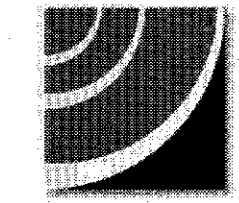

MINERALS COUNCIL OF AUSTRALIA

SUBMISSION BY THE MINERALS COUNCIL OF AUSTRALIA

TO THE

REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS CONSULTATION PAPER

NOVEMBER 2002

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Australia is one of the world's principal producers and suppliers of ores, concentrates and refined metals with a modern and efficient processing sector. This status, of course, has been hard-won. Clearly, to compete in the global market requires minerals companies to gain access to the best assets possible, whether in Australia or overseas.

A recent Productivity Commission research paper, *Offshore Investment by Australian Firms: Survey Evidence*, found that while commercial (or market-related) factors are more important overall than matters subject to government control in influencing decisions about *offshore production*, foreign and domestic tax regimes are important, and the leading government-related influence.

Principles of international taxation

Australia's international taxation arrangements and any proposed reforms to those arrangements should be assessed against the established tax policy objectives of efficiency, equity, simplicity and revenue integrity. In addition, Australia's taxation system should not undermine the international competitiveness of Australian commerce and industry. The Minerals Council has contributed to, and endorses, the principles of taxation developed by the Business Coalition for Tax Reform (BCTR).

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The introduction of dividend imputation in 1987 was an important aspect of the tax reforms introduced at that time. Specifically, the introduction of dividend imputation removed double taxation of domestic corporate earnings for resident shareholders.

Australia's imputation system is strongly supported by the Minerals Council. However, the imputation system and dividend withholding tax arrangements are biased against Australian companies with global shareholding and global investments. This bias was not a concern when imputation was first brought in. It has evolved in recent years as a consequence of the inevitable evolution of the Australian economy.

Options for reform

The Minerals Council recommends:

- **the dividend imputation system be retained;**
- **a suite of fiscal arrangements be introduced to address the clearly identified bias inherent in the current dividend imputation system; and**
- **this suite of arrangements comprise:**
  - **an appropriately developed variation on Option 2.1 A as outlined in the Treasury consultation paper that provides a credit sufficient to compensate for both the withholding tax and any underlying tax, while accommodating situations where the credit rate is higher than the foreign tax paid. Appropriate amendments could include the following:**
    - **the Foreign dividend account system to be converted into a tax paid system;**
    - **an Australian company will be entitled to a credit in its foreign dividend account when it receives a non-portfolio dividend from a foreign company. The credit will correspond to the amount of foreign tax on the dividend and the profits from which it was paid, however the credit will be limited to the Australian tax that would have been imposed on those profits in a domestic context (that is, $^{3}/_{7}^{th}$ of the dividend);**
    - **the credit for Broad Exemption Listed Countries to be limited to $^{3}/_{7}^{th}$ of the dividend and in the case of Limited Exemption Listed Countries and unlisted countries to be based on the actual foreign tax paid but not exceeding $^{3}/_{7}^{th}$ of the dividend;**

- **an Australian company will be entitled to frank a dividend from its franking account and/or foreign dividend account (at its option); and**
- **non-resident shareholder that receives a dividend that is franked from the franking account or foreign dividend account will be exempt from withholding tax.**

- **a dividend streaming system that allowed foreign source income to be streamed to non-residents, outlined under Option 2.1 B in the Treasury consultation paper, which would remove an anti-globalisation bias facing Australian transnational companies that wish to use offshore equity in the parent Australian company to fund offshore investment as part of their key growth strategies.**

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The Minerals Council supports the need to identify technical and other policy issues regarding the CFC rules and consideration of options to resolve them. **While a major rewrite of the CFC rules would be supported in the longer-term, the Minerals Council would be keen to see specific pressing issues resolved in a more timely manner.**

Improving conduit income arrangements

Regional holding companies and capital gains tax

As a general proposition, **the Minerals Council recommends a conduit holding company regime (CHC) be considered to allow the foreign income and gains of regional holding companies to flow through to their foreign shareholders free from the imposition of Australian tax.**

The Council's preferred option would be to provide a general exemption for non-portfolio dividends received from foreign companies (Option 3.9 in the Treasury consultation paper) and for capital gains derived from the sale of non-portfolio interests in foreign companies.

