Senate Select Committee on Superannuation and Financial Services

Main Inquiry
Reference (b)

Submission No. 28 (Supplementary Submission to No. 26)

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Corporate Tax Business Advisory
Melbourne

11 August 2000

Senator Watson
Department of The Senate
Parliament House
CANBERRA ACT 2600

Dear Senator Watson

I refer to my recent evidence provided to the Public Hearing of The Senate Committee on Superannuation and Financial Services held on 14 July 2000. As an incidental matter and for information, I now enclose a copy of a related Submission to the Treasurer concerning Foreign Taxed Income Distributions (Dividends) Between Resident Entities from the Business Council of Australia, Corporate Tax Association of Australia and Minerals Council of Australia.

Should you have any questions I can be contacted on 03 9609 3997.

Yours sincerely

Ian C Edney

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Vice President Taxes

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3 August 2000

The Hon Peter Costello, MP
Treasurer .
Parliament House
CANBERRA ACT 2600

Dear Treasurer

We are forwarding for your consideration a joint submission on a matter of urgent business concern following the recent change to the inter-company dividend rebate provisions under the taxation laws. This has given rise to a substantial anomaly involving the effective double taxation of distributions of overseas profits, where Australian public companies utilise an Australian joint venture company for their investment with partners in offshore projects.

Our concerns are outlined in the Synopsis to the submission, and in the submission itself. Briefly, the imposition (for the first time) of an additional layer of Australian tax on distributions of profits which have already borne foreign tax, will mean that many existing Australian public company investments in overseas projects may become uneconomic. Secondly, Australian public company investors which face this double taxation impost will be at a very real competitive disadvantage compared to foreign counterparts in their efforts to pursue future investment opportunities overseas, and effectively penalised in seeking out investment partners.

We feel the current position in these circumstances runs contrary to the broad objectives of the Review of Business Taxation (RBT) to promote a consistent system of business taxation and an internationally competitive environment for Australian business investment.

Australian business investments overseas will get very different tax treatment depending on whether a company is able to arrange its affairs through different business structures. It is desirable in our view, for Australian investment in joint overseas projects to be able to be channelled through Australian holding companies rather than companies being forced down the path of offshore structures (assuming investors are in a position to do so in the first place).

Our submission recommends a practical solution to the present problem (via simple technical amendment) which we feel is consistent with the thrust of the Government's RBT objectives.

We have met with Treasury officials and briefed them in relation to our concern. We would be pleased to meet further with your advisers to discuss our submission and suggested solution. In the first instance, we suggest you have your Office contact Mr Frank Drenth at the Corporate Tax Association (telephone: 03 9600 4411) to discuss this matter.

Yours faithfully

Dick Wells

(David Buckingham)
Executive Director
Business Council
of Australia

(Frank Drenth)
Executive Director
Corporate Tax Association

(Dick Wells)
Executive Director
Minerals Council
of Australia

Submission Concerning
Foreign Taxed Income Distributions
Between Resident Entities

SYNOPSIS

This submission is made on behalf of the Business Council of Australia, the Corporate Tax Association of Australia and the Minerals Council of Australia.

Following recent changes to Australia's tax laws, Australian public companies which invest overseas through an Australian joint venture company face effective double taxation on profits derived from the overseas investment. This anomaly stems from the recent removal of the inter-company dividend rebate for unfranked dividend distributions between non-wholly owned resident entities. Such double taxation at a company level, materially and adversely impacts the economics and viability of overseas investments, and it is likely that many projects may now prove to be uneconomic. Companies are judged by investment markets on the basis of the after-tax profits which they are able to report to shareholders, and a similar basis is applied by companies in the evaluation of project investments.

The effective double taxing of overseas income where the Australian public company investment is held through a joint Australian company, will impede the growth and international competitiveness of Australian multinationals, and in particular the ability of Australian public companies to take a lead on overseas investment and seek investment partners. We believe this to be inconsistent with the objectives of the Review of Business Taxation regarding a compatible system of taxation for business entities, and an internationally competitive taxation environment for Australian business investment.

Our submission to address this anomaly, is that the existing foreign dividend account ("FDA") and the proposed foreign income account ("FIA") should be amended to prevent the imposition of Australian income tax on non-portfolio unfranked dividends received by an Australian resident company[1] from another Australian resident company[1] out of overseas profits which have already borne foreign tax.

