

International Tax Reform: Removing double taxation of Australian companies which operate internationally

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1 Executive Summary

Australia has seen significant, laudable, international tax reform in recent years to enhance Australia's international competitiveness. This is continuing with initiatives including the review announced in October 2006 of Australia's attribution rules to be undertaken by the Board of Taxation.

This report highlights the need for action on a long-standing inefficient feature of Australia's business taxation system - the need for appropriate recognition for imputation purposes of foreign source income which has borne foreign tax.

This issue represents a major piece of unfinished business in the review of Australia's international tax rules. Without action to resolve this issue, Australia's tax system is not neutral in its treatment of capital and does not promote best use of the capital of Australia's residents, distorting the development of Australian owned businesses which seek to grow to international scale and become internationally relevant.

US and UK investors in UK and US companies achieve better after-tax returns from their companies' global investments than do Australian shareholders in Australian companies investing globally. This lack of neutrality has significant implications for Australia's development.

The Government needs to resolve this issue, which has been the subject of recommended reform on a number of occasions, in addition to the other reform initiatives under way.

The matters discussed in this report have been the subject of review by the Ralph Review of Business Taxation in 1997-9 and the Board of Taxation in an extensive public consultation process in 2002-3. Many submissions have been lodged and are in the possession of Government and Federal Treasury, many of which are publicly available. This report does not repeat at length many detailed submissions but highlights the outcomes of the reviews, their continuing significance and the need for action.

1.1 Australian business, expanding offshore, faces double taxation

Foreign income earned by Australian companies that is distributed to Australian shareholders is subject to excessive taxation. The current system effectively double taxes such income in the hands of shareholders, due to the interaction of Australia's tax system with foreign tax systems.

This double taxation results from the lack of any adjustment in Australia's dividend imputation system for foreign-source income. Australia's dividend imputation system has been a factor supporting strong Australian investment in Australian companies. However Australia's tax system needs refinement to deal with the changes in Australia's open economy and Australian business since the 1986 introduction of dividend imputation.

The double taxation of foreign income is a 'tax wedge' which affects behaviour. It acts as a disincentive to Australian companies expanding globally and the resulting lack of capital import neutrality is a significant impediment to Australia's international economic development at two levels. Businesses raising new capital or employing existing capital need a neutral setting in the Australian tax system. Also, businesses need a realistic after tax return to enable them to compete offshore.

Section 3 of this report illustrates the tax wedge, for an Australian company which operates in a comparable-taxed foreign country, and distributes all of its income to Australian shareholders at various tax rates, including:

- A superannuation fund taxable at 15%
- An individual taxable at the 30% mid-rate plus Medicare levy and
- An individual taxable at 46.5% being the top tax rate plus Medicare levy.

The tax wedge, being the total tax paid on foreign operations as compared with the total tax paid if the company operated wholly in Australia, is:

Australian Shareholder marginal tax rate	15.0%	31.5%	46.5%
Effective Tax Rate including company and shareholder taxation, if company earns only Australian-source income	<u>15.0%</u>	<u>31.5%</u>	<u>46.5%</u>
Effective Tax Rate including company and shareholder taxation, if company earns income taxed in foreign country, taxed at 39%	48.2%	58.2%	67.4%
Tax Wedge for shareholder arising from international income in comparably-taxed country, as compared with Australian-tax income	33.2%	26.7%	20.9%

Australian companies typically conduct business overseas through foreign entities, principally through foreign companies. However, the existing Australian imputation rules result in double taxation where a company pays dividends, sourced from foreign profits which have been taxed in an offshore jurisdiction, to Australian shareholders. Because dividends paid by Australian companies from foreign source income cannot be franked, this results in extremely high total tax. A dividend that is sourced from underlying profits earned by an Australian group in a comparable-tax country, such as the US, that is paid to a top-rate Australian shareholder can result in a total effective tax rate of over 67% as shown above, compared to a 46.5% tax rate for dividends paid out of underlying profits earned in Australia.

This long-running issue is becoming increasingly relevant as more Australian businesses derive increasingly greater proportions of their income from overseas. The international focus has been seen in large Australian companies for many years. However they have been supplemented by a significant increase in the international engagement of many smaller businesses. This is no longer a ‘big end of town’ issue as many medium sized entrepreneurial businesses have a global orientation from early in their lifecycle. Thus Australia’s opportunities to have an efficient and prosperous entrepreneurial sector are affected if the outcome of Australia’s tax system is double taxation on offshore income.

The factors driving the current global business focus include:

- a) Australia represents only about 2% of the global economic activity. Consequently, Australian businesses seeking to develop their sales must look to international operations. This is relevant for larger Australian companies whose domestic growth is constrained by competition and other regulatory constraints, for example in certain manufacturing and financial services sectors. It is relevant also for specialist businesses where the achievement of a credible size and presence compared with international competitors requires international engagement to build scale, for example in the IT and services sectors.
- b) With the globalisation of manufacturing and operation of international supply chains, Australian business is taking up the increased opportunities to become involved in international activities.

The Ernst & Young Entrepreneur of the Year Awards, and the profiles of the finalists, illustrate how many entrepreneurial small to medium Australian businesses look overseas for growth opportunities.

This issue is linked to Australian innovation. Australia's future in an increasingly competitive global business environment must include use, internationally, of intellectual property, development of brands, application of biotechnology applications, development and international use of secret processes and technology. All of these activities require some form of overseas presence for Australian companies, which will typically attract overseas taxation.

While some tax planning strategies may in some cases reduce the potential adverse impact of double taxation, there is no simple, appropriate solution to the problem for Australian companies investing offshore.

1.2 Consequences – costs to business and inefficient business behaviours

This report examines some of the adverse impacts of delaying the implementation of these necessary reforms of Australia's international tax system:

- The inefficient tax policy affects how affected companies obtain their funds for growth.
 - An Australian investor, faced with a very high effective tax rate on dividend income, will be unattracted to investing in such a company by way of ordinary share capital. So affected companies may tend to use debt finance rather than equity, thus increasing their financial risk profile;
 - Shareholders' lower after tax returns on dividends from affected companies may require companies to pay out higher dividend rates, which will result in a higher cost of capital for such companies;
 - Companies might find that foreign investors in them will achieve more efficient after-tax investment outcomes than do Australian investors.
- Australian companies have a reduced incentive to pay dividends to Australian shareholders from foreign profits and indeed have an incentive to retain foreign profits offshore. It might be argued that this results in retention of capital in the company, but it also encourages various strategies to enable the investors to access the capital, and in effect results in an array of tax structuring to overcome the policy defect in the Australian tax system.
- If Australian companies find it more efficient to source foreign capital to develop their businesses this will add to the incentives for them to consider relocating their home base.
- Australian companies will increasingly find it more tax efficient to licence their intellectual property to overseas companies than to build their own international business activities.
- Australian companies may seek out low-taxed intermediate locations through which to carry on international business; and other foreign tax planning and structuring instead of focusing management attention on their inherent business growth.

The outcomes adversely impact the behaviour of Australian business and the growth of Australian entrepreneurialism and innovation. The outcomes also create inefficiency and costs which act as a dead weight for Australian business.

1.3 Recommendations by Board of Taxation and Ralph Review

After an earlier recommendation by the Ralph Review of Business Taxation in 1999, this issue was again reviewed in 2003 by the Board of Taxation.

The Board recommended in 2003 that Australian companies operating offshore and subject to offshore taxation should be permitted, when they pay dividends to Australian shareholders, to offer the shareholders a partial non-refundable imputation benefit by way of a 20% franking offset. Whereas companies earning Australian taxed income can offer a franking benefit (in relation to franked dividends) equal to the underlying Australian tax paid at a 30% rate, the Board recommended that the credit in relation to foreign income should be set at a 20% assumed tax rate.

Following an extensive consultation process, submissions from the Business Council of Australia and the business community generally, this measure was recommended to address the inefficiency and lack of equity between Australian companies which must operate globally in order to grow their activities, and those which operate on a purely domestic basis.¹ Nevertheless the discounted 20% franking rate in relation to foreign-source income retained a benefit for companies generating their income in Australia.

However, the Government deferred consideration of the Board's recommendation in the 2003 Budget, and it has yet to be adequately addressed. This issue received no mention in the reference, on 10 October 2006, to the Board of Taxation to examine various Australian international tax anti-deferral rules, but is at least as significant for Australia's business community.

Comparable countries have taken action to deal with the taxation of entrepreneurial companies operating globally, wanting to bring foreign profits to the home country and pay them out as dividends to investors. The US, UK and Germany have introduced various reforms to improve the tax treatment of dividends received by residents of those countries. Whilst those reforms have not been confined to dividends sourced from foreign income, with the consequence that a bias against foreign income may still exist, the reforms have operated to reduce the effective tax rates on dividend income in absolute terms. The enhanced neutrality of the taxation of capital has encouraged the efficient deployment of the nations' capital and savings².

The Australian imputation system has needed refinement to remove the inefficient bias regarding the employment of Australian capital. This was reported on in 1997 by the Ralph Review. The bias and inefficiency were reported in 2003 when the Board of Taxation recommended reform. The need for adjustment to harmonise the imputation system to Australia's long term interests is even more apparent in 2006 given the pace of globalisation and the increased importance of offshore presence for Australia's entrepreneurial sector.

1.4 Conclusion: Priorities for tax reform

The recommended and simplest solution is to implement the Board of Taxation's recommendation in the 2003 Review of Australia's International Tax Arrangements, for a non-refundable credit of at least 20% for unfranked dividends paid out of foreign source income (without any requirement to trace foreign tax paid or incurred), with the precise detail subject to consultation with business.

We recommend that the modelling of the revenue costs of this measure should treat this not merely as a tax expenditure but should take into account the significant efficiency and growth benefits that

¹ Refer to Chapter 5 of this Report for details of consultation, submissions and recommendations on this issue.

² Cross-reference to come to E&Y Feb 2006 report

would be expected to flow from this improved positioning of Australian business. In particular, government and Treasury should consider and should present to the public the dynamic modelling of this measure, taking into account likely business behavioural and second-order outcomes. This would ensure that there was no misperception of this proposal as having a revenue cost, without appreciation of the long run benefits.

Allowing at least partial recognition, under Australia’s dividend imputation system, for foreign taxes paid, as was comprehensively explored in 1998-99 by the Ralph Review of Business Taxation and again 2002-2003 by the Board of Taxation will preserve significant advantages for Australian companies operating in Australia.

Under the Board’s proposal, the 20% franking credit attributable to foreign-source income passing through an Australian company is less than the 30% franking credit for Australian companies paying dividends to shareholders from Australian activities. We estimate the remaining tax wedge, or incentive for Australian activities on the examples in section 3, as follows:

Australian shareholder marginal tax rate	<u>15.00%</u>	<u>31.50%</u>	<u>46.50%</u>
Effective Tax Rate including company and shareholder taxation, if company earns income taxed in foreign country, taxed at 39%	<u>39.00%</u>	<u>47.77%</u>	<u>59.20%</u>
The 20% franking benefit reduces the effective tax rate at the shareholder level, as compared with no imputation credit for foreign underlying taxation paid, by	9.15%	10.45%	8.20%
The remaining Tax Wedge for shareholders arising from international income in comparably-taxed country, as compared with Australian income, is	24.0%	16.3%	12.7%

It may be the case that after detailed modelling of this proposal by Treasury, and after further business consultation, a view is taken that a higher than 20% credit is both warranted and affordable, especially taking account of second-order outcomes.

Australia’s system of taxing Australian companies with international activities needs to recognise that Australia has moved beyond being a pure capital importing country. Australia’s tax system needs to recognise its needs as a capital exporter, building onto the many recent reforms of the controlled foreign company measures the above-mentioned adjustment of dividend taxation.

2 Australia's tax system must not discourage international activities by Australian business

2.1 Australian business has a strongly international orientation

Australian business has adopted a strong global orientation since the 1980s. This has involved a progressively stronger focus by smaller, fast-growing entrepreneurial businesses, supplementing the larger listed public companies which were the initial leaders in international orientation.

Australian business is moving from a focus principally on purely domestic business activities to businesses investing in overseas subsidiaries and entities to develop their business activities.

Australian businesses have a multinational orientation and investments for a range of reasons:

- a) Because Australia represents approximately 2% of global economic activity, some businesses expand overseas to fully develop their business operations and gain scale.

Business activity is global and growing businesses, in Australia and overseas, look to 'bolt-on' acquisitions to expand their global reach or their global store of products and processes.

Any business which is purely domestic in its focus is, in many industries, under-utilising its potential and is ripe for acquisition by an acquirer with a broader vision and a broader range of activities in which the target and its intellectual, intangible and physical assets can be used.

- b) Some businesses undertake foreign direct investment primarily to source low cost manufacturing or service provision. As Treasury Secretary Dr. Ken Henry has stated:

"It is pretty well accepted these days that Australia's economic interests have been well served by trade liberalisation and globalisation. And yet, even in this country, the accelerating liberalisation of trade in services has attracted the pejorative label of 'off-shoring', with India usually identified as the winner and the industrialised world, Australia included, as the loser.

'Off-shoring' used to be called importing. And that is what it is: importing services. It is true that India gains from being able, because of ICT developments, to export services to the industrialised world. The ICT revolution, initiated in Silicon Valley, and considered by many to have given America 'new economy' status in the 1990s, turns out to be a precious gift to the people of India. But the industrialised world, Australia included, also has much to gain from 'off-shoring' – most obviously through a lowering of costs to business and, ultimately, consumers.

