BTR/Section21 -

21

FOREIGN INVESTMENT IN AUSTRALIA

Limiting Australian tax on income flowing through Australia

Recommendation
21.1 Extension of conduit treatment

That the current foreign dividend account (FDA) be replaced by a foreign income account (FIA) that extends relief from Australian dividend withholding tax (DWT) on non-portfolio dividends to all types of foreign source income passing to non-resident investors.

In Chapter 31 of *A Platform for Consultation*, the Review discusses the taxation of foreign source income flowing through resident entities to non-resident investors. Adverse tax treatment of such conduit income can impact on the attractiveness of investments by non-residents in Australian entities.

The current FDA arrangements provide relief from Australian DWT when Australian companies receive non-portfolio foreign source dividends and subsequently pay unfranked dividends to non-resident investors (unfranked dividends are subject to DWT).

Under the recommendation, relief from DWT will be extended to all types of foreign income including portfolio dividends, foreign branch profits and capital gains. This will ensure that Australia does not cause foreign income to be double taxed where it flows through Australian entities to non-resident investors.

In relation to exempt foreign source income (non-portfolio dividends and foreign branch profits from limited-exemption listed countries), this income will also be relieved from DWT through the FIA. For capital gains and other income subject to the foreign tax credit system, the income that is not taxed in Australia because it has borne tax in the foreign country would be relieved from DWT by the FIA. Entities in receipt of such income will receive a franking credit for the amount that is subject to Australian tax and an FIA credit for the amount that was subject to foreign tax.

The foreign income account provisions will apply to all entities that come under the entity system.

Recommendation
21.2 Australian tax on conduit income

That Australian income tax continue to be levied on conduit income that has not been taxed at an effective rate comparable to that imposed on Australian source income.

There is the question of whether to levy Australian tax on conduit income that has been derived in low tax jurisdictions. Allowing low taxed profits to pass through Australia without tax can provide an incentive to shift profits to low tax jurisdictions (as discussed in *A Platform for Consultation*, page 653). Removal of Australian tax on income that will be distributed to non-residents could also be seen as harmful tax competition designed to attract mobile income from other countries. The OECD has recommended that member countries gradually eliminate harmful regimes and refrain from adopting such measures in the future.

Recommendation
21.3 Operation of the FIA

That the foreign income account (FIA) record the total foreign income derived by the entity.

In *A Platform for Consultation* (pages 657-659), the Review discusses whether the FIA should record the total foreign income of an entity or only the non-residents' proportion of the foreign income. The proportion of non-resident shareholders can vary between the time foreign source income is derived and when that income is distributed to these non-resident shareholders. In principle the FIA should only provide relief from DWT to the extent of the proportion of non-resident shareholders at the time the foreign source income is derived. Recording the non-residents' proportion of foreign source income would accord with this principle, as well as provide greater integrity to the FIA mechanism. However, it would have greater compliance costs because entities would be required to establish the proportion of their members that are non-resident, including those investing through collective investment vehicles and nominee companies.

Had the Non-Resident Investor Tax Credit been introduced (discussed under Recommendation 11.3), or if all tax imposed on inter-entity distributions were to be refunded to non-resident members (discussed under Recommendation 11.2), the non-resident member proportion would have been required to be determined by entities making distributions. Since these options are not recommended, the non-resident member proportion would only be required for the FIA. On balance, the integrity benefits from a proportional approach appear not to justify the additional compliance costs.

Recommendation
21.4 Identifying conduit income passing through other resident entities

That FIA credits be attached to distributions and pass from one entity to another in the same manner as franking credits.

The current FDA arrangements are relatively simple provisions: FDA credits are not attached to dividends and provide relief from Australian DWT only when an unfranked distribution out of foreign source income is paid directly by the entity to a non-resident investor. As a result, the current provisions do not provide relief where dividends are paid to non-residents via other resident entities including holding companies, collective investment vehicles and nominee companies.

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.

Recommendation
21.5 FIA dividends received by holding companies

That company tax on FIA distributions received by a resident entity be refunded if the resident entity receiving the distribution is:

(i) 100 per cent owned by non-residents; and

(ii) has at least a 10 per cent interest in the entity paying the distribution.

In some cases, non-residents use resident holding companies through which to hold their non-portfolio investments in Australian companies which, in turn, invest in non-resident companies. In *A Platform for Consultation* (page 660) the Review explains the option of allowing FIA dividends passing through these entities to be relieved of deferred company tax or DWT.

Under the recommended option for taxing unfranked inter-entity distributions (Recommendation 11.1), FIA distributions paid via a domestic entity to a holding company (not part of a consolidated group incorporating the domestic entity) will be subject to income tax. This income tax would have to be relieved to prevent it impacting on FIA distributions paid to non-residents via entities such as holding companies.

