there no bias.

- The removal of an imputation system would reduce any distortion for companies seeking to raise funds in the domestic or foreign capital markets.

However, unless the rate of corporate tax and / or the rate of tax on shareholders were to fall dramatically, the rate of tax on dividends distributed to domestic shareholders would be likely to stifle domestic investment. Further, there would be an adverse effect on decisions on whether to invest in non-corporate rather than corporate forms and whether to retain rather than distribute earnings. For these reasons, we consider a return to a classical system to be highly undesirable and have not considered the matter further.

Preferential Allocation of Imputation and Foreign Dividend Account Credits

Submission

In the absence of the implementation of a system for the allowance of full imputation credits for both foreign withholding taxes and foreign underlying taxes, we submit that the preferred alternative is to provide for tax efficient streaming of imputation credits to resident investors. Implicitly, this results in the preferential allocation of foreign dividend account credits to non resident investors. This approach is an appropriate policy response to the increasing problems faced by Australian based multinationals as they attempt to expand their business and shareholding on a global basis.

The issue has already been considered by the former Bureau of Industry Economics, the Productivity Commission and the Treasury, all of whom have acknowledged to varying degrees that the current taxation treatment is distortionary. In our view, one solution to this problem is to allow Australian based multinationals to stream (directly or indirectly) dividends from foreign source income to foreign shareholders and dividends from domestic source income to domestic shareholders.

There is a strong conceptual basis for this treatment and it does not represent favoured treatment of Australian shareholders relative to shareholders in Australian companies which do not have foreign source income and foreign shareholders. Australian shareholders will pay tax at their marginal tax rate on all dividends received but will not pay double tax as under the present treatment. The proposed change does not cut across the general anti-avoidance nature of recently enacted anti-streaming measures. Its only objective is to allow non-residents to access dividends from foreign source income and residents to access dividends from domestic source income. It would not enable residents to obtain franking credits on Australian source income unless that income had already been fully taxed at the corporate rate.

We acknowledge that it is possible to envisage one case where the proposed treatment would not provide efficiency gains. However, it would appear that such cases would fall into one of two categories. For example, it could lead to a position where an investment derived no benefit from the proposed change because there were insufficient foreign investors to utilise the foreign profits. However, case should not prevent the proposed policy change. In particular, it is our primary contention that the removal of the current bias against residents investors offshore desirable and the "benefit" that would accuse to residents is merely a return to global neutrality.

We submit that the proposal should be explored thoroughly in the context of broader tax reform currently being debated.

Background

The issue of streaming has been at the forefront of the amendments to the dividend imputation system in recent years and continues to be so in the option for the introduction of a deferred company tax. However, irrespective of the general policy concerns regarding streaming of imputation credits, these concerns do not necessarily apply the allocation of imputation credits to resident shareholders and FDA credits to non-resident shareholders by an Australian based multinational (especially where the company is a publicly listed company).

Nature of the Problem

Various changes in Australia's tax system over the years have been aimed at directing all foreign source income as dividends through the Australian holding company and then to shareholders, whether resident or non-resident. The effect of this has been to increase the overall taxation of income earned by the multinational group for the following reasons:

- increased withholding tax by virtue of the fact that dividends paid to non-residents from income at least partially derived from foreign sources are not fully franked and hence not exempt from withholding tax unless covered by the foreign dividend account system;

- imputation credits that may have arisen in the foreign country are washed out when dividends from this income are paid to the Australian holding company and then to shareholders in the foreign country;

- imputation credits earned on the taxation of Australian sourced income are diluted when income is also earned in foreign jurisdictions and then dividends paid to both resident and non-resident shareholders.

Various changes in the law over the years have been directed at restricting both streaming of imputation credits either directly, or by the use of so called dividend access schemes which have been developed to direct foreign source income predominantly to foreign shareholders, thereby increasing the proportion of fully franked dividends that can be paid to resident shareholders. The general policy intent regarding dividend streaming has been reinforced by the recent anti-streaming provisions.

The effect of this policy approach is that Australian multinational companies are being disadvantaged in their efforts to expand globally because of an increased cost of equity compared with that faced by multinational companies resident in other countries. As the proportion of foreign income and foreign shareholders of Australian companies increases, there is increasing pressure for Australian companies to consider other means of improving their taxation position. These other means could include dual listing arrangements or shifting the listed vehicle out of Australia into a country that provides a more favourable taxation regime. This problem does not arise specifically because of Australia's corporate tax rate. Instead it arises because of the multiple layers of taxation that a corporate group faces when it is forced to channel earnings through the Australian holding company and then on to shareholders.

The Proposed Solution

We submit that there is a viable conceptual basis for changing the current taxation policy in relation to anti-dividend streaming arrangements. More specifically, we are in favour of changes to the taxation treatment of dividend streaming where dividends paid out of foreign source income of an Australian based multinational are streamed to shareholders in the Australian multinational who are resident outside Australia. The justification for this change in treatment is that the existing arrangements provide a distortion that increases the cost of equity capital for Australian companies, thereby discouraging global expansion.

It is important to note that **the proposed change does not allow for unfettered dividend streaming**. In particular, it does not allow for the diversion of franked dividends away from foreign shareholders to domestic shareholders where the source of the franked dividends has been domestic income. The type of arrangements that are canvassed here are, firstly, those commonly referred to as a stapled stock arrangement. Under such arrangements, foreign shareholders who hold shares in an Australian multinational also hold another share in a foreign subsidiary of the Australian company with the second share being stapled to the share in the Australian company. The foreign shareholders then receive dividends via the stapled stock rather than via the share held in the Australian company. The second option (which is not strictly an alternative but is complementary to the stapled stock option) is a system that achieves a similar effect to a stapled stock arrangement, but without the need to formally staple stock.

Existing Treatment and Options for Change

There are several specific provisions that impinge on the question of dividend streaming of the type outlined above:

- where dividend is declared the dividends must he equally franked for all shares, irrespective of the residency status of the recipient.[5]

- where an unfranked dividend is paid to a shareholders in substitution for a franked dividend, then the franking account of the company paying the franked dividend will also be debited as though the unfranked dividend was actually franked.[6]

- non-resident shareholders in an Australian company are able, under certain conditions, to receive dividends free of withholding tax where the dividends are paid out of amounts of income derived from certain sources outside of Australia. The amount that can be paid in this way is determined by the surplus in the foreign dividend account.[7]

- Where an election is made to utilise foreign dividend account credits, the credits must be allocated equally across the capital base.[8]

The foreign dividend account system provides some partial relief from the multiple layers of taxation that can arise where income is earned in a foreign jurisdiction, but it falls well short of the outcome that is argued in this submission.

The anti-streaming provisions introduce a cross national ownership bias into the Australian taxation system. Hence the tax system discourages foreign investors from investing in Australia with the size of the distortion increasing as the amount of foreign investment by the Australian company increases. For a relatively small open capital importing country like Australia, this distortion reduces Australian access to global equity markets.[9]

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5 Section 160AQG of the 1936 ITAA.

6 Section 160AQCB of the 1936 ITAA.

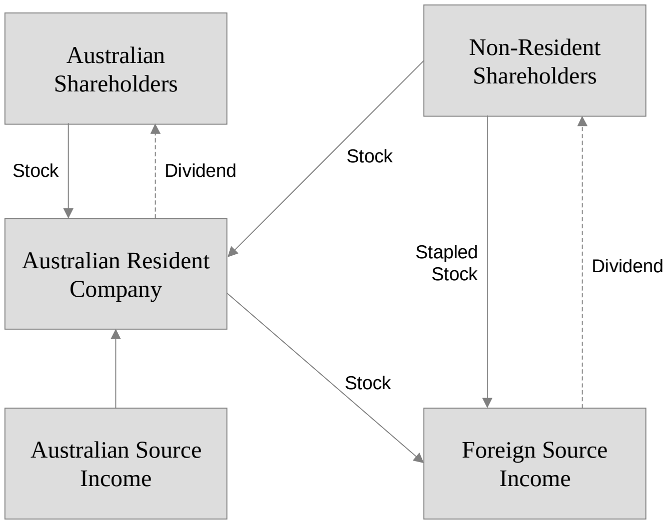
7 Section 128B(3)(gaa) of the 1936 ITAA.

8 Section 128TC of the 1936 ITAA.

9 More specific details on this cross national ownership bias can be found in a 1996 report by the Bureau of Industry Economics *Dividend Taxation and Globalisation in Australia*.

Option One

A model for allowing staple stock arrangements is illustrated in the following diagram.



Under this model, the Australian resident company has both Australian shareholders and non-resident shareholders. The Australian resident company earns both Australian source income and, via foreign subsidiaries, foreign source income. Non-resident shareholders, in addition to their stock in the Australian company, also hold a stapled stock in a foreign subsidiary through which they receive unfranked dividends paid out of foreign source income. To the extent that profits allow, Australian shareholders are paid franked dividends from Australian source income and non-resident shareholders are paid unfranked dividends from foreign source income. If either pool of income is insufficient to meet the dividend requirements of each set of shareholders, then other arrangements would need to be made. For example, if foreign source income was insufficient to meet the revenue needs of the non-resident shareholders, then this group of shareholders would also need to receive top-up dividend payments from the Australian resident company. The dividends received from the Australian resident company would need to be franked to the same extent as dividends paid to the Australian shareholders. From this point of view, the treatment would be no different from the existing treatment.

This treatment not only provides advantages to Australian shareholders by enabling them to derive maximum benefit from imputation credits, it also provides benefits to non-resident shareholders, both through reduced foreign withholding tax payable by the company and the potential to access imputation systems in their home country.

It should be noted that **under this model there is no diversion of imputation credits away from foreign shareholders where the source of the dividends has been domestic income**.

Another way to consider the model is to think of the Australian activities and foreign activities being parts of two independent corporate groups with the Australian source income being derived by a company exclusively with Australian shareholders and the foreign source income by a company exclusively with non-resident shareholders. In this case, the Australian shareholders would receive franked dividends from the Australian source income while the non-resident shareholders would receive their dividends from foreign source income and would be taxed according to the tax laws of their own countries. If the two corporate groups were then merged with the holding company based in Australia, both sets of shareholders would immediately be worse off. Australian shareholders would lose franking credits and non-resident shareholders would incur Australian withholding tax. While the disadvantage to the non-resident shareholders could be corrected by introducing a stapled stock arrangement, this would work to the disadvantage of the Australian shareholders. The only way in which the merger would be attractive would be if a dividend streaming arrangement could be put in place consistent with the model outlined above.

This can be contrasted with the "slice" approach discussed in the Discussion Paper under which each shareholder is considered to have an equal interest in each part of the profits of the company. However whatever relevance the slice approach may have where a company has purely domestic profits, the rationale for a slice approach does not hold where profits are derived from foreign and domestic sources and the capital of the company is derived from residents and from non-residents. In this case, the only question is whether there will be efficiency gains from streaming of imputation credits.

Option Two

A second model for allowing direct access by foreign shareholders to foreign profits is to allow foreign dividend account credits to be fully utilised by foreign shareholders. This would obviate the need for the Australian company to formally staple stock, which may have adverse commercial implications and may not be compatible with the company's existing corporate structure. This model is not an alternative to the stapled stock model. While it has advantages in specific circumstances, it does not address the cost of foreign withholding taxes on dividends paid to the Australian parent, nor does it allow for the possibility of access by foreign shareholders to foreign imputation credits. Rather, the model is one that can be implemented concurrently with the stapled stock option. From an Australian tax perspective, the effect of the option on the Australian tax treatment is no different to that of a stapled stock arrangement. As in the previous model, the Australian company has both Australian shareholders and non-resident shareholders. The Australian company earns both Australian source income and, via foreign subsidiaries, foreign source income.

Under the existing law, imputation credits are required to be equally allocated between shareholders before the foreign dividend account credits can be effectively accessed. Those foreign dividend account credits must then be allocated across the entire shareholder base. Under this model, and consistent with the existing law, when dividends are remitted to the Australian company a credit would arise to the Australian company's foreign dividend account (for simplicity, we have assumed that the dividends will give rise to a full foreign dividend account credit rather than a mixture of foreign dividend account and imputation credits). Similarly, Australian tax paid in respect of the Australian source income will give rise to a credit under the imputation system.

However, unlike the existing system for the application of franking credits and foreign dividend account credits, the company would first apply the foreign dividend account credits to dividends paid to non-resident shareholders.