Opposition to 'off-shoring' is based on the same protectionist nostrums that were once used to support the high tariff wall that a generation of Australian policy makers has been busy dismantling. It may be dressed in different garb, but it is no more respectable."

The market opportunities arise across the entire spectrum of Australian business from:

- Manufacturing, where specialist Australian manufacturers can supply global markets;
- Service industries, where Australian expertise, design and other skills can add significant value globally; and

- Financial services, where Australian talented financial experts and advisors can replicate Australian initiatives internationally and apply their experiences and skills (for example in industries such as infrastructure, development and financing, engineering and architectural services, accounting and legal services).

Expanding globally carries significant business risks and is not tax-driven. The risks include not having:

- The right human capital within the organisation;
- The right business processes and management structures to manage foreign operations; and
- Full appreciation of foreign business methods, regulatory regimes and cultures.

The international orientation is not about a flight of business to lowest-wage or lowest-cost countries. The opportunities and international development of Australian businesses is across the entire spectrum of:

- comparable-tax countries and comparable-wage countries, such as US or UK or Europe, where Australian businesses can establish new business activities or acquire businesses,
- lower-tax countries, with investment incentives or permanent lower taxes, or
- lower-cost countries, some of which are not offering large tax incentives, which are engaging with global business and commerce.

These issues are very relevant for Australia's technology companies:

"Australia's resurgent technology sector has turned its attention to growing international revenues as barriers to enter global markets erode.

A number of listed technology companies said during the 2006 financial reporting season that more than 50 per cent of revenues had come from expanding offshore operations, despite the pitfalls of funding international ventures.

... Andrew Green, chief executive at the Australian Private Equity and Venture Capital Association Limited (AVCAL), said more Australian companies were establishing their headquarters in North America, which remained the proving ground for IT companies.

Companies ... had established headquarters in the US to be close to their biggest customers. "People build machines in Sydney, and put corporate headquarters in North America, and from there they drive Europe," Mr Green said.

... Harvest Road managing director and founder Graeme Barty said more than 85 per cent of the company's revenue now comes from overseas markets.

Mr Barty said historical barriers to conducting business overseas, such as the tyranny of distance or the absence of a free-trade agreement, no longer seemed to be an issue."³ 4

Some Ernst & Young 'Entrepreneur of the Year' winners and nominees illustrate this international orientation:

Peter Hosking and Tony D'Antonio of Global Machinery Company

Winner - National EOY: Overall Winner 2005, Finalist - World EOY 2006

³ "Firms pack bags and head offshore" Mark Jones and Rachel Lebihan with John Davidson, Australian Financial Review, 26 September 2006,

In 1996, both Peter Hosking and Tony D'Antonio left their jobs as senior executives at a power tools company to set up their own small business. Their 'small business', which set out to design, develop, market and wholesale domestic power tools under the name of GMC Power Tools, has achieved \$250 million in annual revenue within just eight years.

While still a relatively young business, GMC has grown quickly both domestically and internationally, having faced some initial hurdles. Their 'nothing to lose' attitude and willingness to do a deal for limited profit in order to build strong relationships quickly saw their business take off. With rapid growth, the duo realised that they could expand the business globally.

Today, GMC Power Tools has a team of design engineers in Australia and the UK creating original and innovative power tools sold not only to the major retail outlets in Australia but throughout the USA, and the UK.

Simon Brown of Resourceco

Growing a concrete crushing business into a resource recovery and processing conglomerate.

Resourceco continues to operate a contract division across Australia and has recently developed a state-of-the-art facility based in Melbourne. Resourceco has also formed a joint venture with an American company that has the Australasian rights to turn key waste to energy facilities.

Simon is focused on delivering future growth at Resourceco from reducing waste to landfill through processing opportunities leveraging the intellectual property developed over the last ten years at facilities throughout Australia and the Asia Pacific.

Mike Cannon-Brookes & Scott Farquhar of Atlassian

Developing software tools for knowledge workers, primarily in task tracking and knowledge management

At just 26 years of age each, university friends Scott Farquhar and Mike Cannon-Brookes have created an international technology house serving 3,000 clients in 60 countries. With two main products: JIRA – an issue tracking, workflow and project management tool; and Confluence – a knowledge sharing tool for teams in large organisations, their expertise touches hundreds of thousands of people globally in many well-known organisations.

With teams now in Sydney, San Francisco and Los Angeles, Atlassian is now one of Australia's largest software exporters, with some 90 per cent of sales to North America and Western Europe. Scott and Mike were named IT Professionals of 2004 by Consensus and in 2005, Atlassian was named by *BRW* magazine as Australia's fastest growing software company.

Scott and Mike are also active in their community and recently launched the Atlassian Foundation, formalising the company's commitment to ethical business, employee empowerment and charitable works.

Leigh Jasper & Robert Phillpot of Aconex

Providing secure, easy-to-use online management services for the storage, exchange, and tracking of project-related information in the construction, resources, and property management industries.

The company serves 25,000 client organisations in 40 countries with 130 full-time staff across 21 international locations. In 2004 Aconex signed three of the company's largest projects to date – a casino resort in Macau; London's White City shopping complex; and the Dubai Burj Residences. Their current projects under management are valued at around \$80 billion and the business is doubling in size every year.

In 2005 Aconex won the Master Builders Association Exporter of the Year award and was the only Australian company listed on Software 500, a listing of the largest software companies and suppliers in the world. Also in the same year Aconex was placed 14th in the 2005 *BRW* Fast 100.

In addition, as recently reported in the BRW (11 January 2007 edition) as a result of globalisation, many start-up firms are “born global” in nature. That is, they see the world as their market from day one, as well as servicing domestic customers. According to the Global Entrepreneurship Monitor, produced by Hindle and O’Connor at Swinburne University, a higher proportion of start-up firms expect more than 50% of their customers to come from other countries compared to established businesses.

2.2 Australia’s tax policy must not discourage international orientation

Against this backdrop it is important to resolve this inefficient feature of the Australian tax system, which provides a tax disadvantage for international activities carried on by Australian companies or entities through entities located in comparable-tax foreign countries.

This tax barrier is well-intentioned, but it results in an element of ‘protectionist nostrum’ (to use Dr Henry’s words) akin to a tariff barrier. Several detailed reports have recommended reducing if not dismantling this barrier, and this report recommends a strong focus on reducing the foreign tax barrier.

The Australian government deserves credit for modernising Australia’s international tax environment. The reform of Australia’s international tax arrangements (RITA) followed the Board of Taxation’s review in 2002-3, building on the earlier work of the Ralph Review of Business Taxation. It has been necessary to remove barriers to Australian businesses’ international activity, that caused some international investors to bypass Australia for certain activities and which meant that Australia was not maximising its opportunities.

The Government has remained committed to delivering most RITA reforms and has gone beyond the Board of Taxation recommendations in some areas to enhance the tax competitiveness of Australia.

However, the need for Australia’s international tax reform has not ended, particularly for Australian-owned companies operating internationally.

Given the globalisation of business, it is critical that Australia’s tax system does not provide impediments to Australian businesses seeking to engage in international business.

While Australia has been reforming its own international tax system, so have other countries. The period since the late 1990s has seen increasing focus on international competitiveness if not competition from a tax perspective. This has arisen because the developed countries’ advantages have been progressively challenged by emerging countries in various ways:

- Low (but rapidly increasing) labour costs are found in, for example, China, India and South East Asia and the greater engagement of low-labour-cost countries from the former USSR;
- Pools of highly educated and talented individuals skilled in knowledge-intensive work tasks are available in India and Taiwan and are now being joined by those in China, and
- Emerging countries continue to seek competitive advantage to attract inward investment and increased global economic relevance through tax concessions such as lower tax rates (e.g. Ireland and the recent experience of the new countries from the former USSR).

These trends, coupled with increased globalisation of business, fuelled by reducing tariff barriers, innovations in transport and communications and the removal of other impediments to business, make for a very competitive environment. This has led to the growing significance of international

trade especially in human and financial capital. Large businesses increasingly segment their activities, picking added value activities and locating these globally in supply chains of their own subsidiaries or of business partners. As a result, trade exchange and economic connection with the global economy have become ever more important for Australia.

The selection of locations of business activities and specialist functions is generally biased towards countries where businesses can gain a comparative advantage (or reduce a comparative disadvantage) and tax is one of the advantages or disadvantages that comes into this equation.

Recognition of these factors, which drove the Australian cycle of international tax reform, is also driving ongoing tax reforms in other jurisdictions. Competitively-driven tax developments are now a feature of well developed countries such as:

- the US;
- the UK;
- Germany and other EU and OECD countries.

As a result, it is important for Australia in its international tax reform assessment not to become complacent and to recognise that there are further challenges for reform in tax and non-tax regimes.

Against that backdrop it is surprising that Australia's residence-based taxation system, overlaid over the Australian dividend imputation system, has not been fine-tuned for 20 years to reduce the bias against international engagement by Australian business.

Australia's international tax system needs to be fine tuned to ensure appropriate neutrality for Australian businesses developing their international activities, to encourage:

- Australian technology and know how to be owned in Australia and based in Australia while being used internationally to the advantage of Australia's economy;
- Australian jobs to be created in the ongoing development of Australian head quarters of global companies, with employment opportunities directly within the companies and also in related service and general activities.

This report does not suggest dismantling Australia's dividend imputation system. The dividend imputation system has served Australia well in reducing the duplication of taxes as between companies and their shareholders in relation to domestic activities. Dividend imputation has resulted in the strong growth by Australian investors of investment in Australia's capital markets, which has strengthened the Australian economy.

2.3 Australia's tax wedge against international activity

However, within the context of Australia's continuing dividend imputation system, some fine tuning is necessary to address the tax barrier or tax "wedge" which disadvantages of Australian-based companies which carry on business activities in overseas comparable tax countries.

This "international growth wedge", which is explored in the next section, has some highly inappropriate consequences:

- a) The disadvantage is greater for lower taxed shareholders in Australian companies than it is for higher taxed shareholders. In other words, if a 15%-taxed superannuation fund invests in an Australian company which conducts business overseas (as distinct from investing in another company wholly focussed on domestic activities) there is a tax disadvantage to the Australian

superannuation fund. This disadvantage is greater than that for an investor at the maximum tax rate, as discussed at section 3 and the Appendix;

- b) This disadvantage is greater where the Australian company invests in a comparable taxed foreign jurisdiction such as the UK or US or Europe, than if it invests in a low-taxed jurisdiction (because the foreign tax is lower and thus the Australian tax disadvantage is reduced).

3 How Australia's tax system increases effective tax rates on foreign source income

3.1 A 20-year-old policy setting in need of modernisation

Australia's tax policy settings for Australian businesses which operate internationally have contained a structural bias in favour of domestic activities since the dividend imputation system was introduced in 1986.

Australian companies can fully frank the dividends which they pay to shareholders, as franking credits can only arise from the payment of Australian company tax.

When Australian companies establish foreign corporate entities as part of their necessary foreign direct investment, they face the double taxation of foreign earnings when these are distributed to Australian investors. Australia's dividend imputation system provides no recognition of the foreign underlying taxes paid by the foreign entities, with the result that dividends paid to Australian investors from foreign sourced and foreign taxed income are treated as unfranked dividends. Australian investors are subject to ordinary taxation on the dividends, with no recognition of the foreign underlying taxes paid.

This additional tax for Australian shareholders in Australian companies operating overseas represents a 'tax wedge' and the policy impact is significant.

This tax wedge is magnified when Australian companies establish corporate entities in comparable taxed countries than where Australian companies operate in low taxed foreign jurisdictions. So this Australian policy promotes the following policies by business, which operate internationally in comparable-taxed countries:

- a) where possible, pay tax in Australia by appropriate structuring of the foreign activities. The reason for this is that the Australian tax payments will maximise the imputation benefits for shareholders when the Australian company distributes dividends to shareholders;
- b) if it is not feasible to pay all taxes in Australia, (for example because the activities need to be located reasonably proximate to the foreign investment destination) to structure the international business to use a tax haven in the geographical vicinity, so as to reduce the foreign taxes and their inefficient outcomes for ultimate Australian shareholders.

Unfortunately, this tax barrier to international investment by Australian companies has not altered in the 20 years since the imputation system was introduced, notwithstanding the significant increased international engagement by Australian business.

In the 20 years, other countries which introduced imputation systems or other mechanisms for reducing double taxation at the company and individual tax levels have modified their systems to reflect the internationalisation of business. This has seen a range of policy actions to introduce partial imputation systems; or to allow flow through taxation of foreign sourced dividends to investors; or eliminate imputation systems.

Australia has seen no refinement of this policy setting in relation to imputation, despite:

- business concern for over a decade;

- the recommendations of the Ralph RBT in 1997-99, the Business Council of Australia and businesses generally in the 2001-2003 period⁴, and the recommendations of the Board of Taxation in respect of RITA in 2002-2003.

3.2 Calculating effective tax rates on foreign source income

This section analyses the precise tax cost of the Australian policy settings, and identifies the disadvantages suffered by Australian companies expanding into offshore jurisdictions and deriving foreign income from such activities that are subject to foreign tax (whether creditable or not).