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1 Or, with effect from 1 July 2001, an Australian resident "entity".

It is submitted that this proposal will eliminate the effective double taxation at a company level of overseas profits, and reinstate due recognition for taxes paid overseas. It has an additional benefit of restoring the integrity of the Government's proposed conduit mechanism which was recommended at paragraph 21.4 of *A Tax System Redesigned* ("*ATSR*")[2].

BACKGROUND

At paragraph 11.1 of *ATSR* it was recommended that all unfranked distributions (other than distributions within a consolidated group) between resident entities should be taxed in the recipient entity's hands. The recommendation was made after considerable discussion of the relative merits of a deferred company tax system, a resident dividend withholding tax, and the final recommendation. Adoption of the final recommendation was announced on 21 September 1999[3], and the relevant legislation[4] received Royal Assent on 30 June 2000. It applies to the unfranked part of dividends paid on or after 1 July 2000.

It is our submission that the discussion which culminated in this *ATSR* recommendation, and in its adoption, was overly focussed upon the *differences* between the three alternative systems, and their implications for *non-resident* shareholders in Australian companies, and did not give sufficient consideration to the consequential impacts upon Australian overseas investment through jointly held Australian investment entities. It would seem a major oversight that no distinction was drawn between unfranked distributions sourced from foreign taxed profits and those sourced from domestic untaxed profits. Consequently, the central issue which we are now addressing, and which is common to all three alternatives, is that a distinction does need to be drawn between foreign taxed income and "tax preferred" income. We contend that foreign taxed income should not be regarded as "tax preferred", especially when it is subsequently distributed from one Australian resident entity to another.

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2 Measures to adopt this recommendation were announced in Attachment I to the Treasurer's Press Release No. 74 of 11 November 1999.

3 See Attachment L to the Treasurer's Press Release No. 58 of 1999.

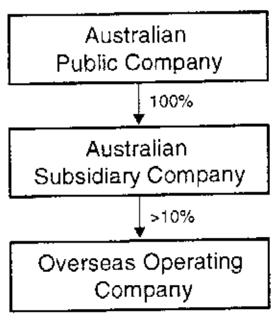
4 See Schedule 1, New Business Tax System (Miscellaneous) Act (No. 1) 2000.

OUTCOMES IN RESPECT OF FOREIGN TAXED INCOME

A key feature of this submission is the increasing commercial propensity to establish joint ventures, joint operations and strategic alliances in pursuing business opportunities. It is increasingly common for Australian multinational companies to share risks and rewards for certain projects, whilst remaining competitors in other areas. This is particularly true of the resources industry where substantial amounts of capital are required, and considerable risks need to be managed, to ensure the ongoing viability of research, exploration and development.

Although several forms of joint activity are available, the form which is best understood internationally is the jointly owned company. This is a particularly useful vehicle when a new participant is invited to join a previously approved investment in a developing country where new approvals can be difficult and time consuming.

Accordingly, an Australian public company group may originally invest in a project overseas under a structure such as:



In most cases the percentage interest in the Overseas Operating Company will far exceed 10% and may be as much as 100%. However, the terms of the approval for the original investment are usually quite specific, and often include a specific percentage being held by local interests.

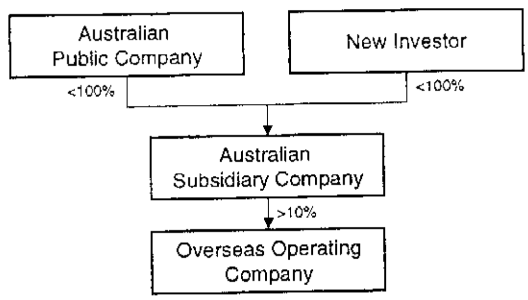
Under this structure, profits which are taxed in the overseas country can be paid as a distribution[5] to the Australian Subsidiary Company and the distribution will either be exempt from Australian company income tax under s.23AJ of the Income Tax Assessment Act 1936 ("the 1936 Act"), or

5 In this submission, the term "distribution" is used to describe not only entity distributions after 1 July 2001, but also dividends paid on or before 30 June 2001.

qualify for sufficient foreign tax credits to offset any Australian company income tax payable on the distribution received.

