Senate Select Committee on Superannuation and Financial Services

Main Inquiry
Reference (b)

Submission No. 38

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Ms Sue Morton
Secretary
Select Committee on Superannuation
and Financial Services
Parliament House
CANBERRA ACT 2600

Dear Ms Morton

I refer to your letters of 8 August and 7 September 2000 and the various discussions between us in relation to issues raised before the Senate Select Committee on Superannuation and Financial Services.

At the outset let me say that many of the submissions in relation to tax seem to suggest that Australia should (at least in particular circumstances) relinquish its right to tax income and gains at source. This would have major ramifications for Australia's revenue and economy. While the abandonment of such taxing rights may benefit particular groups, industries or sectors of the economy, the effect of such a move would need to be weighed against the wider implications for the economy, including efficiency and equity. Apart from this, all of our income tax law is built on the twin interconnected concepts of residence and source and it would be a fundamental shift to remove one of those basic building blocks. It would also facilitate tax avoidance.

Let me deal firstly with the questions on notice you mentioned in your letter of 8 August 2000.

Joint Ventures – BHP evidence and submission

The first matter related to concerns BHP had raised about the taxation of joint ventures. (Hansard SFS 14 July 200 at page 578). After Senator Watson raised this issue (at pages 622 and 623) I agreed to take it on notice.

I answered Senator Watson's questions on this matter at the hearing on the assumption that they dealt with a joint venture offshore. On reading Hansard the exact nature of the concerns BHP had raised were not clear to me. One of my officers, Mr John Passant, rang Mr Ian Edney, Vice President, Taxes, BHP to clarify the position.

Mr Edney confirmed that BHP's concern is with resident joint ventures and a recommendation of the Ralph Committee that the intercorporate dividend rebate be removed for unfranked distributions (other than distributions within a wholly owned company group) between resident companies. The Government accepted the recommendation and it was included in the *New Business Tax System (Miscellaneous) Bill (No 1) 2000*. That Bill received Royal Assent on 30 June 2000.

The Explanatory Memorandum to the Bill explained the reason for the change. It said:

> The current law treats different resident companies in an inconsistent manner. It has resulted in loopholes because most unfranked dividends between companies are freed from tax. This has led to a wide range of complex anti-avoidance provisions dealing with the availability of the section 46 rebate.
>
> The [Ralph] Review considered the advantages of the current treatment to be unwarranted where the distribution is not between companies within a wholly owned group. Therefore, it recommended that the law be altered.

Representations have been made to the Government concerning the impact of the removal of the intercorporate dividend rebate on resident joint venture companies. I have been advised that the Treasurer has responded to those representations indicating that the Government was not attracted to reinstatement of the intercorporate dividend rebate.

Expatriates and Superannuation Guarantee – BHP evidence

The second matter you raised in your letter of 8 August related to comments by Mr Edney (at pages 579-560) in relation to expatriates and the superannuation guarantee. This is a matter of policy on which I understand Treasury has written to Senator Watson.

Gold Trading

At page 637 Senator Watson asked me to take on notice a question about the Citibank World Gold Centre in Australia and "problems as a result of some changes of legislation." The issue, as I understand it, relates to OBU legislation allowing gold trading only with persons who are offshore persons (broadly, not Australian residents) in currencies other than Australian currency.

The Assistant Treasurer wrote to Senator Watson earlier this year indicating, among other things, that:

- to include domestic gold trading in the OBU regime would provide a tax benefit for a substantial domestic activity; and
- the compliance issues associated with the current regime were a necessary feature of a concessional regime that is targeted to a specific cross-border activity.

As I understand it the position has not changed.

Audit activity

Senator Conroy asked me about our level of audit activity and whether I had a concern that we were not doing as many audits as before (page 628). I would like to clarify some aspects of my answer. On the understanding that Senator Conroy's question related to the performance of the Large Business and International business line, I replied that "[i]f you look at what we call audit products, and they go from risk assessment right through to audits, we have been averaging about 800 audit products a year." We had planned 400 for the 1999/2000 year and actually completed 672. The 1999/2000 results are the baseline for 2000/2001 planning and we are aiming to complete at least a similar number of audit products this financial year.