If the pool of profits for which foreign dividend account credits are available is exhausted, further distributions of profits would be equally applied between resident and non-resident shareholders, giving rise to equal distribution of imputation credits between the respective shareholder bases. Again, at this stage the treatment would be no different to that under the existing imputation system.

The following table illustrates the effect of the arrangement where the proportion of foreign shareholders is equal to the proportion of foreign profits (before tax). For convenience, a 50% mix has been assumed, but an equivalent result occurs irrespective of the mix provided the proportion of the foreign shareholders and the proportion of the foreign profits is equivalent.

	Existing	***Model***
Australian Source Income	100	100
Foreign Source Income	64	64
Australian Tax (@ 36%)	36	36
Distributable Profit	128	128
FDA Credit	64	64
Franking Credit	64	64
Foreign Shareholder (50%)	64	64
Franking Credit Attached	32	0
FDA Credit Attached	32	64
Australian Shareholder (50%)	64	64
Franking Credit Attached	32	64
FDA Credit Attached	n/a	n/a
Franking Balance	0	0
FDA Balance	0	0

The matter can be looked at another way, as is often the case in practice (see table below). Since a company rarely distributed the entire profits, it will usually look first at the profit available worldwide to determine the level of dividend payment. It may still be possible to satisfy this dividend from Australian profits, even if no foreign dividend has been remitted to

Australia and no foreign dividend account credits are available. It will then allocate the Australian profits such that part of the dividend is fully franked. Only then will it look to the foreign profits and remit the necessary amount to ensure that the required foreign dividend account credits are available to ensure that the dividends paid to the non-residents are free of withholding tax (the remaining part of the dividend distributed to the resident shareholder will be unfranked).

	Existing	***Model***
Australian Source Income	100	100
Australian Tax (@ 36%)	36	36
Distributable Profit	128	128
Retained Earnings	64	64
Proposed Dividend	128	128
Maximum Franked Dividend	64	64
Foreign Dividend Required	64	64
Foreign Shareholder (50%)	64	64
Franking Credit Attached	32	0
FDA Credit Attached	32	64
Australian Shareholder (50%)	64	64
Franking Credit Attached	32	64
FDA Credit Attached	n/a	n/a
Franking Balance	0	0
FDA Balance	0	0

Whichever way the matter is approached in practice, the result is the same.

The following table illustrates the effect of the arrangement where the proportion of foreign shareholders is disproportionate to the proportion of foreign profits (before tax). For comparison, a 50% mix of foreign shareholders has again been assumed but the mix of Australian profits has been increased.

	Existing	***Model***
Australian Source Income	200	200
Foreign Source Income	64	64
Australian Tax (@ 36%)	72	72
Distributable Profit	192	192
FDA Credit	64	64
Franking Credit	128	128
Foreign Shareholder (50%)	96	96
Franking Credit Attached	64	32
FDA Credit Attached	32	64
Australian Shareholder (50%)	96	96
Franking Credit Attached	64	96
FDA Credit Attached	32	0
Franking Balance	0	0
FDA Balance	0	0

Consistent with a stapled stock arrangement, **there is no diversion of imputation credits dividends away from foreign shareholders where the source of the dividend is Australian source income**.

The model has a greater compliance burden than the stapled stock arrangement, since it is inherent in the model that the Australian company must be able to identify the foreign shareholders. However, we note that this is equally the case under the options presented for the changes to the imputation system

Views of Other Analysts

The stapled stock streaming model presented above has been considered previously be the former Bureau of Industry Economics, the Productivity Commission and Treasury (the analysis of the foreign dividend account streaming method is conceptually identical). The approach has been supported by the Bureau of Industry Economics and has received qualified support from both Treasury and the Productivity Commission. The Bureau of Industry Economics refers to this as pass through income streaming ("PTI").

The Bureau of Industry Economics, in its 1996 report, stated:

> *"Australian unilateral action to permit international dividend streaming ... is considered likely to benefit Australia. It is expected to generate additional domestic and international growth, and increase returns to Australian shareholders. By promoting global efficiency, it would be likely to have indirect benefits for Australia."* (page 108)

and further,

> *"PTI streaming decreases tax bias and inequality ... the reasons are that ... PTI streaming eliminates the cross national ownership bias which discriminates against the growth-by-globalisation strategies of Australian companies."* (pages 103 and 104)

The Treasury in a submission to the Productivity Commission's inquiry into the *Implications for Australia or Firms Locating Offshore* stated as follows:

> *" ... under our imputation system the foreign source income will be allocated to resident shareholders in proportion to the shareholding in the company (giving them an entitlement to an unfranked dividend) and part of the franked dividend from existing domestic investment will be attributed to the new non-resident shareholders.*
>
> *Both of these effects will reduce the after tax return of resident shareholders and if the company was acting in the interests of all shareholders, it may decide not to undertake the offshore investment. This potential distortion may be removed by allowing international dividend streaming because the foreign source income could be streamed to the new non-resident equity holders thereby increasing the franking rate on dividends paid to resident shareholders above its initial level. This is a circumstance where allowing international dividend streaming may improve efficiency."* (page 3)

The Bureau of Industry Economics also assessed this type of dividend streaming against standard tax policy assessment measures. They concluded that such dividend streaming would:

- on balance, be likely to increase the efficiency of the taxation of multinational enterprises;
- provide impetus for growth, through its impact on Australia's large listed multinational enterprises;
- enhance national economic growth;
- reduce pressures for Australian based multinational enterprises to de-agglomerate international operations or to domicile headquarter operations offshore; and
- impose little additional compliance costs because, like the foreign dividend account system, would be optional.

The Productivity Commission stated that there was an in principle case for the streaming of new overseas investments financed by foreign equity. However, this support was qualified due to the uncertainty surrounding the benefits and the costs expected to arise from the implementation of such a proposal.

All of the above analysis provides support for limited dividend streaming. The most rigorous and supportive analysis is that performed by the Bureau of Industry Economics. The Treasury and Productivity Commission conclusions are more limited because of a concern as to economic efficiency aspects associated with the way in which a marginal investment is financed. This issue is discussed further below.

Treasury Economic Efficiency Objections

The Treasury has limited its support for dividend streaming to those cases where the marginal offshore investment is financed by offshore equity. It is not possible to limit the proposed treatment to such cases, nor to assume or prove that any particular marginal investment is financed in a particular way. However, in the longer term, a multinational group would need to finance, on average, its offshore investments through offshore equity in order to derive any benefit from the proposed tax treatment. If a series of offshore investments were financed by domestic equity, there would be insufficient foreign shareholders to whom foreign earnings could be directed.

Comparison with Other Jurisdictions

In general, other jurisdictions do not allow streaming in the manner suggested. However, in a case where the foreign tax is integrated at the shareholder level, this is not necessary. This is true of the system in the United Kingdom. Further, those countries that exempt foreign dividends in the hands of the individual shareholder similarly do not needs to provide for streaming.

Options for Changes to the Imputation System

Submission

The introduction of a full imputation system as proposed in *A New Tax System* is not conceptually dependant on the other proposed changes to the imputation system. That is, there is no conceptual basis preventing the introduction of a full imputation system within the context of the framework of the existing imputation system.

Further, the disadvantages of a deferred company tax regime outweigh any the benefits that it may offer. The impost will adversely affect corporate profits. Contrary to the suggestion in the Discussion Paper, it is doubtful that in all circumstances markets will adjust to fully take account of the impost, such that the imposition of the tax will be neutral. In particular, where the deferred company tax is imposed in respect of dividends paid to resident shareholders but not to non-resident shareholders, the non-resident shareholders would bear a part of the cost of the deferred company tax.

We also have doubts concerning the efficacy of the deferred company tax / dividend withholding tax switch.

In our view, the existing anti-avoidance measures are sufficient to prevent improper access to imputation benefits through dividend streaming.

Therefore, we submit that all options for change to the imputation system should be rejected.

Background

The stated reasons for the changes to the existing imputation system include the following:

- to remove tax preferences on corporate profits at the point that they are distributed to non-residents;
- to remove tax preferences on corporate profits at the point that they are distributed to residents;
- to reduce the compliance burden associated with the operation of the existing imputation system; and
- to reduce or eliminate the scope for streaming of franking credits, and thereby reduce or eliminate the need for anti-avoidance rules.

Only the deferred company tax will achieve the first policy aim, while each option will achieve the second aim. However, we do not believe that the emphasis placed on the third aim is justified given that our practical experience is that the compliance burden on companies is not overly onerous. Therefore, the perceived benefit of simplification arising from changing the imputation system is illusory. Last, the recent introduction of anti avoidance rules effectively eliminate the opportunities for streaming.

Deferred Company Tax Measures

In our view, the perceived advantages of the deferred company tax system are insignificant when compared to its disadvantages.

The Result for Corporate Profits - Foreign Tax Preferences

The Discussion Paper recognises that the deferred company tax would have an adverse effect on after tax reported profits. However, it is then stated that *"(m)arkets and shareholders would need to appreciate the impact of the change on those listed companies deriving significant tax-preferred income"*. The exact meaning of this phrase is unclear. On one level, it could be interpreted as meaning that for deferred company tax to be a viable alternative the relevant adjustment would need to occur. Alternatively, the statement may be taken as meaning that the adjustment would need to occur if analysts were to gain a proper impression of a company's financial position.

In any event, the statement needs to be taken in context. In this section of the Discussion Paper it appears that the comments are directed primarily at tax preferred income arising in respect of Australian source profits. It does not seem to contemplate the likely effect of the impact of deferred company tax on distributions from exempt foreign income and foreign income the subject of a foreign tax credit.

For multinational companies the most significant tax preference is generated from the permanent difference that arises from the receipt of exempt dividends. Other tax preferences are less significant in comparison (and will decline even further over time if timing differences are removed). On the assumption that a deferred company tax would also involve conduit tax relief, a deferred company tax impost in respect of a dividend paid to a foreign shareholder will generally not arise, irrespective of whether the foreign shareholder is paid from the Australian profits or foreign profits. That is, except to the extent that a profit is made from a tax preferred profits other than exempt foreign income, there is no room for a payment of a dividend to non-residents that is subject to deferred company tax.

In discussing the impact of a deferred company tax, the Discussion Paper seems to focus on distributions of tax preferred profits other than exempt foreign income. Put another way, the discussion does not focus on Australian multinational companies.

The comment that markets and shareholders will need to adjust to the imposition of deferred company tax assumes that deferred company tax impacts resident and non-resident shareholders in a similar manner. However, where deferred company tax is imposed only in respect of resident shareholders, the tax system will introduce a bias against foreign shareholders.

That is, where franking credits are insufficient to fully frank the dividend deferred company tax would be imposed. Domestic shareholders would adjust their behaviour (so the argument goes) to reflect the tax benefit arising from the deferred company tax. However, there will never be a benefit to the foreign shareholder from the deferred company tax imposed in respect of the dividends paid to the resident shareholder. The liability imposed on the company, which is borne equally by all shareholders, will be wholly refunded to the resident shareholders. This introduces a bias against non-resident shareholders that does not currently exist, and is the equivalent of the company preferentially distributing profits to one shareholder to the detriment of another shareholder.

Interaction with Streaming Proposal

We understand that during the consultation process it has been suggested that the introduction of a system for preferentially allocating foreign income to foreign shareholders and domestic income to domestic shareholders via the franking and foreign dividend accounts would provide an adequate "trade-off" for the introduction of deferred company tax. While in certain cases this might be factually correct, this will not always be the case and we strongly submit that this "trade-off" is unacceptable.

The purpose of streaming is to eliminate the tax bias against the raising of domestic capital for domestic investments by a multinational company as compared to the raising of similar capital for domestic investments by non-multinational companies. The proposal is not intended to perpetuate or introduce a bias against raising foreign capital for foreign investments by multinational companies. As outlined above, the introduction of a deferred company tax will introduce such a bias. Assuming that the proposal for streaming will negate that bias is incorrect where the Australian shareholders' dividends are funded from foreign income. In this case, assuming that there are no tax preferences in respect of domestic profits, streaming will increase the level of franking benefits available to the resident shareholders by allocating those franking credits solely to the domestic shareholders. However, since domestic profits are insufficient to fully fund distributions to resident shareholders, some level of exempt foreign profits need to be distributed to resident shareholders, giving rise to a deferred company tax impost. Thus, while the adverse effect of deferred company tax on non-residents may be diminished it will not be eliminated.

In our view, rather than an appropriate policy response, the effect of the proposed "trade off" is merely another illustration of why a deferred company tax should not be introduced.