When the Australian Subsidiary Company seeks to pass the income on, as a distribution, to its 100% parent company, the distribution is likely to be unfranked. In this case, the unfranked status of the distribution does not result in a tax liability because of the 100% ownership relationship between the payor and payee[6].

However if there is not a 100% ownership relationship between the parent company and the Australian subsidiary company, the result is quite different. It is not uncommon for a new investor to be admitted to the investment, above the Australian Subsidiary Company, *viz*:



There are often significant commercial circumstances which prevent the introduction of a new investor directly into the Overseas Operating Company, including limitations under overseas country project agreements, burdensome and protracted formal approval processes in the overseas operating country, the pre-emptive rights of local partners in such arrangements, and/or potentially significant transaction costs associated with restructuring participation.

6 See ss.46F(3) of the 1936 Act.

The flow of distributions of foreign taxed income from the new jointly held Australian company to the Australian public company, as illustrated in the above diagram, is materially affected by the removal of the intercompany dividend rebate. Even if the new investor takes only a nominal shareholding in the Australian Subsidiary Company, the Australian Public Company will now be fully taxable in respect of any unfranked dividend which it receives from the Australian Subsidiary Company. No such problem arose prior to 1 July 2000.

The new investor, if it is also an Australian public company, would now face a similar outcome.

If the new investor is not a resident of Australia, then it and the Australian Public Company will confront very different tax implications from the payment of a distribution by the Australian Subsidiary Company. The non-resident investor will be able to receive such an (unfranked) distribution free of further Australian taxation by virtue of the FDA/FIA credit attached to the dividend[7]; whereas the Australian Public Company will be subject to the full rate of Australian company income tax on its unfranked dividend income, with no relief for the taxes already paid overseas[8]. This distinction places Australian multinationals at a significant disadvantage compared to foreign counterparts in analysing and undertaking such overseas investments. In addition, it invites difficulties for joint venture relationships in settling a common distribution policy of the jointly owned entity.

If, in the above example, the foreign income in question was subject to 40% tax overseas and was the only type of income available to the Australian Public Company, the overall tax rate reportable in the company's Annual Report would be 60.4% of its profits; illustrated as follows:

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7 See, for example, s.128B(3)(gaa)(ii) of the 1936 Act.

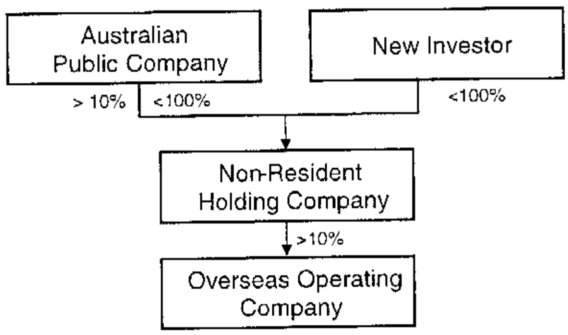
8 For the purposes of this submission, it is assumed that the dividend paid by the Overseas Operating Company is not subject to withholding tax and that no franking credits therefore arise under paragraph 20.1 of *ATSR*.

	$
Foreign Income	100.00
Foreign Tax	(40.00)
	60.00
Australian Tax (34%)	(20.40)
Overall Tax	60.40

The performance of Australian companies is judged by the investment markets on the after-tax profits which they are able to report to shareholders. This basis is also applied by companies in the evaluation of project investments. A number of existing projects with long lead times have already been established overseas on the basis of feasibility studies which have not anticipated this material additional tax at the Australian corporate level. Unless the current problem of effective double taxation is addressed, it is likely that some of those projects will now prove to be uneconomic with the loss of wealth creation opportunities to Australian companies.

WHAT IS THE ALTERNATIVE?

Australian Public Companies might in future invest *via* a *non-resident* holding company. The introduction of a new investor would then take place outside Australia, as follows:



Under this structure, full relief for its share of the foreign tax paid by the Overseas Operating Company can be enjoyed by the Australian Public Company, as and when it received dividends *via* the Non-Resident Holding Company[9]. In other words, this structure would achieve the overall effect which we are seeking in this submission.

Unfortunately, it will <u>not</u> be feasible to convert most existing structures to the above model. For the kind of reasons indicated earlier in this submission, there can be critical commercial barriers to doing so.