In terms of the work in progress over the last three years, cases on hand stood at 758, 882 and 683 at 30 June 1998, 1999 and 2000 respectively. We currently have 725 active cases. These numbers vary (sometimes markedly) throughout the year and are influenced by the normal business cycle and the relative complexity and difficulty of cases being actioned. We expect this number of 725 to remain fairly constant in terms of the overall level of activity, noting that there will be cases started and cases completed throughout the period.

Let me now deal with some of the matters you raised in your letter of 7 September 2000. These matters arise as a consequence of submissions made to the Committee. Page references are to Volume 1 of your compilation of the submissions on the opportunities and constraints for Australia to become a centre for the provision of global services.

FIFs and CFCs – IBSA, AMP and Vanguard Submissions

The Government has accepted in principle the recommendation of the Ralph Review that there be a comprehensive review of the foreign source income rules. The review would cover CFCs and FIFs as well as the transferor trust provisions. The foreshadowed review would seem to present the opportunity for groups such as the International Banks and Securities Association of Australia (IBSA), AMP and Vanguard to make detailed submissions on the issues they have raised before the Committee.

GST and financial services - IBSA and Vanguard submissions

The IBSA and Vanguard submissions deal with the GST and financial services in a global financial centre context. We have forwarded all these issues on to the relevant areas. IBSA also brought a number of issues to the direct attention of the Government. I have been advised that recent proposed changes in *Taxation Laws Amendment Bill No 8 (2000)* address three areas of concern IBSA raised. These changes will:

- allow input tax credits in relation to supplies of precious metals by an Australian entity to an overseas branch or where an Australian branch of an overseas entity supplies its parent overseas. The credits are available where the overseas entity uses the precious metals for making input taxed supplies overseas.

- exempt employee share schemes from a GST liability (reverse charge) where the scheme is supplied by an offshore entity to an Australian 100% subsidiary or branch of the supplier.

- ensure an overseas entity will not be required to register for GST in Australia where the overseas entity supplies employees in Australia to a 100% subsidiary of the supplier. (If the overseas entity supplied employees to a branch this is exempt from GST). The exclusion only extends to those payments made by the Australian recipient that if made directly to the employee would be subject to PAYG. This will mean that the supply of employees is effectively tax free. However, if the overseas entity is making other supplies in Australia and must register because of those supplies, or chooses to register, then the supply of employee services will remain a taxable supply.

Thin capitalisation rules – IBSA submission

Proposed changes to the thin capitalisation rules reflect the differences in tax treatment between debt and equity – in particular the full tax deductibility of interest expense coupled with the lower taxation of interest flows to non-residents - and the desire for neutrality in the taxation of Australian branches and subsidiaries of foreign businesses.

The thin capitalisation regime is an anti-avoidance measure. The Ralph Review accepted that "Australia's current thin capitalisation provisions are not fully effective at preventing an excessive allocation of debt to the Australian operations of multinationals because [the current rules] refer only to foreign related party debt and foreign debt covered by a formal guarantee rather than total debt. Hence they do not restrict the proportion of third party debt that can be allocated to the Australian operations."

The Ralph Review recognised that "foreign multinational groups often have the flexibility to allocate a disproportionate share of debt to their Australian operations with detrimental revenue consequences." At the same time the Review accepted that "a balance has to be drawn between revenue protection and allowing for wide variations in commercial arrangements."

For these reasons the Ralph Committee recommended that the thin capitalisation regime be strengthened by applying it to the total debt of the Australian operations of a foreign multinational investor, including permanent establishments (branches) operating in Australia. This approach will mean that branches and subsidiaries of foreign enterprises will be treated similarly for tax purposes.

Another Ralph proposal will also "ensure that these branches [ie branches of non-residents] are required to have some minimum level of equity for the purpose of determining interest deductions." It is recognised internationally that some minimum level of equity is necessary in these circumstances.

The Government has indicated support for the thin capitalisation proposals.

The proposed thin capitalisation rules are one aspect of allocating income between countries. It should be noted, as the Ralph Review recognised, that Australian multinationals have non-portfolio (ie greater than ten per cent) investments in controlled foreign entities or offshore branches. As the Ralph Review said Australian multinationals (like foreign multinationals) can be in a position to allocate excessive debt to their Australian operations. The result would be that the Australian revenue would bear an undue proportion of the interest expense. For that reason the Ralph Review recommended that Australian multinational investors holding non-portfolio investments in controlled foreign entities or offshore permanent establishments be subject to thin capitalisation gearing limits on their Australian operations. For non-financial institutions this would be a three to one safe harbour gearing ratio. The rules for non-bank financial institutions are more complex and involve a general three to one ratio with the exclusion of on-lending and an overall maximum gearing limit of twenty to one. As recommended by the Ralph Review, the safe harbour for authorised banks is based on the capital levels reported for regulatory purposes.