Efficacy of the "Switch"

In cases where there remains a deferred company tax obligation in respect of dividends paid to non-residents, it is suggested in the Discussion Paper that the increased cost of capital to Australian companies will be partially offset by the option to implement a deferred company tax / dividend withholding tax switch. While this may be true, partial alleviation of the problem is insufficient.

We are also concerned that the concept of a company tax / dividend withholding tax switch will antagonise foreign governments and fiscal authorities, who may not accept the switch because they perceive it to be an unjustified attempt to shift the burden of primary tax from the corporate level to the shareholder level. The level of retaliation from other countries is at this stage unknown.

We understand that the implementation of a company tax / dividend withholding tax switch by New Zealand has not given rise to any adverse reaction and has been implicitly accepted by the United States. However, one needs to bear in mind that New Zealand is a country with a population less than that of Sydney and an economy much smaller than Australia's. Further, the level of investment into New Zealand from sources other than Australia is small compared to that into Australia. Last, the level of outbound investment by New Zealand multinationals in respect of which retaliation may be an issue is confined to only a few companies. Therefore, the effect of New Zealand imposing a dividend withholding tax switch is insignificant whereas the effect is of greater import if implemented by Australia. Unless the Government gains the assurance of our treaty partners that the switch will not be offensive, it must be assumed that there is a risk that a deferred company tax will reduce the return to corporate shareholders by up to 30%.

We note that the switch is not dependent on the introduction of a deferred company tax and could have been introduced at any time since the introduction of the imputation system. The same perceived benefits would then have arisen for fully franked dividends. That this course has not been adopted gives rise to queries concerning whether or not the switch is considered to be efficacious. In fact, we suggest that the switch runs counter to the position adopted by the Government in other areas of international tax. In particular, the Commissioner of Taxation has previously considered as offensive attempts by foreign Governments to impose taxes and then actually or effectively refund them. One such scheme arose where the foreign jurisdiction provided interest rates on borrowed funds far in excess of the market rate, and then imposed full tax on the interest. The result was an after foreign tax return equal to the normal interest rate. However, because the income was subject to foreign tax, the income was exempt from tax in Australia. The Australian Taxation Office considered this scheme highly abusive. Another such arrangement arises in Malta where corporate tax was levied on the Maltese resident company but then refunded to the shareholder upon payment of a dividend. The Government legislated to reduce the efficacy of this arrangement under Australia's Controlled Foreign Company measures. While neither case is identical to the switch the nature of the underlying policy by the country concerned is the same. That is, the tax is imposed with the intention of a foreign government absorbing the impact of the arrangement, in the case of the switch by transferring the incidence of the tax from the company to the shareholder. The arrangement involves an extreme example of a "beggar thy neighbour" approach to international tax policy.

If Australia has in the past found such arrangements offensive, one can but wonder whether other jurisdictions will form the same view. This must already be a concern since the Discussion Paper recognises the possibility that the existence of the switch will hamper attempts to negotiate new, or renegotiate existing, tax treaties. As abhorrent as this would be as an outcome, the initial concern is that the withholding tax would not in any event be allowed as a credit against foreign tax paid by the shareholder in respect of the dividend.

Deferred Company Tax and Distribution Policy

Companies will need to consider the appropriate strategy to deal with the effect that the imposition of the deferred company tax will have on distribution policy where unfranked dividends are concerned. Appropriate reaction can be divided into three categories.

First, assuming the company does not generally distribute all of its profits and therefore has sufficient pre-tax profits to absorb the additional cost of the deferred company tax, the company could continue to distribute the same cash dividend per share. This will have the effect of increasing the return to resident shareholders, since the deferred company tax will provide an additional amount to be credited against the shareholder's tax liability or refunded to the shareholder. This would be an unusual action. Generally, if the company had previously sought to increase the return to the shareholders, it could have done so simply by increasing the dividend per share. Further, the payment of the same dividend, now fully franked, to resident shareholders will have a different effect for non-resident shareholders. The non-resident shareholder will receive the same economic benefit as was previously the case (the gross dividend will be the same). However, as discussed, because the deferred company tax is imposed on the company the non-resident shareholders would be disadvantaged. They would, in effect, be disadvantaged for the sake of providing a benefit to resident shareholders.

Alternatively, the company could substantially reduce or cease dividend payments. This would generally be an inappropriate response.

Last, the company could respond by reducing the dividend to take account of the deferred company tax. The effect for a resident shareholder would be that the shareholder's cash dividend would be reduced but the total return, taking into account the additional level of imputation benefits and leaving aside timing issues, would mean that the economic value of the dividend would be the same. In this case, the non-resident would be disadvantaged because the dividend payment will fall. Again, for any Australian company with a significant foreign shareholder base this is unlikely to be a palatable outcome.

Because the offshore expansion of Australian multinational companies has been financed significantly through its foreign investor base and it is expected that this will continue to be the case, these shareholders cannot be ignored. However, they cannot but be disadvantaged unless dividend payments are severely curtailed. Seeking capital across borders is a natural part of the globalisation of the world economy and a desirable method for financing the offshore expansion of Australian companies. Being progressively excluded from the capital markets because of the interaction of offshore expansion and a deferred company tax is inappropriate.

Cash Flow Effect for Shareholders

Importantly, the deferred company tax system (as does the resident withholding tax system) imposes a potential cash flow burden on all dividend recipients, but has a greater adverse effect for recipients paying tax at less than the 30% marginal rate of tax.

This is only an issue for the company to the extent that the company maintains the economic benefit to the taxpayer by reducing the dividend payment per share to take account of the deferred company tax. This may result in an immediate cash flow detriment to the shareholder but a benefit upon credit or refund of the imputation credit.

The mechanisms proposed to alleviate the cash flow difficulty appear to be complex attempts to alleviate a problem that, fundamentally, cannot be overcome.

Perceived Simplification Advantages

We believe that third and fourth rationales for changing the imputation system – both of which can equally be regarded as simplification issues – are overstated.

Regarding the perception that simplification of the existing imputation system will arise because the necessary calculations will be simply and consistently applied, we agree that this may be true on a purely conceptual level. However, we do not believe that any significant reduction of the existing compliance cost associated with the imputation system will be achieved, given that we do not accept that the existing system is, in practice, particularly complicated.

The operation of the imputation system is now well understood by both company's internal personnel and their external advisers. For the most part, the existing imputation system creates no significant compliance difficulties.

For most companies, there is generally a need to make only six accounting entries each year to fully comply with the existing imputation system. These entries comprise four credits to the franking account of the three instalments of company tax and the final instalment of company tax. The other two entries consist of two debits to take account of dividends paid (assuming, as is the norm for major listed companies, bi-annual dividend payments). Further entries may be necessary to take account of tax payments and refunds arising from amendments to assessments, but these tend to be exceptional rather than regular occurrences.

The second area of purported complication is in the calculation of the required franking amount. This calculation merely represents the amount to which a dividend must be franked and the calculation is not particularly difficult. In any event, a similar calculation would be required to either determine the level of dividends that must be paid to fully utilise franking credits without incurring deferred company tax, or to calculate deferred company tax. It is not apparent why the current calculation of the required franking amount is considered onerous, nor what extent, if any, the practical requirement to make a similar calculation under deferred company will be reduced. It is also apparent that there will remain a requirement to calculate the required franking amount under the resident dividend withholding tax or taxation of inter-company dividend options.

The most significant compliance issue relating to the existing imputation system is the difficulty encountered in passing franking credits through the corporate group to the parent company. This requirement gives rise to multiple franking calculations and difficulties accessing franking credits where accounting profits are less than the level of franking credits or where there are loss companies interposed between the company with a franking balance and the holding company (that is, there is an interposed "dividend trap"). Most companies have had to cope with this issue now for many years, and the issue also existed prior to the introduction of imputation, although not to the same extent. A deferred company tax will not eliminate or even reduce this complexity. However, a consolidation regime may have that effect. Therefore, the most significant compliance issue in the existing imputation system will be unchanged by any of the options.

It is true to say that the drafting of the existing provisions is overly complicated, but this can (and should) be addressed by the Taxation Laws Improvement Project rather than by changes to the design features of Australia's imputation system.

We agree that the full franking of all dividends would allow the substantial removal of current anti-dividend streaming rules. However, in our view this benefit is overstated.

Prior to 1997, the anti streaming rules were narrowly targeted and consequently applied only to eliminate the scope for streaming in a narrow range of circumstances. This situation has now been addressed. It is not apparent to us that the recently introduced specific and general anti avoidance rules are ineffective. To the contrary, at a practical level they appear to eliminate any significant scope for streaming.

Further, the assumption that the anti-dividend streaming rules could be completely removed is, in our view, naive. Dividend streaming occurs where franked dividend streams are diverted from shareholders least able to use them (tax exempt entities and non-residents) to shareholders for whom a greater economic value may be placed on the fully franked dividend stream. The most obvious form of streaming is the substitution of a franked dividends for an unfranked dividends. Under a deferred company tax this opportunity would not arise. However, the transfer of economic benefits would still be available in any case where the transfer of franking credits were not for an alternative unfranked dividend stream (which could no longer arise) but for a capital sum. That is, trading in franking credits could still arise. In our view, anti-avoidance rules would still be necessary, if not initially then over time as the arrangements came to be seen as abusive.

Removal of Deferral Benefits to Resident Companies

The removal of tax preferences at an earlier stage than would otherwise be the case will arise under any of the models canvassed. This appears to be a major policy objective, but there is no justification in the Discussion Paper of the rationale for this objective.

As outlined in the Discussion Paper, under the existing law only three categories of dividends are subject to a tax rebate (and therefore effectively tax free) in the hands of a company – dividends paid by one company in a wholly owned corporate group to another company in that wholly owned corporate group; dividends that are fully franked; and dividends that are paid by a company to a public company.

That is, the only target for the removal of tax preferences is public companies receiving dividends from resident companies outside the wholly owned corporate group.

We do not understand the necessity to implement this policy, certainly not on the ground of avoidance of Australian tax. In particular, it is anticipated that the removal of the section 46 rebate in this case would overcome losses to the Revenue arising from the generation of losses. It is not clear to what avoidance the Discussion Paper refers. However, there are two specific areas where dividend payments subject to the section 46 rebate may give rise to undue tax benefits – in the case of the distribution of pre-acquisition profits and where a dividend strip is involved.

We note that the payment of a dividend from profits arising while a company owns another company and the consequent fall in value of the payer can hardly be described as a manipulation of the section 46 rebate. Rather, it is the correct reflux of the economic outcome. A dividend paid from pre-acquisition profits is somewhat different. In this case, the pre-acquisition profits are usually reflected in the acquisition cost of the shares. Therefore, unchecked, the distribution would have the uneconomic effect of producing a loss on disposal of the shares where no economic loss had been suffered (although one could argue that the vendor would have been taxed on the disposal of the asset and that no loss to the Revenue would arise). The matter is quite easily resolved by reducing the cost base of the share by the amount of the dividend. Economically, there has been no return to the shareholder but rather the purchase price has been refunded. This is already dealt with in the existing law, at least in the case of generating capital losses. To tax the dividend when it is, economically, a return of the purchase price is an inappropriate response. Correspondingly, the tax preferred income (that is, the distribution to the extent that it is not fully franked) will normally have already been taxed in the hands of vendor. Similarly, a dividend strip is merely the most blatant example of a distribution of pre-acquisition profits. To deny a dividend rebate as an inexact means of addressing a basic policy issue is fundamentally incorrect and has the potential to impose double taxation at the point of distribution of the dividend. On a practical level, we doubt that there is any evidence that public companies routinely abuse the Revenue through arrangements to strip pre acquisition profits. We therefore cannot accept that the removal of the rebate can be justified on this basis.

Turning to the expressed desire to remove tax preferences for distributions outside the consolidated group, we fail to see the basis for doing so. Even if it is possible to justify the non-consolidation of companies that are not wholly or almost wholly owned (is not the focus of this submission) it does not follow that investments in companies that cannot fall within consolidation should not be seen as extensions of the same economic entity. In the past, as a factual matter it may have been less common for publicly listed companies to undertake investments in co-operation with another publicly listed company (an exception being the resource industry). However, this position is now changing in both Australia and as a global trend. Primarily, we perceive that the change in the manner of investment has arisen for the three reasons.

First, many projects, particularly infrastructure projects, require significant capital commitments for which few Australian companies have the resources. Therefore, co-venturing is an effective way to access equity funding for such projects. Without this arrangement, it is possible that Australian companies will be excluded from projects requiring significant injection of equity finds and that Australian companies will be placed at a competitive disadvantage.

