The Institute of Chartered Accountants in Australia

30 August 2006

The Secretary
Senate Economics Legislation Committee
Department of the Senate
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir,

**Tax Laws Amendment (2006 Measures No.4) Bill 2006**
**Submission by the Institute of Chartered Accountants in Australia**

The Institute of Chartered Accountants in Australia (the Institute) is pleased to provide a submission to the Senate Economics Legislation Committee in relation to its enquiry into Tax Laws Amendment (2006 Measures No.4) Bill 2006 (the Bill). Our submission is limited to the proposed changes to the capital gains tax (CGT) treatment of foreign residents set out in Schedule 4 of the Bill.

The Institute is Australia's premier accounting body, which represents over 44,000 members who are fully qualified Chartered Accountants working either in the accounting profession providing auditing, accountancy, taxation and business consultancy services or in diverse roles in business, commerce, academia or government.

The Institute is of the view that the proposed measures bring Australian tax law in step with the current OECD model tax treaty which Australia is increasingly following. In particular, the proposed measures consist of two inseparable principal elements:

a) A CGT exemption (the CGT concession) provided for certain capital gains made by foreign residents, but not extending to direct real property interests, in a manner broadly consistent with the OECD model tax treaty; and

b) A CGT expansion aspect (the CGT expansion), whereby Australia's CGT is to be imposed on disposal by foreign residents of interposed companies, including foreign companies, where the majority value of the interposed company assets is directly or indirectly due to Australian real property interests.

## OVERVIEW

a) The Institute strongly supports the CGT concession to enhance Australia's international competitiveness, to encourage greater investment in Australia with the development of Australia's economy and employment. This is discussed in Section A, below.

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b) The Bill should be passed expeditiously. This measure was announced in the 2005 Budget, over 16 months ago, and delay in implementing this measure is affecting non-residents' investments in Australia and is causing some elements of frustration. This is discussed in Section B, below.

c) The proposed CGT concession measures address the major problems relating to the taxation of non-residents under the current CGT regime. However, in order to correctly reflect the policy intent, some adjustment is required to the current drafting concerning the expansion of the CGT rules to tax certain non-portfolio interests in entities. This is discussed in Section C, below.

## SECTION A: CGT CONCESSION IS SUPPORTED

### A.1. CGT concession

The Bill introduces a replacement CGT regime to tax foreign residents only in respect of 'taxable Australian property' including broadly Australian real property assets and business assets of Australian permanent establishments (PEs). This replaces the current requirements that tax assets 'having the necessary connection with Australia' as defined and streamlines and simplifies the operation of the law. The revised rules focuses Australia's CGT regime on a more limited range of assets which promotes efficiency and will reduce business compliance costs.

The Institute supports the introduction of the CGT concession for the following reasons:

a) The proposed CGT foreign resident measures are an important reform in Australia's income tax system and are necessary to improve Australia's status as an attractive place for business investment and to align Australia with international cross border taxation practice including the OECD.

b) The core policy underlying this measure is expressed in the Board of Taxation 2002-2003 International Tax Review, that is, it enables Australia to present a competitive environment to international investors, which encourages international investors to invest in Australian companies which conduct Australian business activities, adding to the strength and the dynamism of the Australian economy.

c) The proposed CGT foreign resident measures promote Australia as a headquarters location, better aligning Australian CGT rules with other countries' rules. The new rules improve the competitiveness of Australia and will encourage inbound global companies to expand their Australian operations.

   Australia's current CGT treatment of foreign residents disposing of shareholdings in Australian companies has caused Australia to be relatively less attractive as a location for foreign investment and as an inappropriate regional base for international businesses.

d) The Australian initiative is not just a unilateral concession. It is against the backdrop of an expectation that Australian companies, investing into overseas jurisdictions and selling their shares in foreign companies will be relieved of CGT in the foreign country of investment.

   This achievement of mutual benefits for Australian investors overseas is an important part of the internationalisation of Australian business and the global relevance and dynamism of Australian business.

### A.2. Policy underlying the proposed CGT changes is consistent with international approaches and Board of Taxation consultation processes

The proposed introduction of the CGT foreign resident measures is an important development in the continuing reform of the Australian international tax system and is part of the Reform of International Tax Arrangements (RITA) package of measures.

The policy behind the proposed CGT foreign resident measures emanated from the RITA recommendations of the Board of Taxation concerning the CGT treatment of foreign residents disposing of Australian companies, made in 2003 but deferred by the Government in the 2003 Budget. The Board's proposals followed a lengthy and detailed review of the international aspects of the Australian income tax regime. This process included community and business consultation conducted by the Board, in which the Institute was an active participant, and significant analysis resulting in the Board's 2003 report 'Review of International Taxation Arrangements'.