The Ralph Review also recommended that if the safe harbour rules mentioned above were adopted the law be amended so that interest expenses incurred in earning foreign source income no longer be quarantined. This would mean that the thin capitalisation requirements would be the only restriction on the deductibility of interest where Australian taxpayers borrow for investment in controlled foreign entities.

The legislation for the thin capitalisation and interest allocation proposals is being developed in consultation with industry, including IBSA.

Interest Withholding Tax – IBSA and Vanguard Submissions

IBSA has commented that the interest withholding tax regime disadvantages foreign bank branches relative to banks (including foreign banks) incorporated in Australia.

There are two aspects to this, depending on whether the comparison is with an Australian owned bank or a foreign bank Australian subsidiary.

Any discussion of interest withholding tax really needs to be had in the wider context of the level of capital flows into and out of Australia and the role of the tax for a capital importing country such as Australia. Australia has always sought a balanced approach to source and residence based taxation. This has enabled Australia to obtain a reasonable level of taxation while still attracting the capital we need. Capital exporting countries have tended to emphasise residence based taxing rights, as have the owners of foreign investment into Australia.

The general rule is that interest paid out of Australia to a non-resident or credited to a non-resident is subject to interest withholding tax at the rate of 10% of the gross amount of the interest paid or credited. In general interest paid to an Australian resident company (including a subsidiary of a foreign bank) or to an Australian branch of a foreign bank is subject to tax by assessment.

Section 128F of the *Income Tax Assessment Act 1936* exempts from interest withholding tax interest paid or credited on publicly offered debentures. IBSA's concern may be that an Australian branch of a foreign bank cannot directly obtain the exemption.
This is because the legislation specifically requires the issuer of the debenture to be an Australian resident company. An Australian branch of a foreign bank is not an Australian resident company.

However, an Australian *subsidiary* of a foreign bank can borrow section 128F exempt funds and on-lend those funds to an Australian branch of the foreign bank. The thin capitalisation provisions were amended in 1999 to allow this to occur without adversely affecting the subsidiary's position for thin capitalisation purposes.

It should be noted that Part IIIB of the *Income Tax Assessment Act 1936* is a special regime for Australian branches of foreign banks. Under Part IIIB interest paid to a foreign bank by its Australian branch is subject to interest withholding tax at approximately half the normal rate. This provision was intended to compensate foreign bank branches for the fact they could not access the section 128F exemption, on the understanding that they would operate as stand-alone structures. In fact (as alluded to above) they have established arrangements whereby associated Australian subsidiaries undertake the section 128F borrowings and on-lend to the Australian branch. So in terms of borrowings raised by means of widely distributed commercial paper the Australian branch effectively gets the full exemption. There is nothing untoward in this and it is consistant with the direction in which legislative policy has developed in recent years.

However the branch also gets a reduction under Part IIIB in respect of moneys borrowed from the foreign bank where there is no wide distribution. For example, if the bank had depositor's funds available to it in its home jurisdiction, these cheaper funds would attract the concession. No other taxpayers can obtain this concession.

The reduction in interest withholding tax by the use of subsidiaries and the further reduction in Part 111B, could outweigh any extra incorporation costs and possible increased funding costs which may arise as a consequence of establishing a subsidiary in Australia to gain access to the section 128F exemption. Unless there is something further to their submission that we do not understand, our conclusion is that, in relation to interest withholding tax, foreign banks are arguably advantaged rather than disadvantaged relative to banks incorporated in Australia.

There is, however, a legitimate concern regarding the compliance costs involved in having to have a dual entity structure of subsidiary and branch in order to access section 128F funding. We are working with industry and Treasury on this matter.

The comments by Vanguard at page 176 about withholding tax are really a reference to the taxation of non-resident beneficiaries and I have included a response in the later section entitled "CGT, taxation of trusts and Australia as a Global Financial Centre – Vanguard Submission".