Second, as well as allowing access to such projects, co-venturing often has the effect of spreading the investment, thereby limiting the risk for any particular company in any particular investment.

Last, and increasingly important, companies often have varied experience and skills and the maximum competence may be in only one part of a project. By combining the company's competitive advantages with the different competitive advantages of their co-ventures, the co-venture can enhance the efficiency of the overall project while each still sharing in equity returns. This provides significant efficiency and therefore competitive advantages.

These ventures are no more than extensions of the business operations of each company and the returns should not be treated as separate to that of the company. To do so is likely to introduce distortions. Competitors that achieve greater efficiency within their own wholly owned group will be at an advantage even where the co-venturers would between them be more efficient. This does not seem to advance Australia's economic interests.

From the costing provided, it appears that the full year gain to the Revenue from this aspect is $90 million.[10]

An International Comparison

Finally, we note that none of Australia's major trading partners have chosen to adopt a deferred company tax system. This in itself is not reason to reject the option. However it provides a useful guide as to the world "best practice".

Obviously, countries like the United States that have a classical system for the taxation of dividends do not require a deferred company tax system. It is also instructive that Canada, a country which is in many ways similar to Australia and which has a partial imputation system, also has no deferred company tax regime. It is true that, where a private company receives dividend income a refundable 33% tax is imposed, this refundable tax can, in turn, be recovered by the company by paying a dividend. We understand that there has been no recent proposal to implement a deferred company tax, despite a thorough independent review in 1997 of the Canadian taxation system.

Even New Zealand, so often held up as a model for policy making, and despite having an imputation system, has not introduced a deferred company tax regime. We understand that there has been no proposal to do so in recent years.

The United Kingdom does not have a deferred company tax. Despite the removal of Advance Corporation Tax, the retention of an integration model for the taxation of dividends means that shareholders resident in the United Kingdom obtain a standard credit which in the case of low to medium rate taxpayers effectively eliminates all liability to tax in the

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10 $420 million for deferred company tax as estimated in *A New Tax System* less the $220 million cost of moving to a 30% tax rate less the $120 million cost of moving to the taxation of inter-company dividends.

United Kingdom. High rate taxpayers also gain a standard credit, which has the effect of requiring a "top up" of United Kingdom tax. The source of the profits of the company are irrelevant. That is, the standard credit is not linked to the actual tax paid by the company and is therefore, in effect, provided where foreign income has been derived by the company and subject to a foreign tax credit. This system is discussed in greater detail in the section *Treatment of Foreign Taxes Under an Integrated System*. While the system is equivalent to an exemption system for low to medium rate taxpayers, it is essentially different to an exemption system since high rate taxpayers are required to "top up" the United Kingdom tax to their marginal rate. Relevantly, the returns of shareholders not resident of the United Kingdom are unaffected by the imputation system.

The only major trading partner that has a system comparable to a deferred company tax is France, but in operation the system is comparable to the option for resident dividend withholding tax. The French system acts as a specific tax on distributions imposed on the distributing company. In all cases, a tax credit is attached to a dividend payment (the exact method of calculation is fairly complex and has been omitted, although we would be happy to provide details if desired). The tax credit is then applied against the shareholders tax liability. If the tax credit is less than the amount of corporate tax paid (for example, if the income of the company is exempt from tax) a compensatory tax is, in effect, levied on the company. It is important to note that under the French system no tax credit is granted to a non-resident shareholder for the dividends distributed by a French company. Therefore, a non-resident who holds shares of a French company obtains a cash refund of the compensatory tax paid by the company. As such, unlike the deferred company tax option, a non-resident of France will not be subject to a higher level of total tax. Further, because the compensatory tax acts for resident shareholders in the same manner as does the company tax / dividend withholding tax switch, the reported profits of the distributing company are unaffected.

Resident Dividend Withholding Tax/Inter-company Dividend Exemption

To alleviate the disadvantages of a deferred company tax proposed in *A New Tax System*, the Discussion Paper went on to query whether the integrity benefits sought by the changes to the imputation system could be achieved in other ways.

Both alternative options in the Discussion Paper ameliorate some of the adverse effects that would otherwise arise for non-resident shareholders under a deferred company tax, and is therefore to be preferred to deferred company tax. However, it does so in a manner that is undesirable when compared to the existing imputation system.

Effect of the Options on Non-resident Shareholders

We understand that where an unfranked dividend is paid to a non-resident, no resident withholding tax will apply and, instead, dividend withholding tax will apply. In concept this is quite straightforward. And is consistent with the over-riding objective of achieving international competitiveness.

Further, we understand that the resident dividend withholding tax will be refunded where distributions that are paid between resident entities and subject to resident dividend withholding tax are subsequently passed to foreign investors. Non-resident dividend withholding tax would then apply to the cash dividend plus the refund. The refund relieves foreign investors from resident dividend withholding tax and the application of dividend withholding tax would produce the same outcome as now for non-residents.

Effect on Corporate Profits

However, like deferred company tax, both the resident dividend withholding tax and the taxation of inter-company dividends will affect after tax profits, although the effect arises in a somewhat different manner. Rather than affecting the after tax profits of the payer company, the recipient company will have its after tax profits reduced by the amount of the resident dividend withholding tax or the tax imposed on the inter-company dividend, notwithstanding that the tax may eventually be refunded.

Therefore, the after tax profits of the recipient are in all cases reduced by 30%. The adverse effect is no different to that of a deferred company tax except that the impact on after tax profits arises at the level of the recipient. This appears to be recognised in the Discussion Paper.

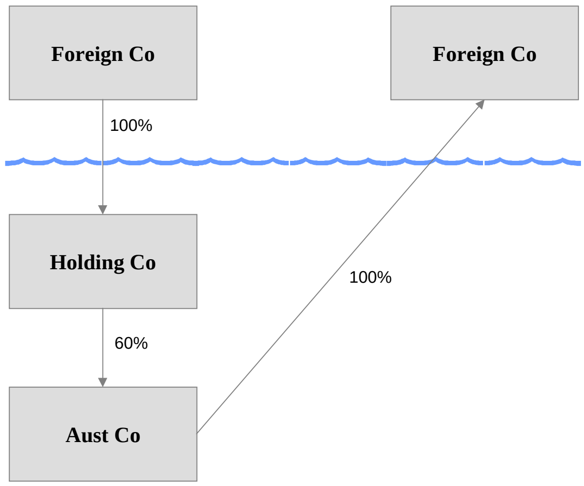
Special Purpose Vehicles

The proposals will impact special purpose vehicles used by non-residents to hold significant minority interests in Australian companies. It would appear that these vehicles could not gain access to the "pass through" treatment explored in the options for collective investment vehicles. Thus, non-resident shareholders in these entities would need to seek the refund of resident withholding tax and have withholding tax imposed on the dividend plus refund.

We are concerned that this will be viewed by foreign tax authorities as a company tax / dividend withholding tax switch. We note that it is not clear from the Discussion Paper whether dividends taxed under the option for the taxation of inter-company dividends would similarly create an entitlement to a refund on payment to a non-resident. However, this is a subsidiary issue.

Our primary concern is that a special purpose holding company will be adversely affected by the proposals, irrespective of the ultimate views of foreign tax authorities.

The problem is best illustrated by example. Assume that an Australian company which derives foreign dividend income has a significant foreign shareholder that holds the investment through an Australian special purpose holding vehicle. This structure can be illustrated as follows.



First under the current law the dividends paid by the Australian publicly listed company are effectively tax free in the hands of the special purpose company due to the operation of the section 46 dividend rebate. However, it will carry with it no foreign dividend account credits. Therefore, the dividend when paid to the foreign shareholder of the special purpose holding company will be subject (in whole or in part) to dividend withholding tax. However, at present, no dividend withholding tax is payable (quite appropriately because the dividend is reinvested in the Australian economy). While not ideal, this result can be accepted given that there is no immediate or anticipated payment of a dividend and therefore no immediate or anticipated withholding tax cost. However, as currently formulated, both options will impose a current Australian tax liability notwithstanding that the dividend received is derived (at least in part) from foreign income. This outcome is hardly appropriate. The issue can practically be resolved by allowing a foreign dividend account credit to be transferred to resident shareholders irrespective of whether or not the resident shareholder owns 100% of the Australian company.

In general, the imposition of a special purpose holding vehicle is appropriate for two reasons. First, it prevents the imposition of cross border taxes in situations where the profits generated are reinvested in Australia. This is not an "avoidance" of Australian withholding tax, but rather accommodates the preferred structure for reinvesting profits. The use of an interposed company in Australia may also occur for the purpose of ensuring that taxes in the country of residence of the shareholder are not imposed until such time as the profits are no longer reinvested in Australia. Therefore, to avoid the timing difference imposed by a resident dividend withholding tax, the Australian special purpose vehicle would need to remit the dividends from Australia to the parent company. This may expose the dividend to tax in the jurisdiction of the parent company. In theory, irrespective of whether or not the dividend is remitted offshore, we could expect the funds to be reinvested in Australia if the return in

Australia was acceptable. However, in exceptional cases, this may affect marginal investments which proceed in Australia because the rate of return is superior as a result of the foreign tax cost involved in repatriation. Moreover, where profits were previously reinvested in Australia the funds would often have been ignored by the foreign parent. The payment of a dividend to the parent may cause the parent to review the use of the funds and divert them elsewhere, causing capital to flow from Australia.

This is a significant issue that would need to be resolved if a resident withholding tax were to be introduced.

One option to resolve this matter would simply be to exempt such holding companies, irrespective of whether or not they passed on the dividend at that stage. Certainly, to the extent that a foreign dividend account credit was allowed to flow through to such companies, there should be no resident dividend withholding tax in respect of the amount of the dividend that carries a foreign dividend account credit.

Last, we note that under the option for the taxation of inter company dividends it is not clear whether it is proposed that the same flow through as applies for resident withholding tax will be included. We could find no discussion on this matter, but the comparison table of the measures seems to indicate the impact of this option on non-resident will be the same. Unless a flow through is provided, it is difficult to see how equality is created. Further, unlike the resident withholding tax option, under the taxation of inter company dividend option there would be no direct nexus between tax paid and the dividend received. Therefore, it is difficult to determine what would be refunded under the switch. If the taxation of inter-company dividends results in no flow through and refund, the adverse effect on special purpose holding companies would be considerable. For this reason, if the taxation of inter-company dividends were introduced, some form of exemption along the lines mentioned above would be imperative.

Remaining Administrative Issues

While the an additional compliance burden would arise for tracking the resident withholding tax paid and the subsequent refund of that tax to the non-resident shareholders, it has been our primary contention that the ongoing compliance burden of the imputation system has been significantly overstated in the Discussion Paper.

Our concerns involve the mechanism for payment of a dividend to a non-resident and the levy of resident dividend withholding tax rather than dividend withholding tax. The first difficulty that we foresee may arise where the company's shareholder register contains a significant number of nominee shareholders, as the case for most large listed companies. In this case, the current withholding tax system applies in practice such that a gross dividend is paid to the Australian resident nominee with no withholding tax deducted. The nominee is then responsible for the remittance of the withholding tax to the Australian Taxation Office. All that is required of the company is the notification to the nominee of the level of franking and the level of foreign dividend account credits that have been applied. In many cases, the company will not know, nor will the nominee be allowed at law to disclose, the identity of the underlying shareholder. It appears that the non-resident withholding tax will not operate in the same manner. We cannot conceive of any feasible system for the imposition of withholding tax rather than resident withholding tax other than to impose the compliance requirement on the company. That is, the dividend paid to an Australian nominee will be treated as a distribution to a resident company and will be subject to the resident withholding tax. Although not clear in the Discussion Paper, we would hope that in this case the disclosure by the nominee of the residency status of the shareholder will allow withholding tax to be levied rather than resident withholding tax. We envisage that it would merely be a requirement of the nominee to disclose the number of shares held by non-residents and not the particular names of those non-residents, which should vitiate the concerns of non-residents.

One could hypothesise that if a non-resident was still not willing to disclose their status to the company, the resident dividend withholding tax would merely be an associated cost of that decision.

However, we presume that the nominee could then pass the dividend to the non-resident and the refund claimed. That is, the nominee would pass on the dividend and the non-resident shareholder would be entitled to claim a refund. It is unlikely that this would be seen as the equivalent of a company tax / dividend withholding tax switch. The operation of the system as it affects nominees needs to be clarified.