Establishing foreign income accounts

The Council supports the Review of Business Taxation's recommendations 21.1 and 21.4 that the current foreign dividend account (FDA) be replaced by a foreign income account (FIA) (Option 3.11 in the Treasury consultation paper). **However, the Council recommends this be expanded to interact with Option 2.1 B.**

Australia's double tax agreement network

The Minerals Council notes that Australia should seek to establish a competitive and non-discriminatory network of double tax agreements (DTAs) under which Australia collects an appropriate share of tax revenue on international business. At present however, Australia has a series of DTAs that can produce inequitable results for Australian companies with foreign subsidiaries. In addition, new DTAs are typically taking over five years to negotiate.

The Protocol to the Australia/United States Double Tax Agreement

The Minerals Council supports modernising Australia's DTA network and recognises that the recent Protocol to the DTA with the United States is regarded as a major step forward in this process. However, the Minerals Council notes that while the Australia/United States tax agreement is an improvement to the current agreement process, further consideration needs to be given as to what specific aspects of this agreement form an appropriate basis for future DTA negotiations and whether certain aspects of other DTAs should be incorporated.

The future of the Tax Treaties Advisory Panel

The Minerals Council supports effective consultation arrangements with business and other parties in achieving successful and timely agreement negotiations and therefore support options to improve the

transparency and effectiveness of current processes. **To further enhance consultation arrangements, the Minerals Council recommends:**

- **the Tax Treaties Advisory Panel continue to operate as a formal consultation mechanism with Australian industry (including the minerals industry) on double tax agreement matters;**
- **the Panel meet more frequently (for example, twice a year); and**
- **consideration be given to lessening the strict confidentiality arrangements surrounding such consultation.**

Place of residence: current problems and options for reform

The Minerals Council recommends the current residency test be clarified to provide certainty for business and remove impediments to the involvement of Australian management in the business of foreign subsidiaries. This could be achieved by:

- **consistent with Option 3.12 in the Treasury consultation paper, amending the statutory definition of residence to ensure that a company is not be deemed to be carrying on business in Australia simply because it has its central management and control here; or**
- **moving to a simple "place of incorporation" test. Such a test would significantly simpler and more certain than the current test or other alternative, but this would need to be balanced against concerns about tax system integrity.**

Section 4 — Improving Australia's Tax Treatment of Foreign Expatriates

Taxation Laws Amendment Bill (No. 4) 2002 and Taxation Laws Amendment Bill (No. 7) 2002

The Minerals Council strongly supports the measures contained in *Taxation Laws Amendment Bill (No. 7) 2002*, which will assist Australian industry (including the minerals industry) to attract key personnel to Australia by reducing the additional extra costs that are typically incurred in employing temporary residents.

Section 5 — Other issues not raised in the Treasury consultation paper

Offshore exploration expenditure

One area of non-deductible business expenditure (or "black hole") concerns overseas exploration expenditure that cannot be deducted against Australian income. **The Minerals Council recommends Australian tax law be amended to allow non-Australian exploration expenditure to be deductible against Australian mining income.**

Royalty withholding tax implications (RWHT) of chartering and similar arrangements

The ATO released draft taxation ruling TR2002/D11 *Income tax: the royalty withholding tax implications of chartering and similar arrangements* on 25 September 2002. The ruling applies to charters of industrial, commercial and scientific equipment such as ships, cranes and aircraft. The examples in the ruling focus on the shipping industry. **The Minerals Council notes the draft tax ruling is flawed in its technical analysis of maritime law and if released in its present format would represent a dramatic change of direction in interpretation by the ATO.**

The Minerals Council recommends that the draft ruling TR2002/D11 be withdrawn and replaced with a more appropriate ruling developed in consultation with industry. The ruling should only be applied to new contracts entered in to post its finalisation otherwise taxpayers potentially impacted by the ruling will not have certainty in determining their business affairs nor time to restructure.

SECTION 1 — INTRODUCTION

1.1 The Minerals Council of Australia and the Australian minerals industry

This submission to the *Review of International Taxation Arrangements* consultation paper (the Treasury consultation paper) is made by the Minerals Council of Australia.[1]

The Minerals Council of Australia is the peak, national organisation representing the exploration, mining and minerals processing industry in Australia. The membership of the Council accounts for in the order of 85 per cent of Australian minerals production and a slightly higher percentage of Australia's mineral exports.

The Council's charter is to promote the development of a safe, profitable and environmentally responsible minerals industry that is internationally competitive and attuned to community expectations.

The industry the Council represents is diverse, commodity oriented, technologically advanced, capital intensive, high risk/high reward characterised, heavily export oriented and increasingly profoundly globally aware and internationally integrated.