In any event, we submit that Australia should not encourage offshore holding companies but rather encourage the undertaking of overseas investment through Australian holding companies, all other things being equal. Indeed, it is an ironic result of "a new tax system" that it should effectively promote such an inconsistency[10].

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9 If the Overseas Operating Company is a resident in an "unlisted country", this relief is obtained as a foreign tax credit under s.160AFC of the 1936 Act. If the Overseas Operating Company is resident in a "listed country" the relief is obtained under s.23AJ of the 1936 Act.

10 At page 107 of "Tax Reform: Not a New Tax, a New Tax System" (published by the present Australian Government in August 1998) it says: *"The fundamental problem is that there is inconsistent taxation treatment of business entities and the investments they conduct ..... Exactly the same investment gets very different tax treatment if conducted through different collective business structures ..."*

INTERNATIONAL COMPARISONS

This inconsistency, which arises where an Australian (but not a foreign) subsidiary company interrupts the flow of distributions from overseas, has been observed by Professor Peter Harris in his 1996 book "Corporate Shareholder Income Taxation: A Comparison of Imputation Systems"[11]. Bearing in mind that this book was written before the current problem arose for public companies in Australia, it is interesting to note that Professor Harris praised the (then) Australian system for *not* being inconsistent. He said, at paragraph 4.2.1 (Page 407):

> *"This inconsistency is not present where imputation systems, while not providing a general exemption for incorporate distributions, effectively permit foreign tax relief to pass between resident corporations. General examples of this approach were provided [at 1.2.1 and 1.3.1] with respect to the Malaysian, Mexican, Norwegian, Singapore and UK (FIDs) imputation systems. Further, under the Australian imputation system foreign tax relief may be passed by Australian corporations to public corporate shareholders as the latter are effectively exempt with respect to intercorporate dividends. Germany exempts domestic intercorporate dividends distributed from exempt foreign source profits.*
>
> *On the other hand, it is inconsistent to provide an exemption or indirect foreign tax credit to direct corporate shareholders in non-resident corporations and also to wash out that relief as a result of domestic intercorporate distributions. This inconsistency is evident where a subsidiary is interposed between foreign source income and resident corporate investors. Where the subsidiary is non-resident, ie. in accordance with the present situation, the foreign income may be distributed to the corporate investor with underlying relief from international double taxation. On the other hand, where the subsidiary is resident, ie. in accordance with the situation discussed [at 1.1.2.1.] no underlying relief from international double taxation is granted to resident corporate investors. This sort of inconsistency is generally displayed to a varying extent by Australia, France, Italy and New Zealand."*[12]

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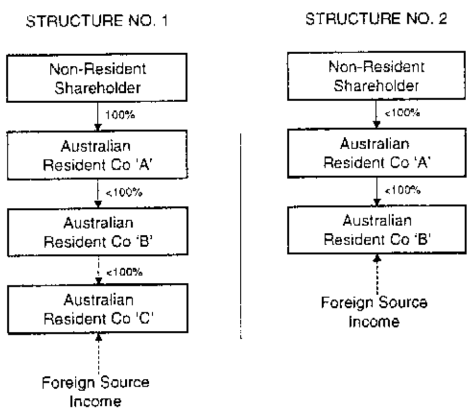
11 IBFD Publications BV, ISBN 90-70125-94-3.

12 This last reference to Australia's "inconsistency" relates only to Australia's (then) treatment of **private** companies receiving unfranked dividends from an interposed resident subsidiary. Since 1 July 2001, the inconsistency has also embraced Australian public companies: an unfortunate contagion, we submit.

A RELATED MATTER - FIA "CONDUIT MECHANISM"

We have so far highlighted the problem of the effective double taxation of Australian public companies which hold investments overseas via non-wholly owned Australian joint venture companies.

Foreign shareholders in Australian non-wholly owned joint venture company structures may also face a similar issue relating to effective "flow-through" of FIA credits under the Government's announced FIA conduit mechanism (which picks up the recommendation at paragraph 21.4 of *ATSR* that the FIA record the total foreign income derived by an entity). This is illustrated in the following structures:



In Structure No. 1, when Company C pays an unfranked FIA distribution to Company B, that distribution will be subject to tax in Company B's hands; consequently, when Company B makes an FIA distribution to Company A, that distribution will normally be franked. Notwithstanding the fact that Company A is 100% owned by a non-resident, Company A will not obtain an "unfranked non-portfolio dividend deduction"[13] because Company A will not *itself* have paid income tax on the FIA distribution (Company B will have paid the income tax).