Allocation of Foreign Dividend Account Credits

Submission

On the matter of foreign dividend account mechanism, we strongly agree that the system for passing foreign income of Australian companies to the foreign shareholders of Australian companies should be retained. However, in our view foreign income should be allowed to be streamed to foreign shareholders, and this issue has been canvassed in a separate submission point. Under this system, proposal for attempting to allocate the foreign income in proportion to the foreign shareholders at the time the foreign income is derived is irrelevant.

Further, we do not believe that the exclusion of branch income is warranted. Even though, in numerical terms, this is not likely to be a significant issue outside of the broad-exemption listed countries, there seems little basis to discriminate merely on the basis of perceived avoidance possibilities which cannot be demonstrated.

Last, the existing anomaly whereby foreign dividend account credit is not granted for the foreign tax credit in respect of the income attributed to a resident from a CFC is unwarranted and should be corrected. The practical effect of the anomaly has been exacerbated by the recent extension of the CFC measures to encompass income that has been subject to significant levels of foreign tax (in many cases, tax rates in excess of that imposed by Australia).

Our submission on streaming bears on the issue of whether or not Australia should give up its right to top up tax on foreign dividends. Were streaming to be allowed, it may be difficult to justify this approach. We submit that the matter can only be examined once the issue of streaming is resolved. We note one exception to this. Where a company is 100% owned by non-residents it would be clear that the Australian company was merely acting as a conduit for the entirety of the foreign income, and in these circumstances no additional tax should be imposed as the income flows through Australia. This would substantially enhance the attractiveness of Australia as a regional holding company location, given that it could be expected that companies seeking to establish Australian based holding companies would need to consider the effect of dividends from unlisted countries, particularly Hong Kong.

Retention of Flow Through Treatment

We agree that the system for passing foreign income of Australian companies to the foreign shareholders of Australian companies should be retained. However, we are not convinced that the option to move to a proportionate allocation of the foreign dividend account credits is justified. Rather we believe that it should be acceptable for the credits to be streamed. In any event, ignoring the streaming issue, the move to a proportionate system would not appear to create any significant gains to the Revenue and would involve significant compliance burdens. First, the amount of the credit allowed per share will fall where there has been an increase in the foreign shareholder base but will also increase where there has been a fall in the foreign shareholder base. While this is unlikely to produce a net zero effect over time, it is unclear to us whether the gain to the Revenue is justified.

In our view, there are no apparent reasons for doing other than continuing with the current approach. If there are concerns about trading in these credits, these concerns are better addressed by the general anti-avoidance rules. While we recognise that part of the tax reform process involves reducing the reliance on specific and general anti-avoidance rules, this must occur in a balanced manner.

Extension to all Foreign Income

The Discussion Paper proposes several options for extension of the foreign dividend account system. None of these contemplates streaming of foreign dividend account credits (the proportionate approach to the allocation of foreign dividend account credits implicitly reinforces the policy of not allowing streaming).

Other than for banks, we expect that little benefit would generally be obtained from the extension of the foreign dividend account system to branch income given that operations via a foreign branch are generally common only in start up phase or for smaller companies which generally do not have foreign shareholders. In our view, the specific needs of these taxpayers should nevertheless also be taken into account. However, it is not a matter that is generally problematic for non-bank Australian multinationals.

However, it is interesting that there is an option for extension of the foreign dividend account system to all foreign income such that no "top up" for Australian tax occurs. It seems to recognise that Australia's taxation right in respect of income derived by a resident company that is allocable to a non-resident should suffer no Australian tax because there is no requisite economic connection to Australia of either the ultimate recipient of the source or the income. We completely agree that this is a desirable outcome in theory and supports our submission regarding streaming. The point of difference between this approach and the approach suggested is the assumption regarding how the entire profits of the company are allocated between residents and non-residents.

Correction of Anomaly for Income Attributed from a CFC

We note one other area that should be taken into account under the foreign dividend account mechanism. At present a foreign dividend account credit arises for exempt dividend income. It also arises for the grossed up amount of foreign tax credited in respect of assessable dividend income.[11] No credit is allowed where foreign tax is credited under income that is attributed under the CFC measures [12] Neither does a foreign dividend account credit arises when the profit that was attributed is distributed. The same is true of the foreign investment fund measures, although the level of foreign tax credits in this case makes the problem insignificant.

In our view, this treatment is inequitable and there appears to be no sound policy basis for this approach.

One basis for this treatment could be that the attributed profit has not yet been remitted to Australia, and as such no addition to the foreign dividend account is warranted. This seems to be a somewhat fine distinction that does not seem to serve any anti-avoidance purpose. Certainly, it does not justify denying the foreign dividend account credit on remittance of the dividend.

The only other basis that we can imagine is that income attributed under these measures is presumed to be from tax avoidance, and therefore should be treated less favourably. Such an argument cannot be sustained. First, there should be no essential difference in approach since the foreign tax that was paid does not represent a gain to the taxpayer. If the Revenue finds abhorrent the loss to the Australian Revenue from the imposition of foreign tax rather than Australian tax, the response would have been to deny the credit. Clearly, this was not the case. More importantly, the

[11] Section 128TA of the 1936 ITAA

[12] For convenience, the general reference to the CFC measures includes an amount included in assessable income under sections 456 to 459A of the 1936 ITAA.

increased scope of the CFC measures has resulted in a wide range of income being attributed where there is clearly no implication of tax avoidance. In some cases, because the foreign tax rates are higher than Australia's, the cost to the multinational of deriving the income in the CFC is actually higher and the application of the CFC measures results in a loss to the Revenue. One would have thought that this is a clear indication that no tax avoidance is involved.

Given this, there seems no reason to exclude from the foreign dividend account credits the grossed up amount of the foreign tax credit allowed on attribution of income under the CFC measures (or at the least on payment of the dividend).

Dividends Flowing Though non-Wholly Owned Companies

Under the foreign dividend account system, an Australian company may pass a foreign dividend account credit to a related company.[13] However, a related company is one in the wholly owned group.[14] There seems no basis for restricting the flow through treatment to wholly owned companies. The process for making declarations to shareholders would ensure that adequate information on the flow through would always be provided, and the recipient of the dividend could then decide whether to utilise the foreign dividend account credit.

Double Tax Agreements

Submission

The Australian Government needs to re-negotiate its existing double tax agreements to ensure with the primary focus on reducing the maximum rate of dividend withholding tax.

The limitation on the level of withholding tax contained in Australia's double tax agreements is generally 15%, which was set at a time when there was general agreement within the OECD that this was an appropriate limit. However, since that time there has been a trend towards markedly lower withholding taxes on dividends, these lower withholding taxes generally only applying as a result of bi-lateral treaties.

However, given that franked dividends and dividends the subject of a foreign dividend account credit are free of dividend withholding tax, Australia has to a large extent unilaterally removed dividend withholding. While some countries, such as the United Kingdom, levy no withholding tax on dividends, most countries have not been so generous and impose dividend withholding tax up to the limit allowed. Therefore, it can be expected that most of the countries with which Australia has

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13 Refer section 128TA(1)(c) of the 1936 ITAA in conjunction with section 128TB(1)(a) of that Act.

14 Refer section 128TA(1)(c) of the 1936 ITAA in conjunction with the former 51AE(16) of that Act.

negotiated double tax agreements will continue to impose significant levels of dividend withholding tax.

Without renegotiation of Australia's existing double tax agreements, Australian companies will continue to suffer restrictions on cross border capital flows, adversely impacting profits and investment decisions.

We realise that renegotiation double tax agreements is a difficult process, and requires the will not only of the Australian Government but that of the foreign government. However, in recent years, it seems that more effort has been placed on negotiating double tax agreements with emerging countries than protecting existing Australian investments. While we applaud the expansion of Australia's network of double tax agreements, we are concerned that insufficient resources are devoted to attempting to renegotiate existing agreements.

One problem is that the process is not transparent. At present, it is difficult to determine what efforts, diplomatic or otherwise, have been employed in seeking to re-negotiate agreements. In our view, the process must be changed. We submit that a separate body be made responsible for the agenda for, and oversight of, the renegotiation of double tax agreements, and that this body (however constituted) report independently on progress to the Parliament. We believe that it is only by elevating the status of the issue that adequate resources will be available, and the necessary commitment made, to ensure that this issue is properly dealt with.

Interest Allocation

Submission

In our view, the policy of quarantining and the subsequent policy of disallowing interest expenses in respect of exempt income is flawed. Therefore, it is inappropriate to introduce rules for the allocation of interest unless the underlying policy giving rise to the necessity for the allocation is re-examined. On a conceptual basis, we believe that interest incurred for the purpose of deriving foreign income should be allowed as a deduction, irrespective of whether or not the investment yields assessable or exempt income. Again, on a conceptual basis, the deduction should not be subject to quarantining. Instead, the deduction should be effectively clawed back on receipt of foreign income, either through credit quarantining (in the case of assessable dividends) or through a deduction claw back (in the case of exempt dividends). Interest allocation rules may be necessary to allocate that expense.

The allocation of interest would be necessary under any policy approach, be it either a system for the disallowance and quarantining of losses or under a system for the calculation of credits and claw back of deductions.

However, the preferable approach is the tracing of expenses rather than by formula allocation or by arm's length rules.

If interest allocation rules are to be introduced, the primary test should be a statutory ratio of debt to equity, first on the basis of a "safe harbour" ratio and then on the basis of the gearing of the onshore operations compared to the offshore operations. Last, an overriding test should be included to ensure that no interest will be disallowed if it is established that the gearing of the Australian investment does not exceed arm's length gearing ratios. We are particularly concerned that the statutory safe harbour test be set at a reasonable level. We are further concerned that the measurement of equity be reasonable to ensure that the ratio maintains its relevance and that the compliance burden is not onerous. Therefore, we submit that further public consultation should occur on the detail of the test.

Background

Under the general foreign tax credit system, a deduction is allowed for expenses incurred in producing the assessable foreign income, but any resultant loss is subject to quarantining. Further, with effect for dividends paid on or after 1 July 1990, dividends paid by a company resident in a "listed country" to a company resident of Australia are exempt from tax in Australia. The exemption also applies where a company resident in an "unlisted country" pays a dividend to a company resident of Australia to the extent that the dividend is paid from profits that arose in a listed country or, in certain cases, Australia.

It is clear that the basis for the exemption rests not with an attempt to provide a concessionary treatment (that is, it does not constitute tax expenditure) but is instead a means for reducing the tax compliance burden associated with the calculation of a foreign tax credit. This essential difference between the dividend exemption and other exemptions is recognised by the legislation in that the exempt income is specifically stated not to reduce losses.

The exemption of the foreign income was not an end in itself but was merely a mechanism for achieving a simplification of the foreign tax credit system. As such, it would have been as easy to provide a rebate of the tax paid or a standard credit of the company tax rate. Either method would have achieved the intended simplification without having the effect of disallowing deductions.

It is therefore incorrect that the general exemption of non-portfolio dividends derived by an Australian company should result in the disallowance of expenses. In our view, it indicates a narrow perspective to policy making to provide a particular treatment merely on the basis that it has always been done that way. Simply because the general treatment of expenses denies a deduction where the expenses relate to exempt income should not mean that an exception is not justified in the case of particular exempt income.

The matter would be of academic interest only were loss quarantining to remain in place in the form enacted prior to 1 July 1990 (modified to take account of the technical problems inherent in the drafting of the original provisions). If this were the case, it would be largely irrelevant that expenses could be deductible since the effect of the quarantining would be that the expense could merely create a growing carry forward loss. In effect, the deduction for expenses would have no value. However, as discussed below, our basic contention is that loss quarantining is not justified in any event.

Loss Quarantining

In our view, there has never been a theoretically justified basis for loss quarantining. The most obvious reason for the attempt to quarantine expenses attributable to foreign source income to that foreign source income was the potential loss of Revenue that might arise from the change over to a foreign tax credit system.