This section also addresses the proposition that reform may not be necessary because Australian businesses, particularly small unlisted businesses, can structure their arrangements to avoid many of the double-taxation disadvantages associated with deriving foreign income. This section demonstrates that tax structuring options are limited in their potential application, complex and involve significant costs and uncertainty in multiple jurisdictions. We question therefore whether a reliance on tax structuring is appropriate when the underlying policy needs to be adjusted.

A number of alternative structuring arrangements are modelled below. The effective tax rates that can result from the alternative arrangements are as follows:

		Effective tax rate	Tax Wedge for 46.5%-taxed investor
Base Case	Business conducted in Australia through an Australian company	<u>46.5%</u>	
	Business conducted in US through a US company owned by an Australian company	67.4%	20.9%
	Business conducted in US through a US company owned by an Australian trust	67.4%	20.9%
	Business conducted in US through a US company with a royalty charge by Australian company	46.5% - 60%+	Varies
	Interposed tax haven company	50% - 60%	Varies

The tax wedge is higher where the Australian investor is a superannuation fund taxable at 15%. More detailed calculations in the Appendix show the tax wedge at three different tax rates – 15% for superannuation fund investors, the 30% typical tax rate, and the 46.5% tax rate for higher income investors.

3.3 Base Case: Business wholly in Australia with domestic income

An Australian company, AusCo operates in Australia only. AusCo is owned entirely by Australian resident individual shareholders. It is assumed the shareholders are on the top rate of tax (46.5%).

AusCo generates \$1,000 of pre-tax profits. These are subject to the company tax rate of 30%. The remaining profits are able to be distributed by AusCo by way of a fully franked dividend to its Australian resident shareholders.

Australian sourced profits	1,000
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⁴ Citation to the White Paper of 2000, various BCA reports

Australian company tax at 30%	<u>300</u>
Distributable profits	<u>700</u>

The net amount of the after-tax profits is distributed to the shareholders.

The effect on individual shareholder on 46.5% marginal tax rate is as follows:

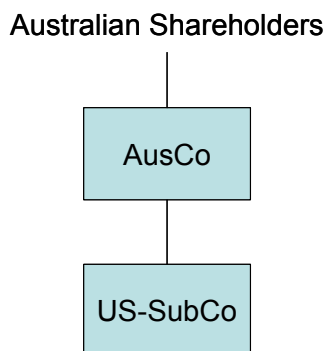
Cash dividend received from AusCo	700
plus franking credits	<u>300</u>
Amount included in shareholder's assessable income	<u>1000</u>
Shareholder's tax liability (46.5% rate)	465
less franking credit offset	<u>300</u>
Income tax paid	<u>165</u>
After tax income received	<u>535</u>
Effective tax rate:	<u>46.5%</u>

3.4 Australian company conducts business or uses a subsidiary in comparable taxed country

We now consider the situation where AusCo identifies a business opportunity in a comparable tax country and operates through a company to conduct the business. For convenience the country selected is the US.

3.4.1 Foreign subsidiary company

Assume that AusCo establishes a 100% owned US subsidiary company, US-SubCo. AusCo is owned entirely by Australian resident individual shareholders. The structure is as set out in diagram below:



US-SubCo generates \$1,000 of pre-tax profits. The profits of US-SubCo are subject to an effective tax rate assumed to be 39%⁵. The remaining profits are distributed to AusCo by way of dividend which is not subject to US dividend withholding tax⁶.

⁵ Assumed US Federal corporate tax rate of 35% plus state tax of 4% (which may vary depending on the particular states in which the operations are carried on) imposed on the taxable income.

⁶ No tax is withheld from the dividend pursuant to Article 10(3) of the US Treaty

US profits	1,000
US Corporation tax at 39%	<u>(390)</u>
Distributable profits	610
US Dividend withholding tax	—
 Net dividend received in Australia	 <u>610</u>
 Total US tax is \$390 on profits of \$1,000, with an effective tax rate of	 39%.

AusCo generates no income that is subject to tax at a 30% rate. The dividend received from US-SubCo is exempt from further corporate income tax in the hands of AusCo⁷:

Australian sourced profits	-
Dividend from US-SubCo (exempt)	<u>610</u>
	610
Australian company tax at 30%	—
Distributable profits	<u>610</u>

The net amount of the repatriated profits from US-SubCo is distributed to AusCo's shareholders. As the dividend income is not liable to Australian income tax it would not give rise to franking credits and does not allow distribution of the foreign source income as a fully franked dividend.

The effect on individual shareholder in AusCo on 46.5% marginal tax rate is as follows

Cash dividend received from AUS-SubCo	610.0
plus franking credits	<u>—</u>
Amount included in shareholder's assessable income	<u>610.0</u>
Shareholder's tax liability (46.5% rate)	283.7
less franking credits	<u>—</u>
Income tax paid	<u>283.7</u>
 After tax income received	 <u>326.3</u>
 Effective tax rate:	 <u>67.4%</u>

We have modelled the impact of this disadvantage at three tax rates:

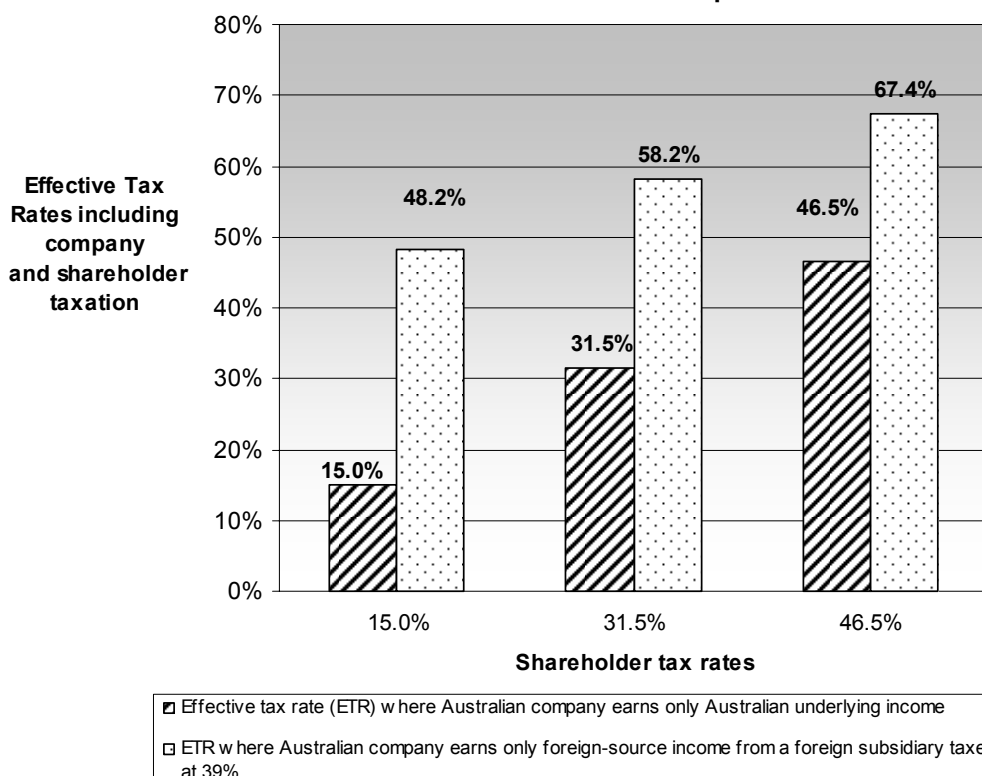
- 15% tax rate applicable to superannuation funds investing in Australian companies;
- 30% tax rate applicable to Australians on middle incomes; and
- 46.5% maximum personal tax rate.

The tax wedge is significant, and is as follows:

⁷ The dividend income is exempt under s 23AJ in the hands of AusCo

Investor tax rate	Tax Wedge for shareholder arising from international income in comparably-taxed country, as compared with domestic income
15% tax rate applicable to superannuation funds investing in Australian companies;	33.2%
30% tax rate applicable to Australians on middle incomes; and	27.3%
46.5% maximum personal tax rate.	20.9%

Effective Tax Rates for shareholders receiving income by way of dividends from Australian companies



3.4.2 Foreign Branch of Australian company

Assume that, as an alternative to using a US subsidiary company, the Australian company decides to operate directly in the US through a US branch.

The result is little different because the US branch income is subject to US company tax, and the US company tax is not recognised for Australian dividend imputation purposes. The tax outcomes are as follows in the hands of the company:

US position	
US profits	1,000
US Corporation tax at 39%	<u>(390)</u>
Distributable profits after US tax	<u>610</u>
Australian tax position	
US Branch income (exempt ⁸)	610
Distributable profits	<u>610</u>

and the effect on individual shareholder in AusCo on 46.5% marginal tax rate is as follows

Cash dividend received from AUS-SubCo	610.0
plus franking credits	<u>-</u>
Amount included in shareholder's assessable income	<u>610.0</u>
Shareholder's tax liability (46.5% rate)	283.7
less franking credits	<u>-</u>
Income tax paid	<u>283.7</u>
After tax income received	<u>326.3</u>
Effective tax rate:	<u>67.4%</u>

3.5 Impact of these policy settings where a company is used

As can be seen the net effect of operating in the US is a sharp increase in the total amount of tax suffered by the Australian resident shareholders. The increase is almost 22% in comparison with the base case scenario, and will if nothing else:

- Reduce the funds flow available to Australian shareholders if they are interested in receiving dividends from the Australian company;
- Affect the dividend yield calculations for Australian shareholders. This will be the case whether or not the company is a private or public company.

3.6 Can structuring overcome these tax disadvantages?

It might be argued that the ability of the Australian company to attract funds will be affected by its profile as a growth company, not just by dividend yield. However, the imposition of a significant tax detriment, absent the shareholders selling out their investments, must affect the attitude of investors to participating in the company. In particular, if an investor is focussed on accepting lower dividend yield in the interests in growth, the investor might have a greater tendency to sell out of the company when the investor needs liquidity.

It might also be suggested that this aspect can be planned around and alternative strategies developed. We explore below some possible responses of the shareholders and management of AusCo assuming that the Australian company had determined that the structure of having dual companies was inappropriate and alternative tax planning strategies were to be considered.

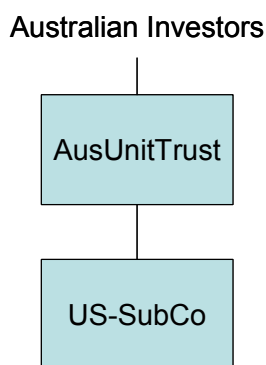
⁸ Foreign branch income of an Australian company is exempt under s.23AH

3.7 Alternative plan – Using Australian trusts

3.7.1 Australian trust owns a US company to do business

The first alternative structure for consideration is to use an Australian trust to hold shares in the US company, thus doing away with an Australian company over the US subsidiary.

An Australian resident trust, AusTrust would hold 100% of the shares in US-SubCo. Assume that a resident beneficiary, who not under any legal disability, would be presently entitled to the whole of the income of the trust estate. This structure is as set out in the following diagram:



US-SubCo generates \$1,000 of pre-tax profits. Again, the profits of US-SubCo are subject to an effective tax rate assumed to be 39%. The remaining profits are distributed to AusTrust by way of dividend which is subject to US dividend withholding tax of 15%⁹.

US profits	1,000.0
US Corporation tax at 39%	<u>(390.0)</u>
Distributable profits	610.0
US Dividend withholding tax 15%	<u>91.5</u>
 Net dividend received in Australia	 <u>518.5</u>
 Total US tax is \$481.50 with an effective tax rate of	 \$1,000 48.2%.

The net amount of the repatriated profits from US-SubCo is distributed to the resident beneficiary.

A trust, other than a corporate unit trust or a public trading trust is not a franking entity and may not therefore frank a distribution.

The effect on the individual beneficiary of the trust estate is as follows:

Share of the net income of the trust	<u>610.0</u> ¹⁰
--------------------------------------	----------------------------

⁹ The reduced dividend withholding tax rate of 5% and 0% under the US treaty only applies to corporate beneficial shareholders that satisfy certain prescribed conditions. The rate otherwise applicable is 15%.

¹⁰ The dividend received by the trustee is required to be grossed up and included in the net income of the trust estate calculated as if the trustee were a taxpayer and a resident.[s 95, 6AC(1)]

Assessable income	<u>610.0</u>
Beneficiary's tax liability (46.5% rate)	283.7
Less foreign tax credit ¹¹	<u>91.5</u>
Income tax paid	<u>192.2</u>
After tax income received	<u>326.3</u>
Effective tax rate	<u>67.4%</u>

So the use of a trust as the holding entity achieves no improvement, because there are dual layers of tax – US company tax and Australian personal tax.

By comparison, if an Australian trust was operating on a purely domestic Australian basis, and the trust derived taxable Australian sourced income which is distributed to the resident beneficiary, the effect on resident individual beneficiary of the trust estate would be as follows:

Share of net income of the trust	<u>1,000</u>
Amount included in beneficiary's assessable income	<u>1,000</u>
Beneficiary's tax liability (46.5%)	465
less franking credits	<u>-</u>
Income tax paid	<u>465</u>
After-tax income received	<u>535</u>
Effective tax rate	<u>46.5%</u>

3.7.2 Australian trust operates through a foreign branch to do business

Assume that, to attempt to do away with the Australian dividend imputation trap US layer of company tax, a unit trust is used to directly derive foreign income (that is, ignoring US-SubCo), in an attempt to better access any foreign taxes paid by the trust if the trust can be treated as flow-through entity for income tax purposes.