The minerals industry is an industry of considerable size and economic and social significance, benefiting all Australians both directly and indirectly. The mining and minerals processing sector accounted for:

- around 8.6 per cent of national gross domestic product in 1999-2000;
- in 2000-01, around $42 billion of Australia's total export revenues, representing approximately 37 per cent of total merchandise exports and 28 per cent of Australia's total exports of goods and services
  - in 2000-01, the share of each sector in Australia's total exports of goods and services of $153 billion was:
    - 28 per cent for minerals and metals;
    - 9 per cent for oil and gas;
    - 21 per cent for the rural sector;
    - 22 per cent for other merchandise goods; and
    - 21 per cent for services
- exports of mining technology, equipment and services of approximately $1.7 billion in 2000-01.[2] This includes a wide range of minerals exploration related technology, equipment and services;
- directly and indirectly, some 240,000 jobs, representing 4.6 per cent of total employment in 2000-01, many of which are in sparsely populated, remote and regional Australia;
- 20.9 per cent of private new capital expenditure in Australia in 2000-01 and, over the decade of the 1990s – given its cyclical nature – new investment in the sector averaged closer to 25 per cent of total private investment;
- total Government revenue payments of $4.3 billion in 2000-01, comprising $1.1 billion, $1.1 billion, $1.7 billion and $0.5 billion for mineral royalties, Government port and rail charges, income tax expense and indirect taxes, respectively. Between 1982-83 and 2000-01, total tax payments (in 2000-01 prices) ranged between $2.0 billion (in 1983-84) and $4.9 billion (in 1989-90) with an average of $3.2 billion. By contrast, net profit ranged between $0.6 billion (in 1997-98) and $5.5 billion (in 1989-90), with an average of $2.2 billion over the period; and

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[1] Further details about the Council can be found at our web site, at http://www.minerals.org.au/defaultx.htm.
[2] Department of Industry, Tourism and Resources (2001), *Mining Technology Services Action Agenda: Background paper on issues affecting the sector*, AusInfo, Canberra.

- significant infrastructure development – since 1967, the industry has built 25 towns, 12 ports and additional port bulk handling infrastructure at many existing ports, 25 airfields and over 2,000 kilometres of rail line. The industry is often the sole provider of social infrastructure – health, education and welfare – in remote areas of Australia; this infrastructure often enduring long past the completion of mining activities.

The industry is vital for the well being of remote and regional Australia. This is evident from the activity in, for example, coal, iron ore, gold, bauxite, manganese and other minerals that are typically mined in remote areas.

Many people are apt to assume that the benefits of such national development are transient. They are not, for the wealth created by successful mineral discoveries often provides the capital and improved infrastructure for other developments and they enhance the health, education and welfare of our most crucial resource – people.

In addition, there are strong links between the operations of the minerals industry and the lives of ordinary Australians living, for the most part, in the cities and urban centres. On one estimate, the Australian minerals industry spends around $15 billion per annum on goods and services, about 80 per cent of that by value being sourced from domestic suppliers.

1. Importance of international taxation issues to the Australian minerals industry

The Review of Business Taxation noted in 1998:

> *To redesign a tax system in a manner which does not take sufficient account of international factors would be to risk a declining revenue base, poorer economic outcomes, inadequate foreign investment in Australia and a poor competitive position for Australian enterprises and Australian based multinationals.*[3]

Australia is one of the world's principal producers and suppliers of ores, concentrates and refined metals with a modern and efficient processing sector.

This status, of course, has been hard-won.

Minerals companies face challenges peculiar to their industry. Exploration to discover economically recoverable ore bodies is an unavoidable first step. Then resource development, proximity to markets, infrastructure and political risk all figure in investment decisions. Overall, however, it is geology that dictates the geographic location of mines. Furthermore, because the resource begins to deplete as soon as mining commences, minerals companies cannot survive without committing to investment in new projects.

Until recently many countries had mineral (including exploration) regimes that were not attractive to international investment. However, that is changing and many of these countries, particularly in South America, Africa and Asia, are now actively inviting international participation in their minerals industries. As a result of this new competitive reality, the attractiveness of the Australian continent for world-class mineral deposit exploration has diminished in relative terms.

In considering the role of public policy in relation the minerals industry, it is useful to keep in mind the type of considerations which companies apply in setting exploration and mining priorities globally. Some of the criteria to be considered include:

- geological prospectivity;
- host country land access and investment rules;
- whether there is a developed legal system;

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[3] Review of Business Taxation (1998), *An International Perspective,* AusInfo, Canberra, December, p. 3.