The Board's report summarises many of the problems with the existing Australian income tax regime at that time in Chapter 3 (at pages 73 to 111 and in particular from page 89) notably including:

a) Problems with international aspects of the CGT regime generally; and
b) Problems in respect of the treatment of foreign residents under the ATO's interpretation of the interaction of the CGT provisions with Australia's double tax agreements (treaties),

and made this recommendation in conjunction with other proposed reforms, many of which have now been implemented by Government.

The Board's recommendation 3.11(2) was that the CGT reform – along precisely the same lines as the CGT concession contained in the Bill – be provided in respect of foreign resident CGT reform on the basis that the law would be introduced on a treaty by treaty basis:

> "The Board recommends an exemption of capital gains made by non-residents on the disposal of shares comprising non-portfolio interests in Australian companies be provided by treaty, on a treaty by treaty basis. To the extent that these companies hold land in Australia, the same look through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax."

An extract of the Board's report which discusses the general problems of Australia's CGT taxation of foreign residents in the treaty context is included as an attachment to this submission.

The decision of the Government to introduce these measures into Australia's income tax law in the Bill directly, rather than modifying many treaties, is a far more efficient way to implement these important measures than the significant delays that would be experienced and the incomplete coverage that may arise if the recommendations had proceeded to be only introduced on a treaty by treaty basis.

The introduction of the measures in the Bill introduces these reforms in a more timely, thorough and efficient manner and is supported.

### A.3. CGT continues to apply to sales of underlying business assets or branch assets

Australian business assets owned by non-residents remain taxable under these proposals. The CGT exemption for non-residents disposing of shares in Australian companies (and similar interests in trusts) does not extend to a CGT exemption for non-residents disposing of direct Australian business assets. Where one non-resident disposes of shares in an Australian company (the Australian target company) to another non-resident, there may be no Australian CGT imposed in relation to the disposal of the shares in the Australian target. However, if the non-resident or the Australian target company dispose of their underlying Australian business assets, Australia continues to impose taxation on asset disposals under the CGT, income tax and capital allowance rules.

It is the holding of equity interests in entities that have the underlying Australian business that may receive more favourable CGT treatment compared to the current rules. The income earned from the underlying business assets remains taxable in Australia. Similarly, CGT continues to be imposed on the direct disposal of the underlying business assets.

In essence, the proposed measures reflect the acceptance of the proposition that the capital gain of a foreign shareholder is more reasonably taxed in the country of residence of the shareholder. This would also address a number of anomalies in the current tax system.

Assets held in an Australian PE also remain subject to Australian CGT on their disposal by a foreign resident.

### A.4. The reforms are positive for Australia's relevance and growth

The measures remove impediments and should be very positive for Australia in the same way as the Institute submits that Australia has benefited from the modernisation of Australia's CGT regime recommended by the Ralph Review of Business Taxation (RBT), in particular:

- Discount capital gains to replace the previous indexation mechanisms;
- Scrip takeovers concessions;
- Demergers concessions; and
- Small business and entrepreneurial tax concessions.

The non-resident CGT concession, and the above measures, has the effect that tax should not be an impediment to sensible and prudent restructures, divestments and acquisitions. In this way, it is submitted that this will enhance the efficiency and employment opportunities in those businesses.

The Institute submits that the increased flexibility and reduced deadweight costs for business restructures since 1999 has helped the growth of Australia by the elimination of tax blockages on Australian businesses.

### Section B: The Institute supports timely passage of the measures

We strongly support the passage of the Bill in a timely manner, incorporating deficiencies identified in Section C below.

If amendments to address deficiencies identified in Section C cannot be addressed in the current Bill, a separate process should be commenced immediately by Government and Treasury to ensure these policy adjustments are made with effect from the same date of application as the measures in this Bill.

### Section C: Refinement of the CGT-expansion features is needed

The Bill also includes a new measure which expands the CGT rules to tax non-portfolio interests in entities, 'indirect Australian real property interests' (IARPI), where the value of such interests is principally attributable to Australian real property. The rules apply to both Australian and foreign entities which may result in some foreign residents being taxed under the Australian CGT rules in respect of non Australian entities for the first time. The IARPI rules are noted in the explanatory memorandum to the Bill as serving an integrity function.

The CGT expansion measure has no transitional measures, which means that Australia has effectively subjected to Australian CGT a large range of foreign investors selling their interests in foreign companies which ultimately have Australian assets. Those investors, newly taxable, are potentially taxable on unrealised gains accrued over past decades. This is inequitable tax policy implementation, compared with proper tax policy and compared with previous Australian tax practice.