However, it is not clear that this remains a significant concern. Firstly, at the time of the development of the foreign tax credit system the significant expansionary phase of investment offshore had only then commenced. Therefore, it would have been difficult to quantify the effect of allowing unlimited deductibility of interest incurred to generate foreign source income. The effect should now be more readily quantifiable. More importantly, we suspect that existing tax law never successfully achieved its purpose of quarantining expenses incurred within a group against the foreign source income of the group. This seems to be accepted in the Discussion Paper, where it is stated that one of the benefits of loss consolidation is the more straightforward matching of expenses (particularly interest) with the income that it ultimately generates. Therefore, it is likely that the practical effect of quarantining was, if not negligible, not significant in policy terms. It may well be the case that the Commissioner of Taxation will seek to litigate this matter to determine the correct interpretation of the law and to overcome cases of abuse. Irrespective of the level of success that the Commissioner may have, it seems clear to us that except where already specifically identified and assessments have already been raised against taxpayers, interest deductions that are now being sought to be the disallowed by more effective quarantining would not represent a loss to the Revenue. The statistics branch of the Commissioner of Taxation may be able to place a figure on this, but we would be surprised if the amount of Revenue would be significant in the overall terms.

It has been speculated that one theoretical basis for the implementation of per country loss quarantining was the prevention of "cross subsidisation" of foreign losses in respect of foreign investments in high tax jurisdictions with foreign income in respect of investments in low tax jurisdictions. However, this is better addressed by the elimination of cross quarantining of credits and the allocation of expenses in determining the foreign tax credit allowed, rather than the quarantining of losses. Few countries with a foreign tax credit system recognise the necessity to quarantine losses. Therefore, the issue is one of allocation of expenses against foreign income for the purpose of determining the Australian tax payable upper limit and therefore the maximum credit, rather than one of loss quarantining for the purpose of determining the deductibility of expenses.

With credit quarantining, the clawback of expenses arises only at the time the dividend is distributed. In effect, loss quarantining has the effect of denying a deduction for the cost of offshore expansion.

An Alternative Model

One alternative in seeking a balance between the genuine financing needs of residents and the necessity to claw back the deduction allowed is:

- to allow all deductions incurred for the purpose of deriving exempt or assessable foreign income without regard to quarantining; and

- to then provide for a standard claw back of the deductions at the point of repatriation of the exempt dividends. This standard claw back will obviate the need for complex allocation rules and, if set at an appropriate level (say, 5% reduction in the exemption), should also not result in a significant bar to repatriation.

Germany has recently examined this issue and decided on a compromise system which balances the bona fide funding requirements of German multinationals with the Revenue considerations.

Where a business expense (including interest) relates to exempt income, 15% of the dividends that are tax exempt are deemed expenses with a direct nexus to tax-exempt income and are disallowed. In other words, the practical result is that generally only 85% of any foreign source dividend is exempt from tax. This follows the Belgium pattern where a dividend is assessable in full but a deemed deduction is allowed for 95% of dividend income (that is, in effect, only 95% of the dividend remains exempt). Expenses related to the derivation of the foreign income are deductible in full.

The policy rationale behind the deemed non-deductible expense is that foreign investments should not be discouraged by the total denial of expenses where the dividend is exempt. This 15% notional claw-back is a compromise. Further, analysis will need to be performed to determine the percentage that would achieve a balance between the theoretically correct position, the potential effect of the rules on profit repatriation and a viable estimate of the expenses related to exempt income.

The Proposal for Interest Allocation

The proposal for interest allocation assumes that there is a significant level of deductible interest claimed in Australia where the equity levels of the Australian operations could not support the level of borrowed funds. Empirically, no evidence has been presented to support the contention. As recognised in the Discussion Paper, it is generally preferable for expenses referable to the operations of foreign subsidiaries to be incurred by those subsidiaries.

Most significantly, we agree that the imputation system acts as an incentive to the payment of tax in Australia. However, the reasons provided in the Discussion Paper do not encompass the full range of commercial imperatives for ensuring that the foreign subsidiary supports its own debt.

In particular, debt incurred in respect of the operations of foreign subsidiaries must generally provide access to funds denominated in the local currency. By incurring this debt directly in foreign currency at the level of the foreign company, the interest payments and debt repayments are matched to cash flow and assets of the local operations. That is, there is created a natural hedge against adverse foreign exchange fluctuations. It might be argued that this exposure could be hedged in Australia in any event, and in some cases this would be true. However, hedging even well traded currencies such as the $US is expensive and the natural hedge is preferable. Further, in the case of some foreign currencies that are not readily traded the cost of hedging is prohibitive. At the extreme, some currencies cannot readily be hedged.

It is true to say that in some cases there would be no tax advantage were the foreign subsidiary to incur debt. For a subsidiary resident in a listed country, this would generally be the case where the foreign subsidiary was in its start up phase and was still incurring losses, such that incurrence of the debt by the foreign company would not be efficient from a tax perspective. However, it must be noted that the more likely reason that the debt is not incurred in the foreign company is that the foreign company could at this early stage not support the debt repayments, or could do so only with difficulty. Once the foreign company became profitable, it would again be desirable from a commercial perspective for the foreign company to incur the debt. At this point, it would also be advantageous from a world wide tax perspective to allocate the debt to the foreign subsidiary. A similar reason for not incurring the debt at the subsidiary level would arise if the foreign subsidiary were to be granted a tax holiday. However, most tax holidays are short term only. Once the tax holiday ceased, it would again be desirable from a commercial perspective for the foreign company to incur the debt. Overall, where there is arguably a mis-allocation of the interest for the initial period of operations, the effect is likely to be transitory and it is doubtful that this would justify complex interest allocation rules.

Further, it is generally true that withholding taxes on dividends are higher than withholding taxes on interest. Therefore, to allocate the debt to the Australian operations rather than to the foreign operations increases both the primary tax paid by the foreign company as well as creating a potential exposure to withholding tax on repatriation of the dividend.

These issues arise where funds can be borrowed in the foreign country. However, this is occasionally not a viable alternative, either because of borrowing restrictions imposed in the foreign country or because the costs of borrowing in that country are prohibitive. Not surprisingly, the countries for which these problems arise tend to be our regional neighbours which, despite the recent adverse economic performances of those countries, represent substantial future investment opportunities for

Australian companies. This is likely to be the only case where there is a significant risk of ongoing mis-allocation of debt but the mis-allocation is not caused by any attempt by the Australian company to gain an Australian tax advantage.

The Deductibility of Interest – Tracing or Arbitrary Allocation

Few countries seek to allocate interest expenses to foreign income for the purpose of denying the interest deduction on outbound investment (the United States have an asset based allocation system, but this is for credit quarantining and does not affect the deductibility of expenses). The basis for the allocation of expenses against foreign income for the purpose of denying a deduction was recently examined in Canada in the Martin Report.[15] In that report, the authors noted an increased level of overall debt incurred by Canadian companies. The Martin Report proposed the denial of deductions related to foreign income that is exempt from tax in Canada and considered several methods for the allocation of interest to foreign investments, including tracing and asset based expense allocation. However, the authors concluded as follows:

> *"One disadvantage of tracing is that past experience with the enforcement of rules governing the disallowance of interest indicates that taxpayers will seek to construct mechanisms aimed at making borrowings that relate to a direct or indirect investment in a foreign affiliate, appear to be traceable to an investment for which the interest expense is deductible. Also, under tracing, it will be difficult – even with elaborate anti-avoidance rules – to overturn arrangements whereby a Canadian taxpayer borrows to invest in Canadian domestic operations and, in separate transactions, uses existing equity to finance foreign direct investment.*
>
> *In practice, a tracing rule would be most effective in the context of Canadian business enterprises that have significant investments in foreign affiliates in relation to their Canadian operations, or where the company's financing arrangements are such that applying the tracing method is fairly obvious. By contrast, one can expect that larger multinationals, with complex financing structures and substantial operations both in Canada and abroad may in some circumstances, be able to avoid the full application of the tracing rule.*
>
> *Bearing in mind these limitations, it is nonetheless the Committee's view that the tracing approach would reduce the amount of funds borrowed in Canada to invest in foreign affiliates, and would induce taxpayers to locate a greater amount of indebtedness in foreign affiliates rather than in Canada." (emphasis added)*

If one accepts the conclusion that deductions in respect of exempt income need to be disallowed, in our view the above conclusion is correct and represents an appropriate balance which recognises commercial considerations.

In particular, cases of mis-allocation that could be described as abuse can already be dealt with under the general anti avoidance provisions.

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15 *Report of the Technical Committee on Business Taxation*

ARTHUR ANDERSEN

Therefore, it would seem that the only remaining area for application of the interest allocation rules is where the arrangements are entered for *bona fide* commercial concerns. Where the arrangements are *bona fide*, there seems little remaining basis for asserting that, on the basis of arbitrary rules, a deduction should not be allowed.

The allocation option in the Discussion Paper may have theoretical advantages. However, the problems associated with the measurement of equity and the arm's length tests (see below) are so significant that the allocation option is likely to be unworkable in practice.

We therefore submit that the preferable option would be to continue with the tracing approach, augmented by tracing through the corporate group through a consolidation mechanism to target the practice of interposition of a resident company to change the source of the income from foreign to domestic. If consolidation rules are not introduced, a specific requirement that has the same effect could be introduced.

The Preferred Test

If evidence of excess gearing exists and the proposed rules are to be introduced, we support a test that is based in the first instance on a arbitrary but realistic ratio of the debt incurred by the Australian company (which has not already been allocated to foreign income) to the Australian equity. Only if this ratio were exceeded and the gearing of the Australian operation exceeded would resort be necessary first to the comparative gearing of foreign operations and Australian operations and then to an arm's length test. Provided that the application of the arbitrary ratio is reasonable and not overly complex, it should ensure that only the most egregious cases of mis-allocation are effected.

We have supported this option for two reasons. The Discussion Paper seems to imply that the arm's length test would be based on the equity of the Australian group – that is, could the Australian equity support the debt for which interest deductions are sought. It is unclear whether the arm's length test is intended to be applied primarily by reference to the equity base. That is, whether or not on an arm's length basis the equity base support the debt borrowed. We are doubtful that a workable arm's length test could be developed based on the total equity of the Australian group, since this does not appear to take into account the process by which funds are lent. In the first instance, lenders turn to interest cover to determine whether and to what extent they would lend to a particular company. The assets of the company are not necessarily indicative of the ability of the company to pay interest and do not objectively identify the use to which the funds have been put. Rather, the assets of the company are used as a secondary measure for risk analysis to determine the ability to recover the capital sum lent in the event of default. An arm's length test is, presumably, intended to reflect the ability of the Australian group to borrow funds. In this analysis, even where it is clear on an objective basis that the funds are borrowed for the purpose of making an investment in Australia, a bank would take into account all of the assets, irrespective of whether or not they generate income. This is analogous to an individual providing private assets such as the family home as security for business loans. Therefore, the real test is whether the bank would have lent funds to the Australian company, having regard to the income flow from the Australian operations and the total Australian equity and foreign equity.

Even if the arm's length test properly takes into account both the ability to service debt and the asset cover, our second concern is that some regard would need to be had to the domestic asset base. In determining that asset base, lenders will adjust their analysis to take into account the market value of the assets. This will not be readily apparent from the financial records of the company and will lead to severe compliance burdens. Further, if the arm's length test develops in the manner of the arm's length test for the purposes of the transfer pricing provisions, severe compliance burdens will be imposed. Comparables in the sense of used in the transfer pricing provisions will never exist. Rather, resort will need to be had to the lending policies of banks and other financial institutions at the time the borrowing was obtained to determine whether such financing could have been obtained. In our view, this will lead to the wholly impractical result that, in order to provide contemporaneous documentation, the company will need to have the Australian operations analysed by third party lenders to determine whether they would lend the funds absent the foreign operations. In our view, this will not be feasible as a primary test.

Therefore, a safe harbour rule is an imperative. However, to be truly effective the safe harbour rule must be broad enough to exclude cases where it reasonably likely that no significant mis-allocation of debt has occurred. It should be noted that while the test could be described as a safe harbour it would involve a significant annual compliance burden. This burden lies not with the measurement of the debt, which should be relatively simple given that a deduction is to be claimed in respect of the debt, but rather with the measurement of the Australian equity. For this reason a viable measurement of Australian equity needs to be developed which neither significantly distorts the true equity of the Australian operations not does it involve a significant compliance burden. In particular, we are concerned that there is no detail regarding the following:

- the ratio (although members of the Business Review Team have indicated that a ratio of 2:1, consistent with the thin capitalisation measures, is appropriate);
- the identification of the debt to be allocated;
- the need to consider further the method of calculation of the Australian equity and the world equity;
- the treatment of non-recourse debt.

Permanent v Temporary Disallowance of the Interest

An issue also arises as to whether the interest should be disallowed permanently, or should be disallowed subject to a deduction being allowed in a subsequent year if the company were no longer to exceed the safe harbour debt to equity ratio. While a serious policy issue, provided that the debt to equity ratio and the measurement of the equity is set at a level that targets only cases of egregious mis-allocation of interest, whether or not the amount is allowed in a subsequent year is not a significant issue.