This might produce better effective tax rates in some cases, where the interests in the Australian trust are not held by an Australian company. If an Australian company were taxable on the foreign trust income it would, when declaring dividends to its own shareholders, be unable to confer any franking benefits in relation to the foreign taxes paid.

The foreign tax position will depend on whether the trust is treated in the foreign jurisdiction as a tax-transparent “look through” entity, with income assessed to the Australian individual holders, or whether it is taxed in the foreign jurisdiction as a company. Assume for simplicity that it is accepted as a tax-transparent entity and the Australian individual investors are taxable directly in the foreign jurisdiction.

US position	
US profits	1,000
US individual tax (assumed) at 40% ¹²	<u>(400)</u>

¹¹ 6AB(3)

Distributable income after US tax	<u>600</u>
Australian tax position	
Distributable income (net)	<u>600</u>

The Australian beneficiary's income is as follows:

Share of gross income of the trust	<u>1,000</u>
Amount included in beneficiary's assessable income	<u>1,000</u>
Beneficiary's tax liability (46.5%)	465
less credit for US taxes	<u>(400)</u>
Australian income tax paid	<u>65</u>
After-tax income received	<u>535</u>
Effective tax rate	<u>46.5%</u>

However the structure is subject to a number of limitations:

- i) The use of an Australian trust structure achieves no benefit if an Australian company is the holder of the trust interests. This is because an Australian company will be taxable on the foreign trust income but will, when declaring dividends to its own shareholders, be unable to confer any franking benefits in relation to the foreign taxes paid. In other words the outcome will be similar to the foreign-branch situation discussed above at 3.4.2.
- ii) From an Australian tax perspective using a unit trust to conduct a business raises the prospect of the application of the public trading trust rules in Division 6C of the Income Tax Assessment Act 1936. The public trading trust rules may apply where:
 - the trust carries on a business which breaches the fairly narrow 'eligible investment business' test (which is essentially limited to holding or trading in passive investment assets); and
 - the unit trust is a public unit trust (listed, more than 50 unitholders and/or 20% of the value of the trust was held by one or more "exempt entities" such as a complying superannuation fund).

If these rules apply then a unit trust would be taxed like a company, with the result that the general pitfalls outlined above would apply.

Division 6C is a significant issue if, for example, the trust had external investors such as venture capital investors which had a material proportion of superannuation fund investment.

- iii) More significantly, conducting significant businesses through an Australian unit trust or discretionary trust is not optimal if the Australian business wishes to bring in additional investors, particularly international investors, in the future. Where foreign investors or business partners are concerned, the use of a trust adds significant difficulty in explaining the intricacies of Australian trust taxation and legal implications to foreign investors.

¹² US individual tax rates, like Australia's, involve marginal tax rates and depend on whether the individual is filing returns as a single or married taxpayer. As well, State taxes are imposed at various rates in different states. To simplify the assumptions we assume a 40% all-up US tax rate)

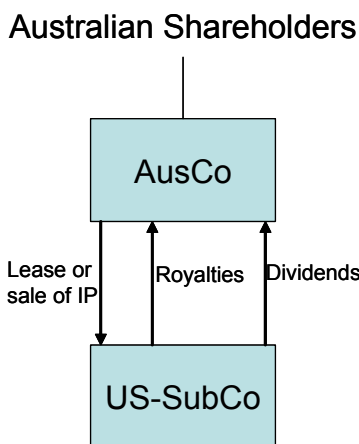
Even if a trust is acceptable during the period in which a business is unlisted and operates in a semi-private manner, if a business is to be floated in an initial public offering, a trust structure is inappropriate and a corporation should be used.

Consequently, trusts are not a simple solution for Australian investors seeking to invest in active foreign business ventures. The use of an Australian trust structure to carry on international business is not a satisfactory response to the concerns expressed by Australian business in relation to this policy weakness in the Australian imputation legislation.

3.8 Alternative plan – Use of royalties from US company which carries on business

The next structure considered is an attempt to minimise the amount of income subject to foreign comparable taxes by utilising a licence arrangement with the Australian company. Under such an arrangement the Australian company, assuming that it has intellectual property which is capable of licensing to a US entity, might sell or licence the intellectual property (IP) to US-SubCo, receiving a royalty which would be tax deductible in the US.

Assume that an Australian company, AusCo has a 100% owned US subsidiary company, US-SubCo. AusCo is owned entirely by Australian resident individual shareholders. AusCo derives royalty income from US-SubCo as consideration for the use of certain rights granted by AusCo to US-SubCo.



As the cameo below demonstrates the total effective tax rate attributable to royalty income might be 49.17%, but the royalty cannot be used unconditionally or automatically to withdraw all profits from comparable-taxed countries. Foreign countries’ transfer pricing regimes limit deductions for royalties and similar fees and depending on the precise nature of the intellectual property and services provided by an Australian company to its foreign subsidiary, and the nature of the subsidiary’s activities, a royalty planning structure can range from a significant royalty to very little.

We analyse two situations below.

3.8.1 Attractive situation: If a royalty can be sustained to extract 75% of US-SubCo’s income

Assume that the market value of the intellectual property provided can support a royalty of \$750 under the US and international tax transfer pricing tax rules.

The income of US-SubCo would be as follows:

US Income	1,000.00
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Less: Royalties paid to AusCo	<u>-750.00</u>
Remaining US income of US-SubCo	250.00
US Taxes (39%)	-97.50
Dividend paid by US-SubCo	152.50

The royalties paid to AusCo by US-SubCo would be subject to US withholding tax of 5% on the gross amount.

The balance of the profits of US-SubCo would be paid as a dividend to AusCo. AusCo does not derive any other income.

The Australian company would then receive a mix of income – the US-sourced royalty income and a dividend from the US-SubCo after-tax income. These two segments of income are analysed individually and then the combined position is shown.

(i) Looking at the US-sourced royalty flow the AusCo position is as follows.

Position of AusCo	Royalty	Cash position
Royalties received from US-SubCo	712.50	712.50
Gross-up for US tax withheld ¹³ at 5%	<u>37.50</u>	
	<u>750.00</u>	
Australian company tax at 30%	225.00	
less foreign tax credit ¹⁴	<u>-37.50</u>	
	<u>187.50</u>	<u>187.50</u>
Distributable profits	<u>525.00</u>	<u>525.00</u>

The effect on individual shareholders at a 46.5% marginal tax rate of the royalty component is

Partly franked dividend received from AusCo attributable to royalty component	525.00
Franking credit	187.50
Taxable income	<u>712.50</u>
Shareholder's tax liability (46.5%)	331.31
Less franking credit offset	<u>-187.50</u>
Tax payable	<u>143.81</u>
After-tax earnings	381.19
Effective tax rate	49.18%

(ii) The effective tax rate on the dividend from US-SubCo as computed at section 3.4 above, is 67.4%.

(iii) Combining the two elements of income, on the basis that:

- the royalty component attracts a total effective tax rate of 49.17% and
- the non-royalty component attracts a total effective tax rate of 67.4%

¹³ s 6AC(1)

¹⁴ s160AFC

the total combined effective tax rate will depend on the percentage the royalty comprises of the US company's pre-tax earnings. If a 75% royalty was feasible, the combined effect of the tax position on the US-sourced royalty flow and the dividends from the underlying US income is as follows.

	Royalty	Remaining Foreign Income	Total tax recognition
Position of AusCo			
Royalties received from US-SubCo	712.50		712.50
Gross-up for US tax withheld ¹⁵ at 5%	<u>37.50</u>		
	750.00		
Dividends received from US-SubCo		152.50	152.50
Australian company tax at 30%	225.00		
less foreign tax credit ¹⁶	<u>37.50</u>		
	<u>-187.50</u>		<u>-187.50</u>
Distributable profits	<u>525</u>	<u>152.50</u>	<u>677.50</u>

And the effect on individual shareholders at a 46.5% marginal tax rate of the royalty component is:

	Tax calculation	Cash position
Partly franked dividend received from AusCo	677.50	695.50
Franking credit	187.50	
Taxable income	<u>865.00</u>	
Shareholder's tax liability (46.5%)	402.23	
Less franking credit offset	<u>-187.50</u>	
Tax payable	<u>214.73</u>	<u>214.725</u>
Net Cash remaining after taxes	<u>462.78</u>	<u>462.78</u>
Effective tax rate	<u>53.7%</u>	

This effective tax rate of 53.7% compares with a domestic income effective tax rate of 46.5% as previously outlined – so the maximum effective rate has fallen from the 67.4% maximum rate but is still almost 8% higher, for shareholders, than if the company were operating domestically.

3.8.2 Less attractive situation: Royalty can extract only 50% of US-SubCo's income

Assume that the market value of the intellectual property provided can only support a royalty of \$500 under the US and international tax transfer pricing tax rules.

The income of US-SubCo would be as follows:

US Income	1,000.00
Less: Royalties paid to AusCo	<u>-500.00</u>
Remaining US income of US-SubCo	500.00
US Taxes (39%)	195.00
Dividend paid by US-SubCo	305.00

¹⁵ s 6AC(1)

¹⁶ s160AFC

The royalties paid to AusCo by US-SubCo would be subject to US withholding tax of 5% on the gross amount.

Assume that the balance of the profits of US-SubCo would be paid as a dividend to AusCo. AusCo does not derive any other income.

Taking into account the combined effect of the tax position on the US-sourced royalty flow and the dividends from the underlying US income the combined position for AusCo is as follows.

	Royalty	Remaining Foreign Income	Total
Position of AusCo			
Royalties received from US-SubCo	475.00		
Gross-up for US tax withheld ¹⁷ at 5%	<u>25.00</u>		
	500.00		
Dividends received from US-SubCo		305.00	
Australian company tax at 30%	150.00		
less foreign tax credit ¹⁸	<u>25.00</u>		
	125.00		
Distributable profits	<u>350.00</u>	<u>305.00</u>	<u>655.00</u>

The effect on individual shareholders at a 46.5% marginal tax rate is

Partly franked dividend received from AusCo	655.00	655.00
Franking credit	125.00	
Taxable income	<u>780.00</u>	
Shareholder's tax liability (46.5%)	<u>362.70</u>	
Less franking credit offset	-125.00	
Tax payable	<u>237.70</u>	<u>-237.50</u>
After-tax income	417.30	417.30
Effective tax rate	<u>58.3%</u>	

So the effective tax rate has risen, on this analysis, to 58.3%, a margin of over 10% higher than the Australian tax rate.

3.8.3 Limitations on using a royalty strategy

This strategy is subject to several limitations. These include:

- a) A licensing strategy to the foreign jurisdiction is effective only if the Australian company has intellectual property capable of being licensed for a substantial royalty or licence fee.
- b) The licence fee payable by the foreign company is subject to foreign transfer pricing rules, denying a tax deduction to the foreign subsidiary if the licence fee is in excess of arms length licence fees. Depending on the profile of the Australian company and its intellectual property, the licence fee may be constrained in amount. As the proportion of the foreign income that is covered by a royalty diminishes, so does the effectiveness of the arrangement as a means of overcoming the double taxation on foreign income.

¹⁷ s 6AC(1)

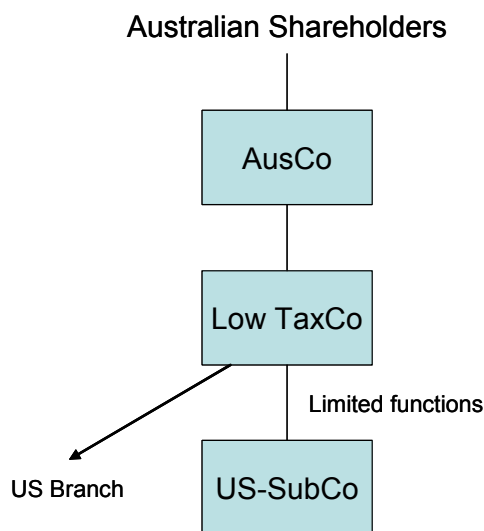
¹⁸ s160AFC

So, depending on the value of the intellectual property and the relevant licence fee subject to US transfer pricing rules, the licence fee may not necessarily reduce the level of income subject to foreign tax. For example, if the Australian company enters the US to undertake a major commercialisation of its property, and the US marketing activities contribute substantially to the value of the company and the revenue flow, then the licence fee may be limited in scope as compared with the total profits of the US company.

3.9 Alternative plan – Use of low-taxed countries to do US business

Another approach for consideration is to use a company located in a low tax jurisdiction, and to structure the sales into the comparable tax so that they generate the lowest possible comparable tax profit. Various techniques might be considered in this context, including the conversion of the comparable tax activities to commission arrangements or other limited function activities.

This structure is set out as follows:



However these measures are themselves subject to significant limitations:

- a) The development of appropriate commission arrangements might, depending on the industry, still leave major income in the US company.
- b) The commission arrangements or other involvement of the low tax jurisdiction will be subject to US transfer pricing rules.
- c) The involvement of an interposed country will obviously add to the operating expenses of the Australian company in order to structure its affairs correctly. This may prove to be a barrier to adoption of this technique.