CIVs – IFSA and Vanguard Submissions

Both IFSA and Vanguard were concerned that the Ralph proposals to establish a defined collective investment vehicle (CIV) regime in the context of entity taxation would adversely affect the funds management industry. They argued that the definition of CIV was too narrow and would result in many funds managed investments being taxed as entities.

The Government received a number of representations about the flow through taxation treatment of CIVs and on 11 October announced that the proposed CIV regime foreshadowed in Ralph would not proceed. In the interests of minimising compliance and restructuring costs, companies, fixed trusts, limited partnerships and co-operatives broadly retain their current tax treatment.

OBUs – IBSA and Vanguard Submissions

IBSA said that the OBU regime was neither easy to understand nor administer (per Submission No 18). One of IBSA's concerns relates to the rules for OBUs to apportion expenses. The ATO has had discussions with IBSA over a period of time on this issue and we are continuing to work with them to solve any expense allocation problems that may arise.

The present expense allocation rules exist in part to guard against the inappropriate taxation of non-OBU income. The aim is to ensure that the taxable income of the OBU is properly calculated and that only income from OBU activities is subject to the concessional tax rate.

IBSA also suggested that all OBU transactions should be GST free. My comments on the GST and financial services mentioned above are apposite here.

IBSA further commented that gold trading with non-offshore persons in Australian dollars should be permitted. My comments above on gold trading are relevant here.

IBSA also said that aspects of the existing rules like the terms under which access will be granted to the OBU regime needed to be developed further. Comments later on by IBSA indicate that the concern here is with guidelines which allow the Treasurer to determine that a company is an OBU. IBSA say it is not clear what capital, employment and other requirements the Tax Office might expect of an overseas applicant.

The specific criteria in the OBU guidelines are:

(a) whether the primary business of the company is, or will be, primarily providing financial services on a commercial basis to third parties;

(b) whether the company primarily provides in-house financial services for a corporate group;

(c) whether the company could be declared to be an OBU under paragraph 128AE(2) (a) (b) (ba) (c) (d) or (e) of the Act;

(d) whether the company has an Australian Company Number (ACN) under the Corporations Law or an Australian Business Number (ABN) under the Act;

(e) in relation to a company that does not have an ACN or ABN - the place where the company is registered and whether the company has, or intends to have, a permanent address in Australia;

(f) the company's history, previous business experience, principal shareholders and worldwide operations;

(g) the company's most recent profit and loss accounts, balance sheets, and insurance policies;

(h) the company's business plan for the OBU for a minimum 12 month period;

(i) whether the company is a member of an Australian financial industry association;

(j) whether the company has agreed that its eligibility for OBU status may be reviewed if required; and

(k) the category, or categories, of OB activity to be undertaken.

The ATO and Australian Prudential Regulation Authority (APRA) undertake a detailed assessment of an application using these guidelines. APRA reviews criteria (f), (g) and (h) and the International Tax Division in the ATO reviews the remaining criteria and co-ordinates the process. The ATO then makes a recommendation to the Assistant Treasurer.

The guidelines are an attempt to replicate the requirements that relate to the other types of bodies which are eligible for OBU status. These bodies include banks, foreign exchange dealers, life insurance companies and so on. All of these bodies are subject to regulatory and prudential overview. It is this status which is a general prerequisite for declaration as an OBU. The guidelines are a mechanism to ensure that any exceptional cases where entities of substance and good reputation operating in similar markets and wanting to perform offshore banking functions fall outside those regulatory and prudential nets can be declared to be OBUs if appropriate.

There are no specific capital or employment requirements in the guidelines. It should be noted that, apart from allowing only appropriate companies to be eligible for declaration as an OBU, the whole of the OBU regime is designed to ensure that the offshore banking activity occurs in Australia, the activity adds genuine economic value and the concession is not abused, for example by being used as a mere conduit for income or for activities like money laundering. Whether the enterprise will add value will depend on the functions to be performed, the assets to be used and the risks that will be assumed. In determining the profits that should be allocated to such an OBU regard would have to be had to the appropriate allocation of capital for tax purposes to the subsidiary or branch through which the relevant bank is operating. The Tax Office would also be concerned to ensure that the procedure for exceptional cases is not used to undermine the integrity of the registration process.

IBSA also commented that the manner in which the new thin capitalisation rules will apply to OBUs has not been stated and that this creates uncertainty. As I noted above, IBSA is one of the bodies involved in consultations about the thin capitalisation measures.