In our view, the disallowance of the interest should be on a temporary basis. We take this view for two reasons.

In our view, the view is that the safe harbour ratio will always be arbitrary in nature and no matter the best intentions and efforts will never provide a totally satisfactory refection of the true equity of the Australian operations and hence the true gearing ratio of those operations. Similarly, the comparison of the gearing ratios for the onshore operations and the offshore operations will suffer the same shortcomings. Last, as discussed, we doubt very much that for the majority of taxpayers an arm's length test is a practical alternative.

Therefore, at a practical level, taxpayers will need to rely heavily on measurement of debt and equity which may be both arbitrary and erratic. The permanent disallowance of the deduction in these circumstances would be an egregious outcome. Rather, by allowing for the temporary disallowance, it may well be possible that the egregious nature of the equity calculation will correct over time and any inequity will, over time, balance out.

Further, even if the gearing ratio approximates an accurate measurement of the true gearing, it is natural for funding requirements to fluctuate from year to year depending on the profitability of the business, the cash flow, the stage of development of the business and the business cycle.

Therefore, it is quite possible that a company will exceed the statutory gearing ratio in a particular year but this will reverse in a subsequent year. These issues need to be recognised and could be dealt with by allowing the carry forward of any disallowed interest.

Capital Gains Tax

Submission

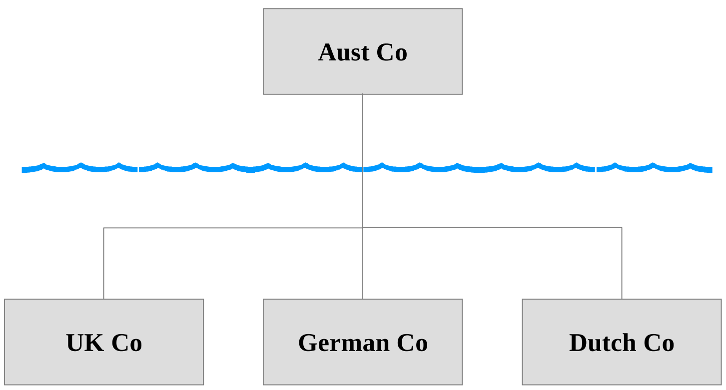
We submit that the current rollover relief provisions be extended to ensure that businesses can enter joint ventures, or alternatively to undertake group reorganisations on a scrip for scrip or an asset for scrip basis without suffering major tax imposts. This is consistent with the objectives of achieving international competitiveness by ensuring that the tax flexibility offered by other countries is, as a minimum, matched by Australia. The extension of the rollover relief provisions in this manner will go a long way towards ensuring that Australia becomes an internationally competitive economy which provides optimum economic growth and encouraging savings and investment to provide employment opportunities for Australian.

Rollover Relief for Transfers from a Resident to a CFC

At present, unless the asset in question has the necessary connection with Australia, an asset owned by an Australian company may not be transferred to a CFC and gain the benefit of rollover relief. This severely restricts the ability of Australian multinational companies to rearrange their offshore holding structures in the most commercially and tax efficient manner, by imposing on the company legal structures not consistent with the management structure and which also increase foreign taxes on the remittance of funds from CFCs to Australia. Such rollover relief may be provided without a cost to the Revenue. The problem can be illustrated by an example.

Assume an Australian company has an interest in several CFCs located in various countries and that the remittance of funds from each of those CFCs would create unacceptable cross-border foreign withholding taxes (arising largely from Australia's outdated and inefficient double tax agreements). However, an alternative structure would allow a more efficient flow of capital.

Before



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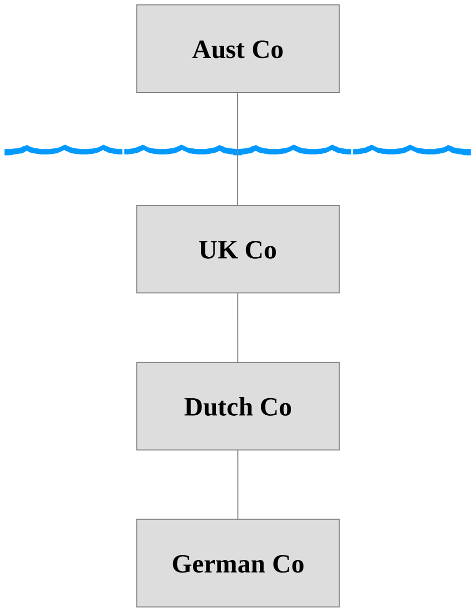


The resultant structure would reduce foreign withholding tax imposts and allow for free-flow of capital both within the offshore corporate group and to Australia. However, the Australian capital gains tax impost prevents this structure. There seems little reason why this restructure should create a capital gains tax impost since, by the application of the CFC measures, the assets remain wholly within the Australian tax net.

Once again, if any reason exists regarding the potential leakage on the gain on the subsequent disposal of the asset by a CFC resident in a broad-exemption listed country, it would be a simple matter to ensure that any subsequent disposal of the asset is subject to the CFC measures.

This is not an example of harmful tax competition. Further, Australia could not be justifiably accused by foreign countries of sponsoring "abuse" of their treaties with third parties by encouraging tax treaty shopping, since the tax treatment of the restructure is equally consistent with that of any treaty partner that allows such capital gains tax rollover relief or does not impose a capital gains tax. Importantly, restructures such as these could have occurred prior to 20 September 1985. It is clearly a matter for the foreign country to introduce or apply anti-abuse provisions if it finds such arrangements offensive. In our view, Australia should not be overly concerned with protecting the Revenue of other countries if they take no effective steps to do so, especially if the overall effect is to the advantage of Australia (both by allowing efficiency and profit gains to its multinationals and by allowing greater remittance of funds to Australia).

CGT and Scrip-for-Scrip Transactions

In our view, rollover relief should be available for all of the following situations.

- Where scrip-for-scrip is offered in the case of take-over or merger of two separate entities, that is, the taxpayer disposes of one asset for another. For example, in the case of a scrip-for-scrip takeover one company acquires another for an exchange of shares rather than cash or a mixture of shares and cash.

- Reverse scrip for scrip or a deconsolidation where a corporate group is split into separate entities and the shareholders in the original group receive shares in the entities such that their newly combined interests are identical to their previous interests.

- Where parties to a joint venture amalgamate their respective assets into a new entity.

- Where a scrip-for-scrip merger, takeover or amalgamation occurs in respect of an Australian Controlled Foreign Corporation.

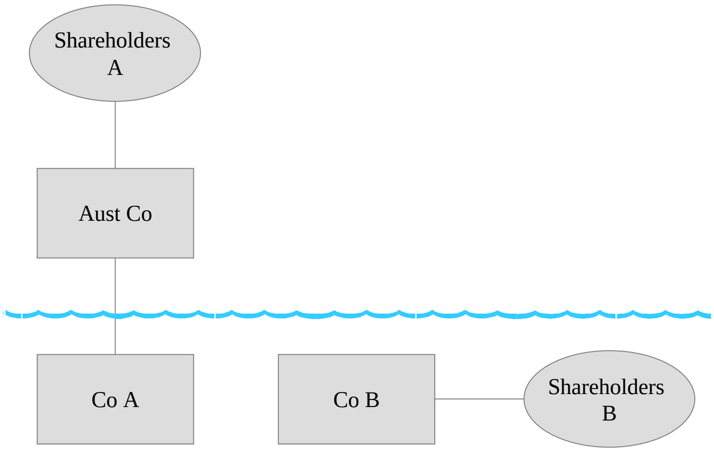
Only three principles should guide the decision on whether or not to allow the relief – does the taxpayer or the underlying owner retain an economic interest in the underlying asset, are the remaining assets and "replacement asset" of a value commensurate with the asset transferred; and do the remaining assets and the replacement asset remain with in the Australian tax net (including vicariously through the operation of the CFC measures).

Clearly, the various scenarios cannot be explored in full in this submission. However, one example should suffice.

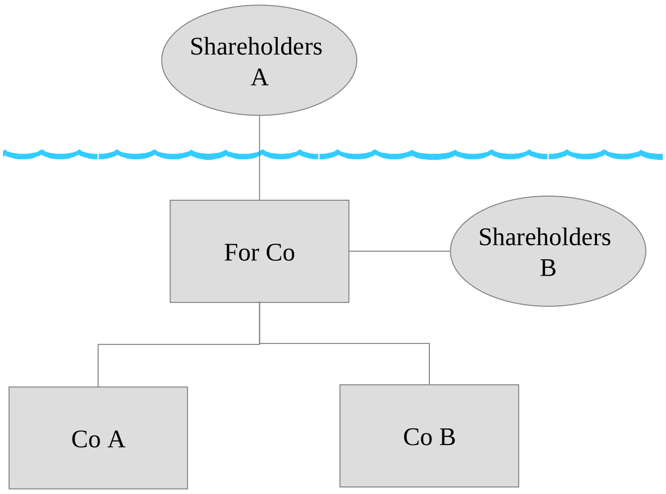
Scenario

For example, assume Aust Co's foreign operations represent a compatible fit with those of For Co. Both companies will be advantaged by merging operations.

Before



After



Shareholders A have made no economic gain, notwithstanding that they have disposed of their shares and acquired shares in For Co of equal value.

Comparisons Made with Other Jurisdictions

Scrip-for-scrip rollover relief is a feature of the taxation regime in many other jurisdictions, including the United States, Canada and the United Kingdom.

In our view, the system the United Kingdom is an appropriate starting point for a review of our rollover relief, given that the system is relatively simple and has a reasonable degree of flexibility. United Kingdom companies are afforded rollover relief where (amongst other things) companies amalgamate or merge; or where companies enter a scheme of reconstruction of reorganisation.

Importantly, the relevant sections of the UK legislation are not restricted by reference to a country of incorporation or by reference to the residence of the acquiring company.

In particular, where a company amalgamation takes place and shares and debentures are exchanged this is not regarded for tax purposes as a disposal of the shares or debentures in the company that is acquired. The shares or debentures received in exchange are treated as acquired by the owner for the same consideration as, and at the time of the acquisition of, the original holding. However, in these circumstances one of the following conditions must be satisfied:

- The company issuing the shares or debentures owns or acquires more than 25% of the ordinary share capital in the target company; or

- The company issuing the shares or debentures does so in exchange for shares as the result of a general offer made to members of the other company of any class of them. The offer must be made in the first instance on a condition such that, if it were satisfied, the company issuing the shares or debentures would have control of the other company; or

- The company issuing the shares or debentures holds, or acquires as a result of the exchange the voting control of another company.

Further, where a scheme of reconstruction or amalgamation[16] takes place and holders of shares in or debentures of a company are issued with shares or debentures in another company in respect of, and in proportion to, their original holdings, the transaction is treated as a reorganisation of capital. Accordingly, the shareholders are not treated as disposing of their shares for capital gains tax.

In both cases, if the consideration for the holding being acquired is partly in cash, a corresponding proportion of the shares or debentures is treated as disposed of for the cash. The cash received its treated as a capital distribution in respect of the original shares. However, the relief will not apply if the exchange, reconstruction or amalgamation is not effected for bona fide, commercial purposes or forms part of a scheme for the avoidance of capital gains tax or corporation tax.

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[16] A scheme of reconstruction or amalgamation merely means a scheme for the reconstruction of any company or companies or the amalgamation of any two or more companies, and references to shares or debentures being retained include their being retained with altered rights or in an altered form, whether as a result of reduction, consolidation, division or otherwise.

Controlled Foreign Companies

Submission

We are disappointed with the omission from the Business Tax Review of any re-consideration of the policy and operation of the CFC measures. In our view several of the issues dealt with in the Discussion Paper are of considerably less importance to the structure of Australia's international taxation system. Further, we believe it is inequitable to exclude independent consideration of the policy features of the CFC measures merely on the basis that the policy has recently been reviewed by the Treasury. As indicated in submissions made to the Treasury in 1997, it was (and continues to be) the position of many in the corporate sector that the solution chosen by the Treasury to the problems encountered was misdirected.

We note that many of the issues under the CFC measures are administrative in nature and can correctly be left to further consideration if it could be guaranteed that such further consideration would be forthcoming and would be given due consideration. However, outside of an independently headed inquiry, we have little confidence that such consideration will occur. We have set out our view on the general design features of the CFC measures that require urgent review.