The Review recommends that entities that are 100 per cent owned by a non-resident should be subject to tax on inter-entity distributions but be able to claim a refund when the FIA distribution is paid from Australia. This treatment will ensure that these distributions are not subject to Australian tax while maintaining the integrity benefits from taxing unfranked inter-entity distributions. It is consistent with Recommendation 11.2 that is designed to apply to such cases as non-residents investing in incorporated joint ventures in Australia via a resident subsidiary.

This refund will be limited to where the entities (or consolidated groups) receiving the FIA distributions are 100 per cent owned by a non-resident and have a 10 per cent or greater interest in the entity paying the dividend.

The alternative to the non-residents of accessing the effect of this recommendation (and Recommendation 11.2) by establishing the holding company as a CIV may not be suitable in some circumstances because of the requirement that CIVs distribute all their income annually that is taxable to the member.

New arrangements for collecting tax from non-residents

Recommendation

21.6 A withholding tax regime for non-residents without a permanent presence in Australia

Withholding tax regime

(a) That a withholding tax regime be introduced in respect of Australian source income and gains on the disposal of assets subject to Australian tax derived by non-residents other than:

(i) where there is a permanent presence in Australia (in which case the existing taxation on assessment will continue to apply); and

(ii) interest, dividends and royalties — which will remain taxable at the appropriate (gross) withholding tax rates.

Rate of withholding to apply

(b) That the withholding tax not be a final tax (except for salary and wages where the withholding tax will be the final tax) and that tax be withheld at the time of payment at:

(i) **10 per cent — on the gross payment for assets, subject to Australian tax, disposed of by non-residents; and**

(ii) **the company tax rate on other payments.**

Rate of tax to apply on assessment

(c) **That, on assessment, the rate of tax be the company tax rate with:**

(i) **non-residents receiving payments subject to withholding at 10 per cent being required to assess their net liability at the company rate;**

(ii) **non-residents receiving payments (except salary and wages) subject to withholding at the entity rate having the option of assessing their net liability at the company tax rate.**

Withholding tax regime

The issues relating to this recommendation are discussed in *A Platform for Consultation* (pages 645-648).

In the absence of effective collection mechanisms, it can be difficult to ensure that the Australian tax liability of non-residents is met if they do not have a permanent presence or assets in Australia. ATO examinations have disclosed high levels of non-compliance by non-residents without a permanent presence in Australia. The most effective way to collect tax is through withholding systems. This is reflected in their widespread use overseas.

The withholding tax regime would not apply to:

- business income connected with a permanent presence of the non-resident in Australia;
- payments for the supply of goods; or
- dividends, interest or royalties (which will remain subject to the existing withholding tax regimes).

The first two exclusions are based on the fact that there is an ongoing business or business assets in Australia which can meet the tax liabilities of non-residents arising from their business activities in Australia. The exclusions also reduce the number of people required to withhold and the administrative cost of processing withheld amounts that are to be creditable.

The amount of withholding tax could be varied by the Commissioner at the recipient's request where, for example, there is no liability as a result of a DTA, there is a reduced liability because of projected deductible expenses, or a loss arises on the disposal of assets. The variation mechanism will allow withholding tax not to be collected in these circumstances, while providing 'real time' information to help combat tax avoidance and evasion.

Rate of withholding to apply

The withholding tax will not be a final tax, and non-residents who receive payments subject to withholding at the entity rate (except salary and wages) will have the option of seeking an assessment on a net basis at the company tax rate.

The general withholding rate will be the company tax rate. However, the withholding tax on the disposal of assets will be set at a rate lower than the company rate reflecting the withholding of tax from the consideration rather than taxing the profit on sale of the asset (to withhold at the entity rate from the profit would require the purchaser to know the tax affairs of the vendor).

It is much more likely for payments for the acquisition of assets, than for other payments to which the withholding tax regime will apply, for the withheld amount to differ from the tax that would apply if the non-resident was subject to a tax assessment on a net basis. There may, for example, be a loss on disposal of the asset.

The recommended approach to non-resident's salary and wages will also deliver substantial improvements — see Recommendation 22.17 for details.

Rate of tax to apply on assessment

Currently non-residents, apart from non-resident companies, are subject to tax at progressive rates on Australian source income. However, much of the income that non-residents derive from Australia can readily be derived through entities. Accordingly, it is proposed to tax non-residents generally at the company tax rate except on interest, dividends and royalties which are already subject to a final withholding tax.

Levying tax at a flat rate will be much simpler. Payers of amounts to non-residents, for example trustees of collective investment vehicles, will be able to withhold tax at a flat rate for all payments (except dividends, interest and royalties and assets subject to Australian tax).