### C.1. CGT expansion was not recommended by the Board of Taxation

We note that the Board recommended that Australia would gain little from CGT expansion measures to tax non-residents disposing of equity interests in foreign entities. The Board recommended that CGT interposed foreign resident entity 'integrity measure' should not be introduced (recommendation 3.6).

This recommendation was driven, at least in part, by an appreciation that the revenue to be collected would be outweighed by the inefficiency of and discouragement for foreign investment in Australia.

Notwithstanding that recommendation, the Bill expands the Australian CGT tax net.
This expansion has been handled in an inequitable manner, from a transitional viewpoint, as it creates new CGT exposures for foreign residents previously not exposed to Australian CGT, in circumstances not resulting from any tax avoidance activity, including for example because:

- foreign residents subject to the measures are not given any enhanced cost base at the commencement of the new rules; and
- the rules may potentially subject to Australian taxation foreign residents' underlying gains on non-Australian assets and non-Australian real property assets.

### C.2. Transitional relief (including cost base) for the CGT expansion is needed

No rules or transitional rules have been included in the proposed CGT changes for calculating the CGT cost bases of taxable Australian property assets. Rather, the rules require CGT cost base calculations to be made using the ordinary CGT cost base provisions.

The new CGT rules, may therefore, result in the inappropriate taxation of unrealised gains that have accrued before the commencement of the law in respect of assets that were not previously taxable as assets with the necessary connection with Australia – in particular overseas companies which might be IARPI entities.

*Recommended Action*

The government should, either before or immediately after the enactment of the Bill, introduce an optional deemed market value cost base, at the date that the CGT foreign resident provisions commence, in respect of assets that were previously not assets 'having the necessary connection with Australia'. Another approach might be to exclude from the Australian CGT net interests acquired prior to introduction of the Bill. This would be consistent with the way CGT was introduced in 1985.

The Institute notes that the implementation of any of the above two alternatives should not result in any further delay to the enactment of this important component of the Government's strategy to enhance Australia's international competitiveness.

### C.3. CGT expansion results in taxation of foreign assets

The Bill includes the entire capital gain (or loss) resulting from a CGT event in respect of an IARPI asset such as an interest in an entity. This means that Australian tax is to be imposed on the value of an IARPI entity including the value attributable to:

a) foreign assets; and
b) Australian assets other than taxable Australian property assets.

The Institute notes that this feature will restrict the attractiveness of Australia as a location for international business.

*Recommended Action*

The Institute submits that consideration be given to amending the provisions to exclude gains attributable to assets other than taxable Australian property assets.

Should you have any queries in relation to this submission, please do not hesitate to contact the Institute's Tax Counsel, Ali Noroozi on (02) 9290 5623.

Yours sincerely

**Graham Meyer**
**Chief Executive Officer**
**Institute of Chartered Accountants in Australia**

**Attachment: Extract of Board of Taxation 2003 Report**

## CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

### Tax Treaties

*Policy objectives*

- A policy objective of the current Review is to promote Australia as a location for internationally-focused companies. Double tax agreements (DTAs) are a significant element in international tax arrangements and need to be considered alongside domestic tax law. As DTAs are the result of detailed negotiations based on the tax systems of the two countries concerned, general DTA policy necessarily must be concerned with high-level issues and processes. A major policy question is the balance between residence and source taxation, and whether the balance struck in the recent Protocol to the US treaty should be the basis of future policy.

*Current position*

- DTAs allocate taxing rights between Australia and other countries. They ensure that the same income or capital gain is not subject to double taxation, or to double non-taxation (or exemption). Until recently, Australia's DTAs have generally given greater emphasis to source taxation than to residence taxation. This is reflected in a number of features, such as:

  - a wide definition of permanent establishment (PE), which increases Australia's taxing rights over non-residents' business operations in Australia; and

  - relatively high withholding tax rate ceilings for dividends, interest and royalties derived by non-residents from Australia.

- When Australia introduced its CGT in 1985, two important issues arose for DTAs: (1) how did existing DTAs apply to the CGT, and (2) how would future DTAs deal with it? Consistent with Australia's broad-source taxing policy, the ATO has taken the position that pre-CGT treaties do not limit CGT taxing rights (see Taxation Ruling TR 2001/12). It has also preserved domestic law source taxing rights over capital gains in treaties negotiated since them. In the case of investment in companies, the CGT taxes non-residents on gains on shares in resident private companies and non-portfolio interests in public companies. The CGT does not extend to shares in non-resident companies which hold Australian assets. The RBT recommended that the CGT be extended to non-portfolio interests in non-resident companies having their principal assets in Australia.

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- The emphasis of treaty negotiations over recent decades has been on extending Australia's DTA network to new countries, while updating the most important treaties on about a 20-year cycle.