Further, notwithstanding that the Discussion Paper has generally excluded consideration of the CFC measures, two matters that have been included in the Discussion Paper have direct relevance to the taxation under the CFC measures. In our view, these issues – both relating to the availability of rollover relief under the CFC measures - are the proper subject for consultation within the parameters set in the Discussion Paper. In his regard, we submit that:

- the current rollover of assets under the CFC measures should not be constrained in the manner suggested in the Discussion Paper;
- rollover relief should be extended to allow for tax free rollover of assets between CFCs that are members of the same wholly owned group, irrespective of the countries of residence of the CFCs;
- rollover relief should be extended in respect of a CFC resident in a broad-exemption listed country where that relief is consistent with relief provided by the broad-exemption listed country; and
- rollover relief should be available for transactions by in scrip for scrip transactions not involving wholly corporate groups.

Design Features of the CFC System

The 1997 review of the CFC measures significantly expanded the operation of those measures. Based on the statements made the *Proposed Changes to the Taxation of Foreign Source Income An Information Paper December 1996* the restriction of the listed countries for CFC purposes had only one basis, being the risk to the revenue of tax leakage where the designated concessions were not monitored with sufficient vigilance. In particular, the following statements are relevant:

> *"Efforts to designate tax deferral opportunities in listed countries have had only limited success and are made more difficult by the large number of countries which must be monitored."*

and further,

> *"The effectiveness of the list for CFC taxation purposes will be maximised when only genuinely comparable tax countries are included on the list. If any country not consistently levying comparable tax on a current basis is listed for CFC purposes then taxpayers can readily derive tainted income there rather than Australia at an obvious cost to Australia's revenue base."*

The general rate of tax in the countries then listed was considered comparable, and there was no indication to the contrary in the 1996 Information Paper. Further, the potential reduction in Australia's the rate of corporate tax to 30% would ensure parity with listed countries could be achieved.

At the outset, we would like to state that, to the best of our knowledge, the original list of comparable tax jurisdictions included countries not contemplated in the original public submissions during the development of the CFC measures. Indeed, in respect of some of these countries Australia had (and still has) little foreign investment (for example, Kiribati or Kenya). Therefore, the length of the list and any resultant administrative difficulties associated with monitoring that list were, at least in part, the creation of the previous Government. Consequently, we wish to stress that we are not opposed to proposals to alter the CFC measures to mitigate against an administrative burden imposed on the Treasury and the Australian Taxation Office. However, this is subject to the proviso that any increased compliance burden that results does not outweigh the administrative savings, and that any changes produce net efficiency savings for Australia. Unfortunately, as was anticipated, the 1997 changes resulted in income subject to comparable foreign tax being subject to attribution under the CFC measures. Therefore, the 1997 changes have caused a significant increase in the compliance burden of taxpayers with an interest in a CFC resident in a limited-exemption listed country with no consequent gain to the Revenue. To this extent, the 1997 design changes were inconsistent with their stated policy.

A preferable avenue for dealing with any perceived tax leakage (arising from the failure to designate a concessionary tax treatment and the administrative difficulties in doing so) would have been for the Government to confine any changes to the perceived problem. For example, it would have been possible to retain for the purpose of applying the CFC measures a longer list of comparable tax countries, and then generally designate any tainted income that is subject to a reduction of tax. This could have been (and still is) quite simply achieved within the framework of the existing law by amending the Regulations.

Even if the CFC measures were amended this way, problems would still arise under the definition of tainted income where the income was concessionally taxed in a listed country. However, at least the adverse impact would be limited. Notwithstanding this limitation of the impact, we submit that the changes to the definition of tainted income should be enacted to ensure that the CFC measures retain their original aim of not taxing active income derived by a CFC.

We accept that, weighed against any increase in compliance burden, must be the potential effect that tax arbitrage on tainted income will have on the Revenue. In our experience, there was little evidence that companies were using listed countries to a significant extent to gain a tax arbitrage on tainted income (obviously, there will be instances where this occurred). Of course, the reduction in the rate of Australia's corporate tax rate will prevent scope for such arbitrage. In any event, if evidence of widespread tax arbitrage exists, it is appropriate that actual examples be provided so that the public is aware of the basis for the Government concerns, in the same way that the ATO has often insisted on actual examples from taxpayers before considering alleviating the adverse effects of anomalies in the CFC system. This could then allow for the option of removing the particular country from the list of comparable tax countries. Without evidence of this tax arbitrage, it is only natural that affected taxpayers not involved in the perceived tax minimisation will be sceptical regarding the justification for the changes. This is hardly an appropriate basis for consultation or policy development. In our view, the scope for, and advantages of, tax arbitrage on tainted income were of significantly less concern than was perceived by the ATO. To have significantly redesigned an entire CFC system to deal with the perception of isolated abuse was undesirable.

Removal of Existing Rollover Under the CFC Measures

The Discussion Paper suggests an option under which the current rollover relief under the CFC measures be denied. The rationale for this option is that, in the Australian context, under the consolidation option no further rollover would be allowed outside the consolidated group. Since the CFC will by definition be outside the consolidated group, no rollover relief would be allowed for the transfer of assets between CFCs (and presumably from CFCs back to Australia). We find the reasoning unconvincing and the impact on Australian multinational companies cannot be overstated.

The original policy of the CFC measures cannot be so simplistically reconciled with the option for a consolidation regime. It may be one matter to attempt to make an analogy between the operation of the CFC measures and the consolidation regime if the CFC were to form part of the consolidated group, such that losses arising in the calculation of the attributable income of the CFC could be consolidated with the Australian companies in the consolidated group. Such treatment of losses was considered in detail when the CFC measures were implemented and specifically denied. Having denied the ability for a company to form part of the consolidated group it hardly follows that the treatment of that company must be consistent with the treatment of an Australian company that elects to be outside the consolidated group.

Whatever the conceptual basis for allowing or not allowing rollover relief, these are insignificant once the practical effect of the denial is appreciated. As noted in the Discussion Paper, denial of the rollover relief to a CFC will have the potential effect of locking corporate groups into existing structures. As a practical matter, it is only existing operations that will be potentially locked into the corporate group not new operations. However, those new operations will then be locked into the new corporate group and as circumstances change it will not be possible to transfer shares in those new companies (and so on). The option to deny rollover relief in the calculation of the attributable income of a CFC will effectively impose inefficiencies on Australian multinationals and seriously hamper their competitive ability.

This is not in the interests of these companies nor is it likely to raise any revenue. We note that there does not appear to be any significant Revenue effect ascribed to this option.

Rollover Relief for a CFC Resident of a Broad-Exemption Listed Country

At present, rollover relief is allowed between CFCs in the same wholly owned corporate group if the transferor and transferee are resident in any country except a broad-exemption listed country.[17] Additionally, rollover relief is available between CFCs in the same broad-exemption listed country. We submit that there is no reason to restrict the rollover of assets on a jurisdictional basis.

It is likely that the original restriction of rollover relief was included on the basis that, if unlimited rollover relief was provided, Australian tax leakage may result if a gain on the subsequent disposal of the asset was not subject to Australian tax under the CFC measures. [18] In particular, an asset transferred to a CFC resident in a broad-exemption listed country would (except in the case of New Zealand which has no capital gains tax regime) be subject to capital gains tax. Typically, this gain would be calculated by reference to the market value of the asset at the time the asset was transferred to the CFC. Since the gain would be subject to tax in the broad-exemption listed country (albeit that the foreign tax charged would be by reference only to the gain since transfer) the gain would not be subject to tax under the CFC system. Therefore, substantial gains could escape taxation under the CFC measures. However, while the denial of

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17 Broad exemption listed countries are defined to be Canada, France, Germany, Japan, New Zealand, the United States and the United Kingdom.

18 Rollover relief was previously even more restrictive in that the restriction applied not only in respect of transfers to CFCs resident in the 7 broad-exemption listed countries, but to any of the approximately 61 listed countries. The 1997 changes to the CFC measures reduced the issue to the 7 broad-exemption listed countries.

the rollover is one avenue to prevent the potential avoidance of the Australian tax on the portion of the gain that is not subject to tax in the broad-exemption listed country, it is has the effect of limiting the ability of an Australian based multinational to restructure its offshore operations. It would be preferable for the potential avoidance to be prevented without limiting the flexibility of offshore restructures.

One way to achieve this would be to simply subject to tax under the CFC measures at the time of disposal of the asset the portion of the gain accrued to the date of rollover. In this case, the CFC measures would apply irrespective of whether the gain accruing after the transfer of the asset was subject to tax in the broad exemption listed country, and also irrespective of whether or not the CFC passed or failed the active income test. Given that the number of broad exemption listed countries is now limited to 7 proper implementation and monitoring of the extension of rollover relief should present no difficulty. Even if the list were extended, designating the gain arising prior to the transfer would ensure protection of the Revenue.

Rollover of Assets Between CFCs not in the Same Corporate Group

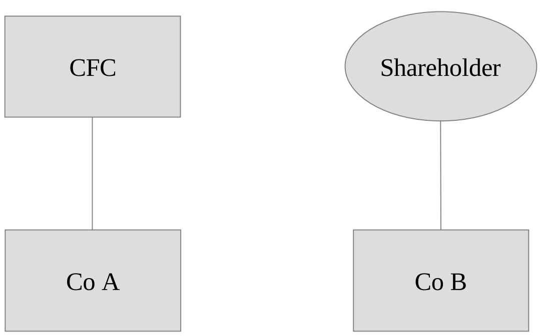
Consistent with our submission regarding the extension of rollover relief for scrip-for-scrip exchanges, we submit that similar rollover relief should be provided where a CFC disposes of an asset (including shares in another company) to another company in exchange for shares in that other company. In these cases, the exchange of assets is not equivalent to rollover relief for proceeds reinvested in a similar business. Rather, the relief is merely a recognition that the transferor has retained an interest in the underlying assets transferred.

A scenario that we have encountered that has inhibited the expansion of the offshore operations of Australian multinationals is set out below. This is only illustrative of the problem.

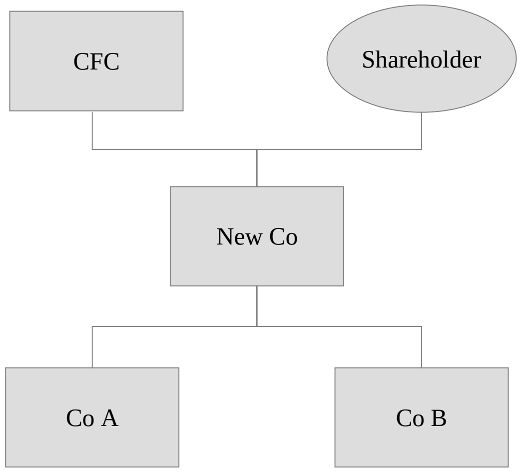
Scenario

One scenario occurs where two parties wish to merge their assets into a single joint venture company. This can be illustrated as follows:

Before



After



In this case, a CFC owns 100% of the shares in Co A. Another unrelated company (whether or not a CFC) wished to merge its assets with those of the CFC to create a joint venture. At present, no rollover relief is available because the existing CFC and the joint venture company (New Co) would not be part of the same wholly owned group.

There is no apparent reason to deny this rollover relief. The shares in the joint venture company will fully reflect the value of the shares previously held. The economic effect of the transaction is similar to the situation that would arise if the CFC instead had originally purchased the relevant assets via a wholly owned subsidiary, and that wholly owned subsidiary issued shares to the third party in exchange for the assets of the third party. This transaction would not have constituted a disposal of an asset by the CFC and no amount would have been subject to tax under the CFC measures. It is merely by "accident" of the original purchase of the assets that the merger attracts a gain subject to tax under the CFC measures.

This arbitrary non-neutrality between transactions that have the same economic effect hinders expansion of the foreign operations of Australian based multinational companies. As importantly, such rollover relief is consistent with the rollover relief provided in the United Kingdom and the United States. As such, the CFC is placed at a competitive disadvantage when seeking to expand offshore.

Clearly, further consideration of the full range of circumstances that require extension of rollover relief remain to be explored.

However, as a starting point, any rollover provided to a CFC resident in a broad-exemption listed country in accordance with the capital gains tax provisions of that country should be an acceptable rollover for Australian tax purposes. Given that the tax systems of these countries are relatively comparable, it can be expected that the rollover relief provided would not allow for the eventual avoidance of tax in that country. Therefore, since the ultimate gain will be taxed in that country, there seems no reason to restrict the rollover relief to that provided outside the CFC context.