3.10 Other potential structures

In the Business Council of Australia’s 2001 White Paper, there was specific consideration given to some potential structuring options that may alleviate the problems that were under consideration (franking credit wastage for Australian income distributed to non-residents and double taxation on foreign source income distributed to Australian residents).

The structures considered were:

1. relocation of residency of listed company
2. dual listed stapled structures
3. dual company stapled structure
4. dual company non-stapled structures¹⁹.

Structure 1 was predicated on the basis that the Australian company was predominantly foreign owned, deriving predominantly foreign income. In such circumstances the migration of Australian residency may be commercially appropriate.

Structures 2 to 4 were predicated on the basis that there was:

- a mixture of domestic and foreign income; and
- a mixture of foreign investors and Australian investors.

In respect of scenarios which matched the above requirements, there were issues as to whether various anti-streaming rules may apply.

However, those structures do not resolve the double tax issue in respect of a typical scenario of an Australian owned company investing overseas. We submit that the abovementioned structures would not provide any relief against double taxation for an Australian resident shareholder in such circumstances. Such limitations were clearly identified in the BCA White Paper²⁰.

Consequently, such sophisticated structuring arrangements should be disregarded (or at least significantly discounted) when considering the merits of the proposal for imputation credits for foreign source income.

3.11 Recommendations over the years to remedy this problem

This issue is not new. Recommendations to government, recommending a reform of this policy setting, have now flowed from both the Ralph Review of Business Taxation in 1997 and the Board of Taxation in 2003. These recommendations are considered at section 5 of this report.

¹⁹ Refer to paragraph 3.8, page 44.

²⁰ “Are dual listed companies sufficient to resolve the issue”, paragraph 3.14.2, page 54.

4 How other countries deal with the bias against foreign income and encourage remittance of foreign income

The international trend has been to provide investors with relief from double taxation through either:

- The provision of a credit to individual shareholders equal to a proportion of the value of the dividend, regardless of the actual amount of tax paid at the company level, or whether that dividend income comes from domestic or foreign sources; or
- A reduced rate of personal income tax on dividend income.

Such reforms have helped various countries to reduce the effective rates of tax imposed on dividend income, and reduce the inherent bias that an Australian style imputation regime creates against investment in resident companies with international activities.

4.1 United States

In the United States (US), dividends, interest income and capital gains are considered portfolio income and are generally taxed at the ordinary rates.

However, dividends received by individuals from domestic corporations and "qualified foreign corporations" are treated as net capital gains for the purposes of applying the capital gain tax rates for both the regular tax and the alternative minimum tax. Consequently, dividends are taxed at a rate of 15% (5% for taxpayers with income in the lower brackets)²¹. This concession is available under certain temporary rules which became effective recently in 2003 and which have been extended to 2010.

To illustrate, assume a wholly owned Australian subsidiary (AusCo) of a US company (USCo) earns income of \$1,000 in an income year. The after tax position for a US individual investor would be as follows:

Treatment of AusCo

Australian taxable income	1,000.00
Less: Australian company tax (30%)	<u>-300.00</u>
After-tax income	<u>700.00</u>

²¹ To qualify for the 15% tax rate, the shareholder must hold a share of stock for more than 60 days during the 120 day period beginning 60 days before the ex-dividend date.

Treatment of USCO

Assume further that AusCo makes a fully franked dividend payment of \$700.00 to USCo. AusCo would not be required to withhold any tax from the payment²². In the hands of the US parent, the dividend income would be exempt and attract a hypothetical all-up US 39% corporate tax rate.

Foreign income	700.00
Gross up for foreign tax	<u>300.00</u>
Taxable Income	<u>1,000.00</u>
Less: US taxes (assumed 39%)	<u>-390.00</u>
Foreign tax credit	<u>300.00</u>
Net US tax	<u>90.00</u>

Treatment of US Investor

The remaining 61% would be distributed to the US company's shareholders who would pay tax at 15% (assuming the dividend constitutes qualified dividend income).

Dividend to US investor	610.00 ²³
US tax paid by individual investor, maximum rate for qualified dividend	<u>-91.50</u>
After-tax dividend	<u>518.50</u>
Total tax paid on underlying income	481.50 ²⁴
- as a percentage	48.15%

4.2 United Kingdom

In the United Kingdom (UK), companies are subject to tax on foreign income but may claim credits for foreign withholding tax. Relief from foreign underlying tax is available in three ways:

- Unilaterally;
- Under the EC Parent-Subsidiary Directive; or
- By exemption.

Each form of relief requires the satisfaction of numerous conditions.

Resident individuals are entitled to fixed rate credits in respect of dividends received from domestic companies equal to 1/9th of the dividend. This fixed rate credit applies regardless of the source from which the dividend is paid.

To illustrate, assume a wholly owned Australian subsidiary (AusCo) of a UK company (UKCo) earns income of \$1,000 in an income year. The after tax position of a UK Individual shareholder would be as follows:

²² Franked dividends are excluded from the withholding tax rules under s.128B(3)(ga) ITAA 1936

²³ Dividend to US investor = Aus taxable income less Aus tax less US corporate tax = 1,000 – 300 – 90 = 610

²⁴ Total tax paid = Aus tax + US corporate tax + US individual tax = 300 + 90 + 91.50 = 481.50. This amount is exclusive of US state and local taxes.

Treatment of AusCo

Australian income	1,000.00
Less: Australian company tax (30%)	<u>-300.00</u>
After-tax income	<u>700.00</u>

Treatment of UK Co

Assume further that AusCo pays a fully franked dividend of \$700.00 to its UK parent (UKCo). The Australian subsidiary would not be required to withhold any tax from the payment²⁵. In the hands of UKCo, the dividend income would be taxable at 30% (assuming the large companies rate applies).

Net Dividend received	700.00
Add: Foreign tax paid	<u>300.00</u>
Gross Dividend Taxable	<u>1,000.00</u>
UK tax payable (assumed 30%)	300.00
Less: Foreign tax relief	<u>-300.00</u>
Additional UK tax due	<u>0.00</u>
Net dividend paid from UK Co	<u>700.00</u>

Treatment of UK Investor

The distribution from UKCo to the UK resident shareholders will include a notional (non refundable) tax credit equal to 1/9th of the dividend. This can be offset against the UK resident shareholder's total tax liability. The UK resident individual shareholder will be taxed at either 10% or 32.5% on the dividend income depending on the level of their other income. The table below assumes the individual will be taxed at 32.5%.

Dividend to UK investor	700.00
Plus Notional tax credit (1/9 th of dividend)	<u>77.78</u>
Total income	<u>777.78</u>
Tax payable (assumed at 32.5%)	252.78
Less: Notional tax credit	<u>-77.78</u>
Additional tax due	<u>175.00</u>
Net after tax proceeds	<u>525.00</u>
Total tax paid on underlying income	475.00
- as a percentage	47.5%

The granting of fixed rate credits creates a measure of equity for UK resident shareholders as the credit is applied irrespective of whether the dividend has been subject to foreign or domestic tax. In this respect, the UK model provides greater equity than the existing Australian imputation regime.

The above figures assume that the double tax relief available to UK Co exactly matches the liability it has on that income. Due to the accounting treatment and the UK's double tax relief rules this may not always be the case.

²⁵ Franked dividends are excluded from the withholding tax rules under s.128B(3)(ga) ITAA 1936

4.3 Germany.

Recent changes to Germany's tax regime have seen the following relevant reforms:

- Corporate profits are subject to:
 - Local income tax imposed by municipalities.
 - (1) The rate varies from 13% to 20.5%, depending on the municipality. Trade tax is deductible as a business expense and is generally imposed at 18.37% on major commercial centres.
 - (2) Trade tax exemptions are available for dividend income derived from certain non-portfolio investments in foreign subsidiaries with underlying active income.
 - Corporate income tax rate of 25% which is not creditable;
 - Solidarity Surcharge of 5.5% imposed on corporate income tax rate paid;
- A flat rate of 5% of domestic and foreign dividends are included in the assessable income of a company recipient (no credit is granted for any foreign withholding tax);
- 50% of a domestic or foreign sourced dividend received by a resident individual is exempt from income tax.

Depending upon the particular arrangement, there may be a tax incentive for resident individuals to invest directly in non-resident companies to enjoy the benefit of foreign tax credits. This is due to the fact that German resident companies are unable to claim credit for foreign dividend withholding tax.

To illustrate, assume a wholly owned Australian subsidiary (AusCo) of a German company (GerCo) earns income of \$1,000 in an income year. The after tax position of a German individual shareholder would be as follows:

Treatment of AusCo

Australian income	1,000.00
Less: Australian company tax (30%)	<u>-300.00</u>
After-tax income	<u>700.00</u>

Assume further that AusCo pays a fully franked dividend of \$700.00 to GerCo. AusCo would not be required to withhold tax from the dividend payment²⁶.

The German parent would then include 5% of the dividend payment in its assessable income and pay tax at the German corporate tax rate of 25%.

²⁶ Franked dividends are excluded from the withholding tax rules under s.128B(3)(ga) ITAA 1936

Treatment of GerCo

Foreign dividends	700.00
Foreign income included in assessable income (5% of foreign dividend)	35.00
Less: Trade Tax (35 * 18.37%)	- 6.43
Less: Corporate Tax (28.57 * 25%)	- 7.14
Less: Solidarity Surcharge (7.14 * 5.5%)	- 0.39
After-tax income (700 - 13.96)	<u>686.04</u>

Treatment of German Investor²⁷

The German company would then distribute its after tax income (21.04) plus its non-taxable income (665.00) to its shareholders. Half of that dividend payment would be deemed to be exempt income, with the shareholder paying tax on the other half at their marginal rates.

Dividend to German investor	686.04
50% of dividend received assessable income of German investor	343.02
German tax paid by German investor at maximum marginal rate 42%	- 144.07
Solidarity Surcharge (5.5% on income tax paid)	- 7.92
After-tax dividend (191.03 + 343.02)	<u>534.05</u>
Total tax paid on underlying income	465.95
- as a percentage	46.59% ²⁸

²⁷ Assumption that individual taxpayer is not subject to trade or church tax.

²⁸ 46.22% if trade tax exemption were to apply at corporate level.

5 The bias confirmed: Ralph Review, Treasury and Board of Taxation

This bias in Australia's international policy setting is well known and confirmed. Recommendations to Government proposed a reform of this policy setting, from both the Ralph Review of Business Taxation (RBT) in 1998-99 and from the Board of Taxation in 2003.

5.1 Review of Business Taxation views in 1999

The RBT report titled *A Tax System Redesigned* contained recommendations in respect of some of the international tax problems highlighted in *A Platform for Consultation*.

The RBT considered this issue and stated that:

“the current imputation arrangements provide a credit to resident individual shareholders for company tax paid on Australian source income (resulting in franked dividends) but levy a layer of domestic tax on distributed foreign source income. Hence foreign taxes are ignored when personal income tax is levied on dividends paid by resident companies out of foreign source income. While there is only one layer of Australian tax levied on distributed dividends, foreign tax has the potential to discourage offshore investment relative to domestic investment. This may be contrary to Australia's best interests given the increased opportunities for Australian entities to invest profitably overseas. A growing number of large public companies in Australia derive an increasing proportion of their income from overseas. In many cases they have outgrown the Australian market place and have expanded offshore.”

It recommended a partial solution²⁹, that imputation credits of up to 15 per cent of repatriated dividends be provided for foreign dividend withholding tax (DWT) paid, including for DWT paid on repatriated exempt dividends.... The RBT stated that an imputation credit for foreign DWT (up to a maximum of 15 per cent of the dividend)

“will:

- partially remove the current imputation system's bias that discourages foreign investment over domestic investment, including where the underlying risk adjusted rates of return are identical;
- provide a benefit to resident shareholders of companies deriving significant foreign source income - irrespective of the number of foreign shareholders - by converting some unfranked dividends into franked dividends;
- reduce the extent to which foreign dividend withholding taxes can discourage the repatriation of profits from offshore;
- achieve comparability with investments made directly by Australians in foreign companies (currently Australian individuals can claim a foreign tax credit for DWT if they invest in a foreign company either directly or via a resident trust, whereas Australian-based multinational companies are unable to pass on a credit for DWT to their Australian shareholders); and
- maintain this flow through effect for foreign DWT under the proposed entity tax regime for investment offshore by Australian individuals via resident trusts...”

Additionally the RBT recommended³⁰ there should be no streaming of foreign source dividends. This meant that foreign source dividends not be allowed to be streamed to foreign shareholders

²⁹ Recommendation 20.1

³⁰ Recommendation 20.2

(and therefore franked dividends not be able to be streamed to Australian shareholders) and the extra layer of tax on foreign source dividends paid to Australian shareholders could be addressed by also allowing streaming of unfranked dividends out of foreign source income to foreign shareholders.

The RBT considered that allowing streaming of foreign source dividends to foreign shareholders “is estimated to have a greater revenue cost than providing imputation credits for DWT of up to 15 per cent. Furthermore, providing an imputation credit will benefit a wider range of entities - not only those with some franked income and some foreign shareholders. All entities will have an equal incentive to expand offshore into profitable ventures. If only streaming were allowed, entities with no foreign shareholders or franked income would receive no incentive.”

Similarly, the RBT recommendation that stapled stock arrangements should remain carried with it a proposition that there would be credits to the franking account, for the same policy reason.