In Structure No. 2, when Company B pays an unfranked FIA distribution to Company A, that distribution will be subject to tax in Company A's hands; and because Company A is less than 100%

13 Consistent with new s.46FA of the 1936 Act.

owned by a single non-resident shareholder, Company A will (again) not be entitled to an "unfranked non-portfolio dividend deduction".

We contend that the Government's good intention in accepting *ATSR* 21.4, ie. to provide a broad relief for foreign taxed income which is distributed to foreign shareholders[14], will often be frustrated by this inconsistent interaction with the recommendations of *ATSR* at paragraph 11.1 (unfranked distributions between resident non-consolidated entities) and paragraph 11.4 (a "gross-up and credit" mechanism to replace the inter-company dividend rebate)[15].

However, if our suggested general solution in this submission is adopted, we submit that the effectiveness of this proposed conduit mechanism will also be materially restored.

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14 The relevant *ATSR* proposition was described at paragraph 21.4 as follows:

"For the FIA to operate as a general conduit mechanism and provide relief in most common circumstances, it will be necessary for unfranked distributions to be identified as FIA distributions by residents receiving those distributions. Subsequently, relief from DWT can be allowed when those distributions are paid to non-residents. This will require the FIA to be similar in design to the current franking account. That will involve some additional complexity but will deliver a more equitable outcome."

15 As we understand it, no firm decision has yet been made, but it is likely that a "gross-up and credit" mechanism, rather than an intercompany dividend rebate, will apply to franked, inter-entity distributions after 1 July 2001 consistent with paragraph 11.4 of *ATSR*.

SUGGESTED SOLUTION

It is suggested that the problems identified in this submission can be solved by simple technical amendment.

An Australian resident entity should be relieved from paying income tax on the receipt of an unfranked distribution to the extent that both of the following conditions are satisfied:

(i) the unfranked distribution has been debited to either an FDA or an FIA by the entity paying the distribution; and

(ii) the Australian resident entity which receives the distribution has at least 10% of the voting power[16] of the entity paying the distribution.

Since the problem is, at root, related to the foreign tax credit system[17], we recommend limiting the solution to resident inter-entity relationships which correspond to those qualifying for underlying tax relief under s.160AFC of the 1936 Act.

For the 2000/2001 year of income, this relief could be simply introduced by adding a new subsection to s.46F of the 1936 Act. The new subsection could read as follows:

> *"**46F(5) [Foreign Dividend Account dividends]** Subsection 2 does not apply to the extent that the dividend is both a non-portfolio dividend within the meaning of section 317 and does not exceed the foreign dividend account declaration amount (if any) in respect of the dividend under section 128TC."*

For 2001/2002 and subsequent years, the form of the relief will depend upon the Government's response to paragraph 11.4 of *ATSR*. Assuming however that this response opts for a "gross up and credit" approach, we submit that the proposed FIA will lend itself ideally to our suggestion. The fact that the FIA is expected to be expressed in tax dollars means that, provided the unfranked income received satisfies the non-portfolio condition, the FIA credit attaching to the unfranked income will be claimable by the receiving entity as a proper tax credit against its gross income tax liability. The

16 As defined in s.160AFB(6) of the 1936 Act.

receiving entity would then be able to pass on the FIA credit to other entities as and when it makes subsequent unfranked distributions, consistent with paragraph 21.4 of *ATSR*. If the response to paragraph 11.2 of *ATSR* does not opt for a gross-up and credit approach, the proposed solution for the period to 30 June 2001 could simply remain in place for 2001/2002 and subsequent years.

CONCLUSION

We consider that our suggestion is consistent with the broad policy objectives of tax reform. It has the additional benefit of overcoming some inconsistencies in both the imputation system generally, and in the proposals for the improved fairness of the Foreign Income Account. We commend this suggestion for your favourable consideration.

Melbourne
3 August 2000

[17] Including, where relevant, S.23AJ of the 1936 Act.