IBSA also raised the issue of the interaction between the OBU provisions and the foreign bank branch provisions contained in Part IIIB of *the Income Tax Assessment Act 1936*. The concern is that interest payments by a foreign bank branch are subject to the LIBOR restriction on the maximum amount of interest deductible under section 160ZZZA of Part IIIB.

Under Part IIIB a foreign bank branch is treated, for certain purposes, as if it were a separate company for determining the liability of a foreign bank to tax. In particular, loans to the branch from the foreign bank and derivative transactions and foreign exchange transactions between the branch and the foreign bank are treated as if they were made between two separate legal persons.

In relation to intra-bank loans to the Australian branch, where the funds are provided at a rate that is in excess of LIBOR the branch is denied a deduction for the excess. In other words, the *maximum* rate of deductible interest on intra-bank loans is LIBOR. This is an attempt to prevent abuse by the loading of interest deductions in Australia.

Part IIIB is a compromise package which needs to be considered in its entirety. The ATO's view is that the overall package is concessional.

Vanguard raised concerns about the cost of establishing an OBU and the necessary duplication of operations required (page 176 of your volume of submissions on Australia as a global financial centre).

An OBU can be either a resident company or a permanent establishment (an Australian branch of a foreign company). I am assuming that the additional costs referred to are those associated with the incorporation of a subsidiary to obtain an interest withholding tax exemption under section 128F. My earlier comments refer.

In so far as other expenses are concerned, the OBU regime is concessional. OBUs have to maintain sufficient records, in accordance with generally accepted accounting principles and tax law, to identify OBU transactions passing through the accounts. This ensures that the taxable income of the OBU is properly calculated and that only income from OBU activities is subject to the concessional tax rate. There are also other safeguards to make sure that the use of non-OBU money does not benefit from the concession. While these requirements may create some complexity and impose some additional costs on OBUs, they are necessary to implement the focussed policy and to make sure the revenue is protected from abuse. It is of course a matter for judgement by each company as to whether the benefit of a concessional income tax rate of 10% outweighs the costs they perceive are involved in obtaining that benefit. As I said previously, we are working with IBSA to iron out any difficulties they are having with expense allocation.

CGT, taxation of trusts and Australia as a Global Financial Centre – Vanguard Submission

Vanguard made a number of points in relation to the operation of our CGT regime and the taxation of trusts from the point of view of the establishment of funds management operations in Australia, the import of funds management services into Australia and the export of funds management services from Australia. (See pages 174 to 176 of your compilation of submissions.) Their submission raises fundamental questions in relation to the taxation of non-residents who derive capital gains from Australian sources.

The Government's exposure draft on entities retains the flow through treatment of capital gains in that fixed trusts will continue to be taxed under the present tax provisions. For non-residents who are beneficiaries in a fixed trust this will mean that their share of the net income is subject to tax at the rates applicable to non-residents generally as if they had invested directly. Trustees are required to withhold an amount to cover taxes (if any) payable by a non-resident beneficiary. Vanguard describe this as WHT on trust income. However, in Australia the law has operated on the basis that income retains its character as it passes through a trust (eg interest, dividends, capital gains etc). Any CGT discount will apply where the non-resident investor meets the holding and other requirements.

In relation to non-resident investors being subject to CGT where they own ten per cent or more of units in an Australian managed fund, this is in fact a concession. It recognises that where the holding is less than this no Australian CGT is payable on the gain in the units. The threshold of 10% provides some level of protection against the use of interposed entities to avoid Australian taxes that could arise if non-residents invested directly. This 10% holding rule is a common one used by a large number of countries to distinguish between portfolio and direct investment. To extend it would be to give up taxing rights in circumstances where a unit holder has what has traditionally been regarded internationally as sufficient connection with the source country (Australia) to ground a taxing right. This thinking is reflected in Australia's double taxation agreements and in Division 136 of the *Income Tax Assessment Act 1997* which deals with CGT and non-residents.

I should also point out that while it is technically possible for an individual investor to hold 10% or more of the units in an Australian managed fund, this is only likely to occur where the fund is specifically marketed to a small number of individuals. Most managed funds market their operations to a wide range of investors to ensure that no one investor holds ten per cent of the units.

If you have any further questions, please contact John Passant on (02) 6216 2731.

Yours sincerely,

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