So, even in 1999, the RBT recognised the trade-off inherent in this policy. The RBT:

- a) recognised that a less efficient mechanism should be preferred (absent streaming of foreign dividends); and
- b) that some adjustment of the dividend imputation system, even if only partial, was appropriate.

The Government deferred implementation of this measure until further review. One suspects that the Government may have been influenced by fact that the RBT estimated that it would have a cost of \$830m over a five year period. However, the more substantive reason is likely to be the fact that the Australia / United States double tax treaty was being re-negotiated at the time, and it could have been expected that the rate of foreign DWT could be significantly reduced. Given that the United States accounts for more than half of all Australian direct investment offshore, the validity of the need for a refund for DWT would have dissipated.

5.2 Board of Taxation 2003 Review of International Tax Arrangements– recommendations and Treasury paper

After the Business Council of Australia’s White Paper the Government asked the Board of Taxation to review an array of proposals for international tax reform.

The Treasury consultative document in August 2002³¹ identified the bias in relation to the interaction of dividends and franking:

“Table 2.1 examines an investment by a resident individual or superannuation fund through an Australian company, where the company can choose to directly invest domestically or offshore. It shows the difference in the pre tax rate of return required for alternative investments to achieve the same after tax return to the investor. Investments in comparable and highly taxed countries require a higher pre tax rate of return, reflecting a higher effective tax rate. However, for the individual, the investment in the low tax country provides a marginal tax advantage. This reflects tax deferral benefits from retaining profits offshore in a low tax country.

The general direction and extent of the possible overall tax bias for direct investments offshore by resident individuals or funds through an Australian resident company are summarised in Table 2.2.

³¹ Review of International Taxation Arrangements, A consultation paper prepared by the Commonwealth Department of the Treasury

Table 2.2: Summary of the overall tax bias on direct investment offshore

Direct investment in:	Nature and extent of tax bias as against a comparable domestic investment
High tax country	Clear overall tax bias against the direct investment offshore, arising from the high level of foreign tax and the imputation treatment of foreign source income. The higher the dividend pay-out ratio to the underlying resident shareholders, the greater the bias.
Comparable tax country	Some overall tax bias against the direct investment offshore arising from the imputation treatment of foreign source income. The higher the dividend pay-out ratio to the underlying resident shareholders, the greater the bias.
Low tax country	Overall tax bias in favour of direct investment offshore for individuals unless the dividend pay-out ratio to the underlying resident shareholders (or to the Australian parent if the host country is not 'listed') is high. Tax bias against the investment offshore is maintained for the superannuation fund.

The consultative document was cautious about the significance of such a bias for larger enterprises but Treasury, even in the consultative paper, tended to agree that smaller Australian fast-growing companies with an international orientation would be adversely affected by the bias.

“A tax bias against direct investment offshore funded by domestic equity capital would suggest that the cost of domestic capital for offshore investment is adversely affected (Table 2.1). However ... large, internationally recognised, Australian multinationals may have sufficient access to international capital markets such that the availability of franking credits for their resident shareholders may not significantly affect their cost of capital. For smaller Australian multinationals and companies considering offshore expansion, access to international capital markets may be more restricted, and the domestic capital market may be a more important source of funds. For these companies, often in the process of rapid expansion, the effect of any shareholder level tax bias against direct investment offshore may be more significant.”

The consultative paper set out three broad options for consultation:

“Option 2.1 for consultation: ... to consider three alternative options:

- A: providing domestic shareholder tax relief for unfranked dividends paid out of foreign source income;
- B: allowing dividend streaming of foreign source income; and
- C: providing franking credits for foreign dividend withholding taxes.”

The Board consulted widely and summarised submissions to it as follows:

“Evidence of the problem

- 2.20 The submissions argue that the imputation system penalises Australian firms expanding overseas, compared to firms deriving all their income from Australia. The penalty is demonstrated in a number of ways: for example, a higher cost of capital or lower share price (or price earnings multiple). At the extreme, the imputation system can become a significant factor in location decisions by Australian firms — not so much on the location of investment (as there is little choice beyond a certain firm size), but as to the company's residence.
- 2.21 It is difficult to do modelling work on this issue, so the submissions generally cite little direct evidence to support their view. However, they cite a number of indirect indications to establish the effect on the cost of capital. These include two sets of studies:

- studies on the value of imputation credits (indicating ranges generally of 40-60 per cent of face value); and
 - studies on the predominance of investment in resident companies by individuals and institutional investors, contrary to modern portfolio theory (which is usually explained by the better knowledge of investors about local firms).
- 2.22 The second group of studies also supports the argument that Australian multinational firms effectively have to compete with other Australian firms for capital in Australia. This puts them at a disadvantage due to their lower franking capacity compared to firms whose market is primarily in Australia.
- 2.23 The Board considers that there is sufficient evidence to support the view that the Australian capital market significantly affects the cost of capital of Australian firms, and further, that the capacity to frank dividends affects the cost of capital in that market.
- 2.24 Hence, the Board considers that the current bias in the imputation system towards domestic investment by Australian firms impedes the ability of Australian companies to attract equity capital for offshore expansion.”

Option 2.1.A was preferred, as retaining advantages for Australian companies to pay tax in Australia while allowing a reduced tax deadweight for Australian companies expanding offshore:

“2.36 Adding Option 2.1A to the imputation system retains the advantages of imputation. The imputation system generally encourages Australian firms to pay Australian tax so that dividends can be franked. Hence, most firms are less likely to aggressively tax-plan away Australian tax payments (although they are encouraged to plan conversion of foreign tax to Australian tax)...

2.39 Ultimately, the appropriate level of credit will depend on modelling its effect on the cost of capital. Revenue considerations will also play a part in deciding the level. Given the current state of knowledge, the Board considers that a modest but meaningful level of automatic credit is most appropriate. It may be possible in the future to devise a workable system that allows credits for actual tax paid, which would most closely reflect the policy underlying this kind of proposal....

2.41 The Board supports the view that the credit level would need to be set at a reasonably low rate. This is because it is provided without reference to foreign tax paid (which may be low in some cases); also, it would retain the benefits of imputation (noted above). However, the Board considers that a 10 per cent credit would be too low to have a significant impact on the cost of capital. Moreover, the Treasury Paper (Table 2.3) notes that virtually 80 per cent of Australia's direct foreign investment goes to the US, the UK and New Zealand (NZ), all of which have underlying tax rates (income tax plus state taxes plus withholding taxes) in excess of Australia's 30 per cent domestic rate.”

So the Board recommended:

- “(a) that domestic shareholder tax relief should be provided for unfranked dividends paid out of foreign source income derived after the commencement date; and
- (b) that the relief should be provided by way of a non refundable tax credit of 20 per cent and without any requirement to trace foreign tax paid or incurred.

Recommendation 2.1(2):

The Board recommends that the Government implement Option 2.1B to enable the streaming of foreign source income from an Australian parent company or through stapled stock arrangements from a foreign subsidiary, without adverse franking consequences (the Board does not recommend streaming between resident taxpayers).”

The Board considered that this approach would generate the following benefits:

- Reducing the cost of capital by removing the current investment distortion will allow Australian companies to more effectively deploy capital so that they can more easily achieve increased scale and the up-take of new technologies and business systems
- Removing tax-induced distortions in investment decisions will enable internationally-oriented Australian companies and investors in them to derive greater returns. Over time, this will force an increase in the productivity of Australian companies, flowing through to an increase in national income and the tax base.
- These recommendations remove the current bias against the repatriation of overseas income to Australian shareholders. A survey by the Productivity Commission³² found a low repatriation, which suggests that Australian businesses currently use a significant portion of foreign-sourced profits to build up international investments. By providing dividend relief, the Board's recommendations will remove the bias against repatriation and offshore investment relative to domestic investment by Australian business and shareholders.

The cost of such a recommendation was considered likely to be less than Treasury's estimated cost because of a possible permanent lift in the pay-out ratio of Australian companies and subsequent increase in the tax base, and an increase in the longer-term tax base as a result of the economic efficiencies achieved through this recommendation, providing opportunities for companies to achieve critical mass and earn a higher return on their savings, so that GDP and GNI will increase over time.

The Treasurer deferred the necessary action. He stated in his Press Release of 13 May 2003:

“However, after carefully considering the Board's views, the Government does not believe it is appropriate to implement these proposals at this time.

The Board noted that its recommendations reflect an ‘on balance’ judgement and concedes that there could also be negative effects from implementing these proposals.

The imputation system is an important feature of Australia's tax system that enjoys wide support amongst both business and shareholders. The Government does not rule out future consideration of the issues examined by the Board.”

5.3 Board of Taxation 2003 recommendations retain a bias towards Australian companies generating Australian taxable income

The Board of Taxation recommendation for a partial imputation credit retains the elements of the dividend imputation system which continue to:

- foster investment in Australia by Australian companies,
- encourage Australian companies to pay taxes in Australia rather than overseas, and
- address any concerns which might exist about protecting the Australian revenue base.

It is clear from our analysis³³ that when the proposal for an imputation credit for foreign income based on:

- a hypothetical 20% foreign tax rate
- and which is non-refundable,

³² Productivity Commission, *Offshore Investment by Australian Firms: Survey Evidence*, Commission Research Paper, 2002, p. 28.

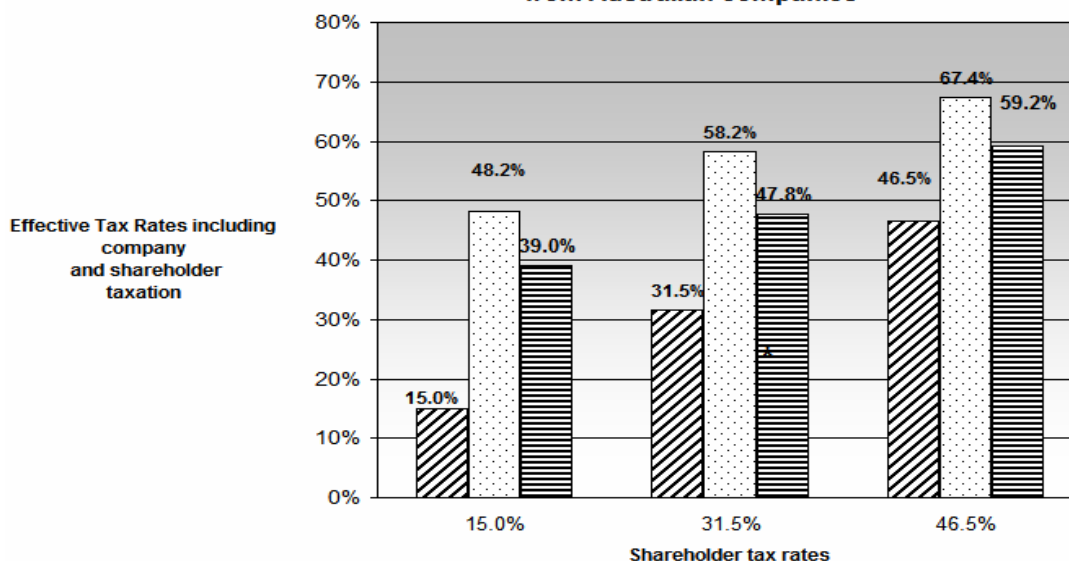
³³ Detailed calculations are in the Appendix

is compared with the taxation outcomes which would arise from a fully refundable imputation credit for Australian income, based on Australia’s 30% imputation credit, that there is still significant Australian tax imposed on Australian residents who receive dividends attributable to foreign income.

We calculate the Tax Wedge on foreign income generated by Australian companies, even if the Board’s proposal were adopted, as follows

Australian shareholder marginal tax rate	15.00%	31.50%	46.50%
Effective Tax Rate including company and shareholder taxation, if company earns income taxed in foreign country, taxed at 39%	39.00%	47.77%	59.20%
The 20% franking benefit reduces the effective tax rate at the shareholder level, as compared with no imputation credit for foreign underlying taxation paid, by	9.15%	10.45%	8.20%
The remaining Tax Wedge for shareholders arising from international income in comparably-taxed country, as compared with Australian income, is	24.0%	16.3%	12.70%

Effective Tax Rates for shareholders receiving income by way of dividends from Australian companies



Effective tax rate (ETR) where Australian company earns only Australian underlying income
 ETR where Australian company earns only foreign-source income from a foreign subsidiary taxed at 39%
 ETR where Australian company earns only foreign-source income from a foreign subsidiary taxed at 39% with Australian imputation credit at a hypothetical 20% foreign tax rate

We reiterate that the Board of Taxation recommendation represents an extremely balanced recommendation, favourable to the interests of the Australian Revenue and Investment in Australia, and for that reason alone should be acceptable to Australian companies which continue to maintain a focus on domestic business.

As the Board of Taxation reported³⁴:

“Table 2 below ... illustrates the immediate effects of implementing the Board’s recommendation on the returns to companies, shareholders, governments and national income.... an overseas investment whose *pre-tax* rate of return is the same as that of the Australian investment (column 1) would now yield after-tax income much closer to, **although still below, that from the domestic investment.**

... where *post-tax* returns were equal under present taxation arrangements ... (for an overseas investment by an Australian company, assuming a shareholder at a 50% tax rate) after tax return now exceeds the 5.25 per cent from the domestic investment ... **However the 6.56 per cent is still well below the after-tax return (7.5 per cent) which would be derived from a domestic investment that matched the pre-tax return of 15 per cent here assumed for the overseas investment.**

The nature and desirability of these outcomes is canvassed in a number of the submissions to the Board. For example, the Australian Stock Exchange Ltd (ASX) considered that this reform would:

'reduce the effective marginal tax rate imposed on that FSI, thereby **reducing the disincentive for Australian investors to invest offshore through Australian multinational companies**'; and

□ 'reduce the cost of capital for those Australian companies with restricted access to international capital markets.'