Non-residents who receive payments subject to withholding at the company tax rate (except salary and wages) will have the option of seeking an assessment on a net basis for the year of income at the entity rate. A refund of withholding tax, where applicable, would be made.

Non-residents who receive payments subject to withholding tax at the 10 per cent rate will be required to lodge a return and be assessed for the year of income at the entity rate. This will enable the correct amount of tax to be assessed where it exceeds the amount of tax withheld. Again, refunds of withholding tax will be available where applicable.

There was general support for the recommended approach during consultations.

Taxing gains from the disposal of interposed non-resident entities

Recommendation

21.7 Avoidance of tax on capital gains by non-residents

That legislation deal with the avoidance by non-residents of Australian capital gains tax by disposing of an interposed entity holding Australian assets rather than the assets themselves.

In *A Platform for Consultation* (pages 649-650), the Review canvassed the issue of indirect transfers of Australian assets held by non-residents. Non-residents who wish to dispose of Australian assets can avoid Australian capital gains tax by interposing a non-resident company between the relevant Australian assets and the non-resident owners. The interposed company can then be sold with no Australian tax payable. Failure to address this issue would mean that, through relatively simple tax planning, non-residents would continue to be able to avoid capital gains tax.

Consultations and submissions were generally supportive of measures to address this issue, subject to the law being targeted at tax avoidance arrangements rather than commercial transactions. While this is an area of concern, the wider issue is that, regardless of their purposes, these arrangements can have the practical effect of frustrating Australia's policy of taxing substantive assets located here when their ownership changes. In other words, the measure is necessary to protect Australia's existing taxing provisions where there is an indirect disposal of the underlying assets.

The legislation will target appropriate cases in accordance with the following framework.

- Australian assets will need to be the principal assets of the entity holding those assets. Determining whether the Australian assets are the 'principal assets' will be made not by reference to a definition but by reference to a set of criteria in the legislation — such as the market value of the assets and whether the assets produce the majority of the entity's income.

- Control of the assets will need to pass from a non-resident entity to another party.
- The regime will not apply where the gain on sale of the interposed entity is subject to tax in broad exemption listed countries or would have been subject to tax in such a country except for recognised rollover relief.

While it is recognised that the collection of tax on the deemed disposal of an Australian asset in these circumstances poses practical difficulties in some cases (non-resident to non-resident transactions), it is considered that, in treaty negotiations, Australia should continue to seek agreement to provisions that will provide for bilateral enforcement of capital gains tax provisions in these situations.

Interest withholding tax on government securities

Recommendation
21.8 Interest withholding tax on government securities

That the exemption from interest withholding tax (IWT) not be extended to government securities issued in Australia.

Several submissions to the Review argued that government securities issued in Australia be exempt from IWT.

IWT is currently levied on interest paid to non-resident investors in relation to Commonwealth and State Government securities issued in Australia. Offshore issues by both governments and companies are free of IWT. The Government announced in December 1997 (in its paper *Investing for Growth*) that company issues in Australia will be free of IWT.

Providing an IWT exemption for government securities would allow State governments to issue all their bonds onshore, creating increased liquidity for the market. It would directly reduce borrowing costs modestly, and there would be a further small reduction in yields from 'market deepening.'

However, the key consideration in exempting government securities from IWT is the cost to revenue. The estimated revenue loss for 1999-2000 would be around $150 million. Initially most of the cost would arise from IWT payable on existing bonds (on which at the time of issue lenders would have expected to face IWT for the life of the security). An exemption would result in a windfall gain to these bondholders.

In the short term, the cost to revenue would not give rise to a corresponding fall in government borrowing costs because the lower borrowing costs would only arise from new debt issues whereas the IWT forgone includes the large stock of existing debt.

Over the longer term, the benefits from lower borrowing costs (as more new issues are made exempt from IWT) would increase but these would still be outweighed by the cost to revenue. This is because many non-resident borrowers would not be greatly affected by the extension of the IWT exemption. Those borrowers currently receive tax credits in their home countries equal to IWT paid in Australia and hence face the same overall tax liability with or without an IWT exemption. In these circumstances, the lenders would continue to seek a similar yield on their loans and the benefit of the removal of the IWT will accrue to foreign Treasuries.

The long term reduction in annual borrowing costs for Commonwealth and State governments is estimated at $80 million per annum based on current levels of government debt. This is significantly less than the estimated revenue loss of $150 million for that level of government debt.

In the context of the revenue neutrality constraint applying to its recommendations, the Review does not consider extending the IWT exemption of sufficient priority to recommend the exemption.