- Like many other contracts entered into by governments, DTAs are negotiated largely in secret. To some extent, this is changing: in Australia in recent years the negotiation process has been partly opened to consultation, through the ATO's Tax Treaties Advisory Panel and direct dealing with specific taxpayers on particular issues. But the balance is still very much on the side of secrecy.

*Problems*

- The source-based DTA policy has detrimental impacts on Australian firms investing offshore, because it exposes them to high taxes in tax treaty partner countries. Yet Australia has unilaterally given up significant areas of source taxation under domestic law, such as DWT on franked dividends and interest withholding tax on widely-issued debentures.

- Further, the treatment of capital gains has been a vexed issue under pre-CGT treaties for over a decade. The overwhelming private sector view is that pre-CGT treaties override the domestic CGT rules. However, the ATO view is that they do not. This standoff has detrimental effects on investment decisions by non-residents in relation to Australia, as the CGT treatment of the investment is uncertain. While the position under more recent DTAs is clear, the broad CGT jurisdiction claimed by Australia is out of line with international norms and also affects investment decisions by non-residents under these treaties.

- Extending the CGT to shares in non-resident companies as proposed by the RBT will give even greater emphasis to source taxing rights. Further, the extension would add significant complexities to the tax law and would be very difficult to administer. Although the issue has been well understood internationally for many years, very few countries have sought to extend their CGT to shares in foreign companies. Indeed, apart from land rich companies, the international norm is not to levy CGT on non-residents when they dispose of shares in domestic companies, whether portfolio or non-portfolio interests. In some countries this result follows under domestic tax law; in other countries it follows as a result of DTAs.

- In recent decades, the source emphasis in Australia's DTAs had made updating some major treaties problematical. Several major treaties have now run for more than 20 years without any significant updating (UK, 1967; Japan, 1969; Germany, 1972; several other European countries in the 1970s). The RBT has led to a shift of emphasis towards updating the major treaties. However, the DTA negotiation agenda is large, due to earlier inactivity and the practice of giving priority to extending the DTA network to investment partners that are relatively minor (at least, from Australia's point of view). Political and economic events may also affect negotiation priorities at particular times.

- As Australia's overseas investment is concentrated in a few countries, extending the tax treaty network to countries with which Australia has little trade or investment is less important than revising existing major treaties.

- The submissions suggest that the Tax Treaties Advisory Panel has had mixed success. In recent and current tax treaty negotiations, major companies have found it necessary to bypass this forum to make sure that their concerns receive a proper hearing.

*Evidence of the problems*

- The evidence on change in investment flows in and out of Australia is now well known, although its implications went largely unnoticed before the RBT. The need to protect source taxation is now far less significant than 20 years ago, when inbound investment was four times the level of outbound investment. The emphasis on source taxation creates significant tax obstacles to foreign investment by Australian-based multinationals, and leads to collection of tax in foreign countries rather than in Australia. The problem of foreign withholding taxes on dividends was a significant element in one major company's recent decision to move out of Australia.

- The standoff in the application of pre-CGT treaties in the CGT context is the subject of many published articles and many disputes with the ATO. No test case has yet been run to settle the issue, despite the ATO's significant general test case activity in recent years. Australia's international treatment of CGT on shares is a recurring theme in the problems of establishing Australia as a base for internationally-focused companies.

- The majority of submissions stated that while the Tax Treaties Advisory Panel has given advice on a number of technical issues, it meets infrequently compared to other Panels, is often presented with proposed treaty texts where there is little or no room for change, and has little input into major policy matters. Also, its practice does not conform to the new consultation processes recently established for tax legislation. Major OECD countries are much more open than Australia in this regard. For example, more information is publicly available in the US on the 1983 DTA with Australia than is available in Australia.

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**Option 3.6: To consider whether or not to proceed with the Review of Business Taxation proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets**

- Almost all submissions addressing this issue overwhelmingly opposed the proposal that Australia should extend its source taxing rights to gains made by non-residents on the sale of non-resident interposed entities with underlying Australian assets.

- Such a measure would be difficult to comply with and hard to enforce. It would cause inadvertent breaches by creating hidden tax exposure for overseas investors for relatively small revenue gain. It would also harm Australia's international competitiveness by making Australia a less attractive investment destination. Targeting the measure properly would also increase the complexity of the tax law.

- The uncertainty surrounding the operation of pre-CGT treaties also has detrimental effects on investment in Australia.

**Option 3.6: Extending capital gains tax to sale of shares in non-resident companies**

**Recommendation 3.6:**

The Board recommends against proceeding with the Review of Business Taxation proposal to apply capital gains tax to the sale by non-residents of non-resident interposed entities with underlying Australian assets.