(emphasis added by Ernst & Young)

This analysis shows that Australian companies will still find it attractive to pay their taxes, where possible, in Australia, in order to maximise the franking benefits for Australian shareholders.

5.4 Possible reasons for inaction

Why is there inaction? Possible reasons might include:

- a) A view that Australia has strong economic activity and there is no current overwhelming need to provide the concession;
- b) The (misconceived) suspicion that Australian businesses can restructure their affairs to deal with this issue, in Australia or overseas. However, as noted above, the structuring options have limitations and cannot suffice in all cases to counter the tax disadvantage for Australian companies;
- c) Concern that a more neutral policy setting might cause Australian businesses to invest overseas not in Australia and might ultimately reduce the tax revenue of Australia.

Irrespective of the reasons, the delay in dealing with this issue creates risks for Australia.

The chief risk is that by delaying action until it is seen to be unavoidable in the face of some future crisis or demonstrated loss of growth, Australia’s business development will be restrained. In particular, the risk is that Australian businesses will:

³⁴ Addendum to Chapter 1 of the report, pages 56 and 57

- a) be dissuaded from investing overseas by the tax inefficiency;
- b) will retain income in companies without distributing it to investors;
- c) will tend to leave Australia in pursuit of more tax-efficient structures;
- d) will continue to make tax-inefficient dividend distributions to investors but investors will tend to downgrade the companies for their reduced franking benefits. This may reduce the companies' relative attractiveness, unless the companies have other non-tax growth characteristics to attract investment.

This issue is masked or manageable for Australian companies which have strong Australian operations, paying Australian tax, sufficient to allow a 100% franked dividends or highly-franked dividends notwithstanding their foreign operations. Conversely this issue is more significant for Australian companies whose foreign operations generate the bulk of their profits, and the Australian income of which is insufficient to allow the needed franking attributes for the dividends to shareholders.

This issue is important for major listed public companies which find their international expansion causing pressure on their ability to pay fully franked dividends (that are typically preferred by share market investors).

Australian companies can maintain their attractiveness to Australian shareholders provided they have sufficient profits in their mature Australian business to continue to generate franking credits. If they do not, then Australia will remain a relatively unattractive location for companies growing offshore while their income generated overseas is effectively taxed twice – firstly overseas in the market where the income is generated and, secondly, in Australia when the profit is distributed to shareholders.

Moreover, the ongoing globalisation of both large multinational enterprises and in recent years, small and medium size entrepreneurial companies further exacerbate the problem with bias against offshore activities.

Is the marginal investor a foreign investor uninterested in franking?

There may be a view that no action is required in relation to this matter as Australian listed companies can source their capital requirements from global capital markets, so the marginal additional investor in an Australian company is a non-resident of Australia not interested in dividend imputation benefits. On this basis there would be no advantage to an Australian company in its capital raising strategies by allowing a more neutral setting in relation to foreign business carried on by Australian companies.

While the available survey material on this topic has conflicting views, the general view in corporate Australia is that the payment of franked dividends creates a significant advantage for Australian shareholders and is a significant attraction for Australian shareholders to Australian companies. It is clear that Australian managed funds are attracted to products which focus on franked dividend yields from Australian companies, Australian superannuation funds are attracted to companies paying franked dividend yields (in part to shield their exposure to taxation in relation to superannuation contributions received and other income) and lower income investors see franked dividends as an investment with a minimal or nil additional tax cost.

The dividend imputation system, and general investor presence, have meant that Australian companies tend to have high payout ratios, and there is not a US-style focus on retention of profits in companies.

Impact for unlisted and smaller companies

In any event, particularly when the analysis moves to emerging companies which are privately owned or which are early stage companies which have just been listed, it is difficult to sustain a proposition that the marginal additional investor is a non-resident.

However, this is a particularly challenging issue for companies which are strongly focused on international business and have less income subject to current Australian taxation or smaller buffers of franking benefits to frank their dividends.

5.5 Addressing integrity issues

This policy setting is governed by a range of factors, including:

- a) Ensuring ease of compliance, without taxpayers and indeed the Australian Taxation Office having to work through hugely complex chains of calculations in reaction to the foreign income suffered by Australian companies.

An alternative which would involve tracing of the actual foreign taxes paid would result in significant compliance for Australian companies and the ATO, and complex legislation also, to deal with foreign income which is paid through multiple tiers of foreign company structures, income which is retained in foreign structures for one or more years and is then paid, dealing with situations where foreign jurisdictions change their tax rates, and numerous other issues which complicate foreign tax credits calculations in Australia and overseas.

- b) Need for appropriate revenue integrity, and
- c) A desire to retain incentives for Australian companies to continue to operate in Australia.

The Board of Taxation therefore raised various issues for further development:

- a) The Board considered that a 10% credit (that is, a 10% deemed tax rate for purposes of a quasi imputation system) was too low and recommended “on balance... a non-refundable credit of 20% without any requirements to trace foreign tax paid or incurred.” However the Board noted that “to ensure that the level of relief remains relevant to future offshore expansion by Australian companies, the Treasury should conduct on-going modelling in conjunction with the business sector. The purpose would be to consider further developing the credit on the basis of its effect on the cost of capital of Australian companies that expand offshore.”³⁵
- b) The Board was conscious of the need to maintain the integrity of the Australian tax regime and set out a proposed mechanism for an account similar to the foreign income account in order to properly track the relevant foreign source income³⁶

Integrity of the Australian tax system is also maintained by:

- the continuing strong Australian rules for controlled foreign companies (CFC) as well as the rules for foreign investment funds (FIF) and controlled foreign trusts (CFT). The

³⁵ Paragraph 2.44 of the Board’s report.

³⁶ Para 2.45 of the Board’s report.

Australian CFC rules provide that income in low tax countries, which does not benefit from specific concessions aimed at active foreign businesses, is attributed to Australian companies' Australian income tax positions.

- Australia's strong transfer pricing rules to protect against taxpayers engaging in transactions involving foreign associates at uncommercial consideration.

Thus Australia's interests are appropriately protected. Similar issues arose in relation to the expansion of Australia's exemption for Australian companies of their dividend income from foreign non-portfolio investments. This exemption was originally available only in respect of dividend income from comparable-taxed countries, but was expanded in the course of the RITA 2003 announcements to dividends received from all non-portfolio investments, recognising that the abovementioned mechanisms counter inappropriate behaviour by Australian companies.

In any event, the integrity issues can be reviewed in the implementation of this policy.

6 Revenue Cost and impact of this reform

The assessment of this measure is influenced by the revenue costing and understanding the impact of the measure.

The Board of Taxation's 2003 recommendation included some costing material from Treasury but this material needs not only to be updated to 2006-2007 but also to be supplemented by clearer dynamic modelling of the measure, as discussed below.

6.1 Board of Taxation in 2003

The Board noted that, in the limited time it had, the Board was not able to undertake a full analysis of revenue implications of the changes it proposes. However, from the advice received — principally from the Treasury — the expected revenue costs (in a full financial year when measures are in full effect) were summarized, for the 20 per cent tax credit (Recommendation 2.1(1)) as \$350 million to \$400 million³⁷.

However the Board noted that this did not represent the true impact for Australia.

The Board noted;

“For the purpose of its assessment, the Board has accepted these Treasury estimates. The Board has not, in the time, conducted its own work. Nor has it examined the assumptions used for these estimates. As noted the impact of the costings will build up (generally) over 2 or 3 financial years before the full impact shown above. These estimates are being refined by the Treasury. ... From the work it has done, the Board considers that the benefits outweigh the costs...”

and:

“In the longer-term, therefore, the Board believes that the balance of benefits to be realised from its recommendation will be increasingly net positive over time, and will make the revenue costs worthwhile. The Board acknowledges that this is an 'on balance' judgement — in that investment within Australia by some companies will not be as great with the present bias removed as it would otherwise be, and there may be some economic costs as government finances are readjusted; and therefore, that it will take time for *net* benefits to come through that justify the budgetary costs. In reaching that on balance judgement, the Board sees as the key factors:

- reduced cost of capital for Australian companies wishing to expand overseas, only partly offset by an increased cost of capital for those remaining focused on domestic opportunities;
- reduced cost of capital for internationally-oriented companies wishing more readily to combat overseas competitors, to gain scale, to speed up the adoption of new technology and business systems and generally to operate more efficiently, including at home;
- benefits to Australian shareholders from the growth of Australian companies which otherwise would have been unable to grow at comparable rates domestically (again, these positive shareholder gains being only partly offset by *relatively* negative effects on the share prices of domestically-focused companies);
- increased repatriation of profits to Australia, thereby increasing the wealth of Australians and taxes paid;

³⁷ Executive Summary, page 14

- increased foreign investment, as the bias which makes Australian domestic investments relatively expensive to foreign investors and relatively cheap to Australians is reduced; and
- reduced levels of borrowing by Australian companies to finance foreign investment, thereby reducing risks and potential credit rating downgrades.

Over the longer-term, the impact on GNI and GDP from the Board's recommendation to provide limited dividend relief depends essentially upon 'supply side' effects — that is, how much more efficiently capital is used, both domestically and internationally, by Australian companies using Australians' savings. Removing the investment distortion will reduce the cost of capital and enable Australian companies to deploy their capital more effectively and make investments based on their intrinsic risk/return commercial characteristics. There may also be a defensive aspect, as ICAA emphasised in its submission

'For Australian global companies to retain Australian bases, and raise capital in Australian markets, is an important element in protecting the relationship of those companies with their Australian investors, and their ongoing activity in Australia.'

The benefits in terms of productivity and innovation by Australian companies and ultimately the income they earned in both their Australian and overseas operations for their shareholders, and in turn the Australian tax base, will of course depend on how companies and investors respond to the change.

While the Board's recommendation may conceivably result in increased offshore investment by Australians at the expense of some domestic investment by Australians that might otherwise have occurred, the Board considers, that in economic terms such an effect would be outweighed by the other factors discussed above.^{38,39}

6.2 Transparent Treasury forecasts

It is important, in progressing this reform, that the full economic impact is understood, and the presentation of the impact of this measure is not merely as a revenue cost without any presentation of the likely or potential economic benefits to Australia.

Publicly-released forecasts of the revenue impact of proposed tax reforms typically do not include estimates of the second round effects, due to the uncertainty surrounding the magnitude of those impacts. It is understandable and prudent practice not to formally include second round impacts in formal Budget forecasts. However, it is important in having public acceptance of reform proposals for the public to understand the potential future effects not immediately quantified..

Treasury and government do consider in their decision making the likely second round impacts of new policy proposals, including possible behavioural changes, benefits to particular sectors and industries and the economy. The impacts are sometimes discussed in testimony to parliamentary committees.

For example, when the Joint Treaties Committee was considering the US Double Tax Agreement, Treasury provided some discussion about its approach to identifying the net economic outcomes for Australia³⁹: and in testimony to the Senate Economics committee in respect of the renegotiated UK and Mexico agreements⁴⁰ a senior Treasury representative stated:

³⁸ Ibid., pages 58 and 59

³⁹ "The table is a comparative static exercise, and not economic modelling. It does not attempt to trace through the consequences of the Protocol in terms of cross-border investment levels, technology access, reduced cost of capital and economic growth and jobs. The table does however illustrate that the assumptions underlying the \$190 million revenue estimate support a conclusion that Australia has a static net gain from the Protocol. The expected increase in cross-border trade and investment should add significantly to that gain. "Extracted from Treasury letter included in

"The Treasury, perhaps conservatively, but along with longstanding practice and what is also a common practice in many countries ...take the first-round effect and publish that. We draw attention to the other effects - second-round effects, assumption driven effects or other things which we are less certain about but we have not incorporated them in the official costing ... For example, we may well publish a costing for the research and development tax concession, but of course the purpose of the research and development tax-concession is to create dynamic benefits in the Australian economy. We do not publish, and we do not seek to estimate, in our costing what those benefits are..

... the dynamic and other benefits to the Australian economy of these treaties will end up flowing through the parametric process that we use to estimate revenues. So it is two different processes doing a costing and doing a revenue forecast. Some of these benefits will no doubt implicitly be included in future revenue forecasts but they are not in the current ones. "

By comparison, to improve its tax reform forecasting processes, the United States Federal Treasury announced in February 2006⁴¹ a new 'dynamic analysis' division, seeking these benefits:

"Dynamic analysis, which incorporates the full gamut of behavioural responses, including how tax policy changes affect total output, has the advantage of emphasising the economic benefits of many of the President's tax policy initiatives. Dynamic analysis will also help frame the public dialogue on tax reform by highlighting its economic benefits."

The US Treasury has stated that "Treasury plans to continue to rely on their traditional approach for "official" estimates of the revenue effect of the tax proposals, and to present dynamic analyses as supplemental information⁴²."

So this increased transparency will not detract from the Budget and formal forecasting processes. However the increased transparency is significant to build proper understanding of this measure and its impact.

Hansard at Report 46 Treaties tabled 12 March 2002. Additional information provided by the Commonwealth Treasury 25 June 2002 <http://www.aph.gov.au/house/committee/jsct/12march2002/treasury.pdf>

⁴⁰ Senate Economics Legislation Committee Public Hearing Monday, 13 October 2003, Inquiry into the International Tax Agreements Amendment Bill 2003, testimony by Greg Smith, then Executive Director, Revenue Group, Hansard discussion commencing at page E14 <http://www.aph.gov.au/hansard/senate/committee/S6997.pdf>

⁴¹ www.treas.gov/offices/tax-policy/fact-sheet/Dynamic-Analysis-Office.pdf

⁴² Fiscal Year 2007 Budget Initiative: Division on Dynamic Analysis Office of Tax Policy, at <http://www.ustreas.gov/offices/tax-policy/fact-sheet/Dynamic-Analysis-Office.pdf>

Appendix

This Appendix contains the analysis of the effective Australian tax rate for various Australian shareholders in Australian companies, from investments undertaken by their companies, to identify the international tax wedge calculations under the current settings and in respect of the Tax Board recommendations.

The shareholders selected range across three different tax rates:

- The 15% shareholder represents a typical Australian superannuation fund;
- 30% shareholder represents a typical middle income Australian investor;
- The 46.5% tax rate investor represents a high income investor.

The calculations are in 3 sections.

The first section examines the after tax earnings from the company's activities wholly in Australia, where the company pays company tax on its entire earnings and distributes all earnings to shareholders. Because company tax has been paid the dividends to shareholders are franked dividends which are, under Australia's tax law, grossed up and the shareholders receive franking credits which are refundable against their other income.

As the chart below shows, the effective tax rate at shareholder level on the underlying income equate to the shareholders' own marginal tax rates.

Thus a superannuation fund pays only 15% on the underlying income (in fact it's net after tax income is greater than the actual cash dividend received) and other shareholders suffer tax at their own marginal tax rates.

Aust. Shareholder marginal tax rate	<u>15.0%</u>	<u>31.5%</u>	<u>46.5%</u>
Australian sourced profits	1,000	1,000	1,000
Australian company tax rate @30 %	300	300	300
Distributable Profits	<u>700</u>	<u>700</u>	<u>700</u>
Position of the Australian shareholder			
Cash dividend received	700	700	700
Franking Credits	300	300	300
Amount included in shareholder's assessable income	1,000	1,000	1,000
Shareholder's tax liability (46.5%)	150	315	465
less franking credit offset	300	300	300
Income Tax Paid	<u>(150)</u>	<u>15</u>	<u>165</u>
After tax income received	850	685	535
Effective Tax Rate including company and shareholder taxation	<u>15.0%</u>	<u>31.5%</u>	<u>46.5%</u>

This next segment shows the calculations in relation to the scenario at section 3.4.1, where the Australian company generates only foreign source income, through a foreign subsidiary in a comparably taxed country.

As noted in section 3.4.1 the country selected for this example is the USA and a 39% all up effective US tax rate is assumed (inclusive of an assumed state tax rate).

The calculations illustrate the effect of the Australian company and its shareholders receiving no franking benefit in relation to the foreign income tax in a comparably taxed country.

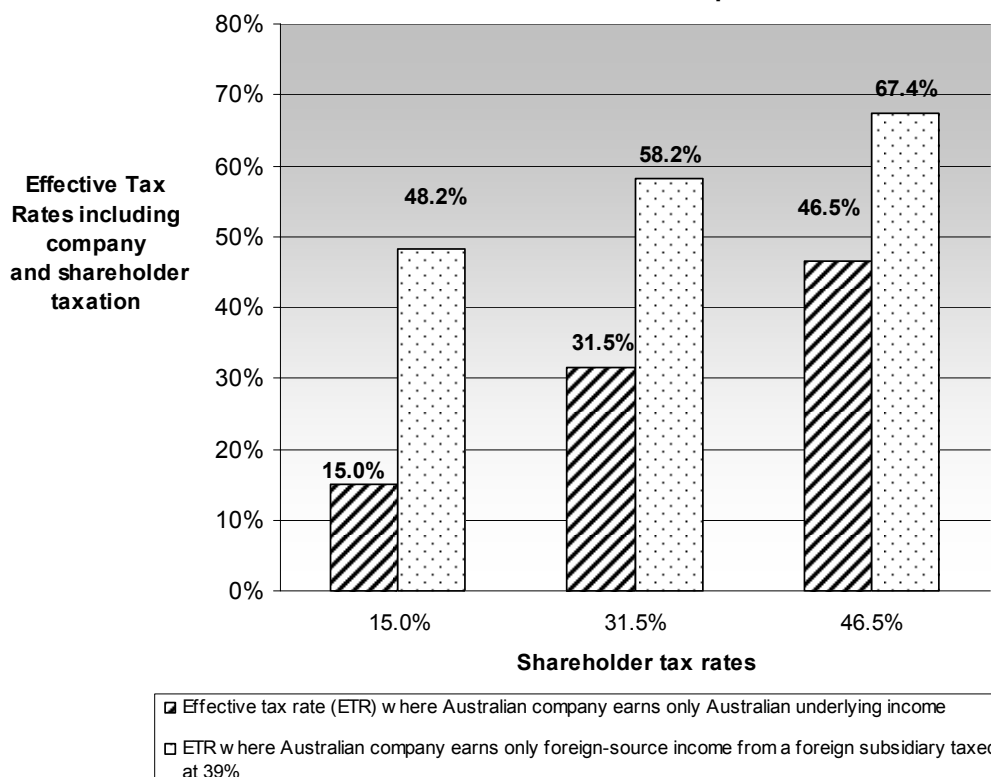
**Australian company wholly owned in Australia with a Foreign Subsidiary
Company which suffers a foreign tax rate of 39%, effect for shareholders under
current tax law**

Aust. Shareholder marginal tax rate		15.0%	31.5%	46.5%
Foreign Profits		1,000	1,000	1,000
Foreign Corporation tax	39%	390	390	390
Distributable Profits		610	610	610
Foreign Dividend withholding tax		0	0	0
 Net Dividend received in Australia		610	610	610
 Actual Total foreign tax		390	390	390
 Position of the Australian head company				
Australian sourced profits		-	-	-
Dividend from Foreign-SubCo (exempt)		610	610	610
		610	610	610
 Australian Company tax at 30%		-	-	-
Distributable Profits		610	610	610
 Position of the Australian shareholder				
Cash dividend received		610	610	610
plus franking credits		-	-	-
Amount included in shareholder's assessable income		610	610	610
Shareholder's tax liability		91.5	192.15	283.65
less franking credits		-	-	-
Income Tax Paid		91.5	192.15	283.7
 After Income Tax received		519	418	326
 Effective Tax Rate including company and shareholder taxation		48.2%	58.2%	67.4%

Summary of position before reform

Aust. Shareholder marginal tax rate	15.0%	31.5%	46.5%
Effective Tax Rate including company and shareholder taxation, if company earns only Australian-source income	<u>15.0%</u>	<u>31.5%</u>	<u>46.5%</u>
Effective Tax Rate including company and shareholder taxation, if company earns income taxed in foreign country, taxed at 39%	48.2%	58.2%	67.4%
Tax Wedge for shareholder arising from international income in comparably-taxed country, as compared with Australian-tax income	33.2%	26.7%	20.9%

Effective Tax Rates for shareholders receiving income by way of dividends from Australian companies



The differences are stark, particularly where Australian superannuation funds are involved. As compared with the 15% effective tax rate on Australian-sourced income, the superannuation fund investor will find an all up effective tax rate of 48.2% in relation to income sourced from the US, representing the compounding effect of the US taxes and Australian taxes.

The impact for shareholders at other tax rates is also shown.

As noted in the earlier discussion, this significant differential might be expected to cause Australian companies in this position.

The third section explores the implications for the three shareholder groups of adopting the recommendation made by the Board of Taxation in its 2003 report to Government on Reform of Australia's International Tax Arrangements.

This proposal, described generally as a 20% credit on dividends from foreign source income, in fact operates as follows:

- The mechanism operates in the same way as Australia's dividend imputation system;
- However, instead of the dividend gross-up and franking credit operating on a 30% tax rate attributable to Australian companies, the gross up and credit would operate at a 20% tax rate. The 20% tax rate, a discount to the Australian tax rate, would be paid irrespective of the source of the foreign profits.

As the calculations below illustrate, the Board of Taxation proposal would not remove entirely the benefit to shareholders arising from the company carrying on its business activities in Australia.

**Australian company wholly owned in Australia with a Foreign Subsidiary
Company which suffers a foreign tax rate of 39%, assumed imputation
credits at a deemed (automatic) tax rate of 20%**

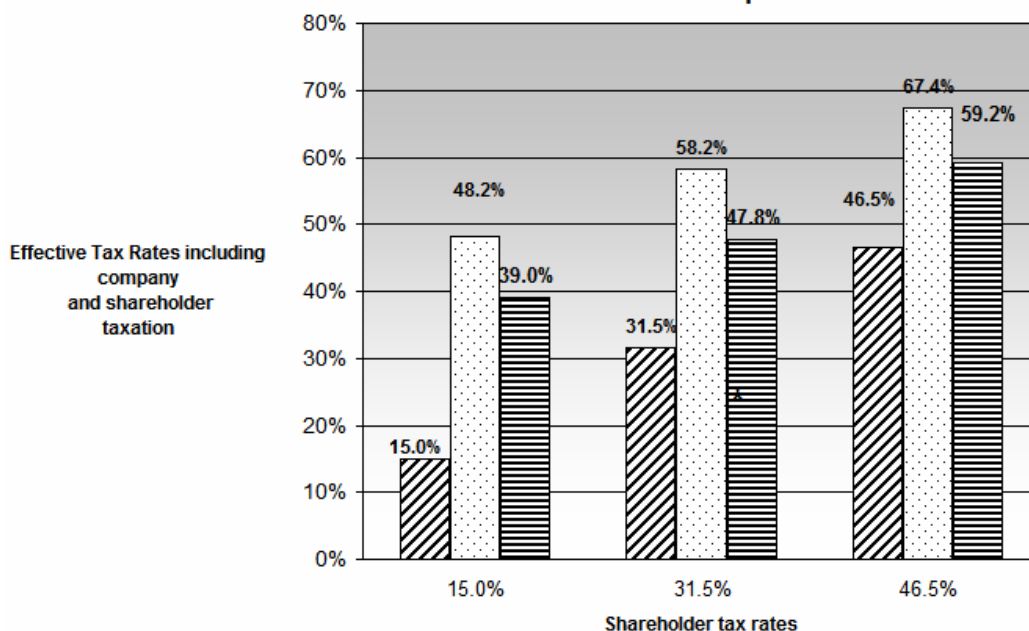
Aust. Shareholder marginal tax rate		<u>15.0%</u>	<u>31.5%</u>	<u>46.5%</u>
Foreign Profits		1,000	1,000	1,000
Foreign Corporation tax	39%	<u>390</u>	<u>390</u>	<u>390</u>
Distributable Profits		610	610	610
Foreign Dividend withholding tax		<u>0</u>	<u>0</u>	<u>0</u>
Net Dividend received in Australia		<u>610</u>	<u>610</u>	<u>610</u>
Actual Total foreign tax		39%	39%	39%
Position of the Australian head company				
Australian sourced profits		-	-	-
Dividend from Foreign-SubCo (exempt)		<u>610</u>	<u>610</u>	<u>610</u>
		610	610	610
Australian Company tax at 30%		<u>-</u>	<u>-</u>	<u>-</u>
Distributable Profits		<u>610</u>	<u>610</u>	<u>610</u>
Position of the Australian shareholder				
Cash dividend received		610	610	610
Add: gross-up for Australian tax		-	-	-
Add: gross-up for franking credits (at deemed foreign tax rate of 20%)		<u>152.5</u>	<u>152.5</u>	<u>152.5</u>
Amount included in shareholder's assessable income		<u>762.5</u>	<u>762.5</u>	<u>762.5</u>
Shareholder's tax liability		114.38	240.19	354.56
less franking credit for Australian tax		-	-	-

less franking credit for foreign tax (at deemed foreign tax rate of 20%)	114	153	153
Income Tax Paid	<u>0</u>	<u>88</u>	<u>201.56</u>
After Income Tax received	<u>610</u>	<u>522</u>	<u>408</u>
Effective Tax Rate including company and shareholder taxation, if company earns income taxed in foreign country, taxed at 39%	<u>39.00%</u>	<u>47.77%</u>	<u>59.20%</u>

The 20% franking benefit reduces the effective tax rate at the shareholder level, as compared with no imputation credit for foreign underlying taxation paid, by	9.15%	10.45%	8.20%
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The remaining Tax Wedge for shareholders arising from international income in comparably-taxed country, as compared with Australian income, is	24.0%	16.3%	12.7%
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Effective Tax Rates for shareholders receiving income by way of dividends from Australian companies



- ▨ Effective tax rate (ETR) where Australian company earns only Australian underlying income
- ETR where Australian company earns only foreign-source income from a foreign subsidiary taxed at 39%
- ▨ ETR where Australian company earns only foreign-source income from a foreign subsidiary taxed at 39% with Australian imputation credit at a hypothetical 20% foreign tax rate