- whether the mining law is well defined and emphasises ownership of resources and the rights and conditions attaching to exploration and mining activities;
- **the taxation rules governing how the host country shares the benefits of production;**
- land use and environmental policies; and
- stability of rules and perceptions of country risk.[4]

Of course, in practice, different companies will attach differing priorities to these conditions that may also differ according to country-specific considerations.

Considerations of this nature have been confirmed more recently in a Productivity Commission research paper, *Offshore Investment by Australian Firms: Survey Evidence*, which found that while commercial (or market-related) factors are more important overall than matters subject to government control in influencing decisions about *offshore production*, foreign and domestic tax regimes are important, and the leading government-related influences. For those firms involved in *headquarters* relocation, improved access to world markets and proximity to investors are the main motivations, while the Australian tax regime is the most important influence subject to government control.[5]

1.3 Principles of International Taxation

Australia's international taxation arrangements and any proposed reforms to those arrangements should be assessed against the established tax policy objectives of efficiency, equity, simplicity and revenue integrity. In addition, Australia's levels of taxation should be internationally competitive.

The Minerals Council has contributed to, and endorses, the principles of taxation developed by the Business Coalition for Tax Reform (BCTR).[6] These principles can be found at **Attachment 1**.

The specific BCTR principles relevant to the international tax review are:

1. The tax system should be simple, transparent and should minimise uncertainty.
2. The design, administration and operation of the tax system should be undertaken with full and effective consultation with relevant stakeholders including the business community.
3. The tax system should fairly balance the need to protect the taxation revenue base with the principles of a good tax system, i.e. efficiency, fairness (horizontal and vertical equity), simplicity, clarity, certainty and low compliance costs.
4. The tax system should enhance competitiveness by providing a climate conducive to improved investment in Australia and from Australia for Australian-based entities and individuals.
5. The tax system should avoid the double taxation of business income and provide relief for all business expenses.
6. The tax system should not impede organisational restructuring.

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[4] Johnson, C. (1990), 'Ranking countries for mineral exploration', *Natural Resources Forum*, 14 (3), August, pp 178-86; and Otto, J. and Bakkar, P. (1993), 'Minerals investment conditions in Asian regions – a checklist for success', *International Seminar on Minerals Sector in India*, Hyderabad, February.

[5] Productivity Commission (2002), *Offshore Investment by Australian Firms: Survey Evidence*, Commission Research Paper, AusInfo, Canberra (available at http://www.pc.gov.au/research/commres/offshinvest/index.html).

[6] The Business Coalition for Tax Reform (BCTR) is an apolitical organisation whose members are industry and professional associations from all sectors of the economy representing small, medium and large businesses. The BCTR members have a common desire to provide a unified approach to building a better tax system that enhances both international and domestic business competitiveness and fairness and which assists in creating a business climate conducive to investment, growth, job creation and private saving. The BCTR has been closely involved in taxation reform since its inception in 1997. For more details, see http://www.bctr.org/default.asp?pnewsid=1083.

For the purpose of this submission, the Council has extended the above principles to include the following design rules:

1. Foreign income and the sale of foreign assets by foreign shareholders should not be taxed in Australia.

2. Australia should levy tax only on passive (for example, interest and royalties) foreign income earned in unlisted countries.

3. Active income taxed in a foreign jurisdiction should not be subject to further tax in Australia (through to the "ultimate" shareholder).

4. The tax system should not discourage foreign companies from locating parent or regional parent companies in Australia and not discourage foreign ownership of assets under Australian companies.

5. Foreign expatriate employees should face the same tax treatment as Australian employees.

6. Determination of residency for Australian taxation purposes should be simple and certain.

SECTION 2 — ATTRACTING EQUITY CAPITAL FOR OFFSHORE EXPANSION

2.1 Dividend imputation in Australia

The introduction of dividend imputation in 1987 was an important aspect of the tax reforms introduced at that time. As was noted by the Bureau of Industry Economics in 1996

> *The Australian imputation system has proved to be fundamentally sound, both in principle and practise.*[7]

Specifically, the introduction of dividend imputation in 1987 removed double taxation of domestic corporate earnings for resident shareholders, replacing the "classical" system under which companies were taxed on their profits as separate legal entities and, when those profits were passed on to individual shareholders in the form of dividends, were taxed again as personal income.

In so doing, dividend imputation reduced the bias against paying dividends and raising equity and renders additional investment in company shares more attractive. In this way, the dividend imputation system has proved to be generally sound in principle and practice and represents a welcome and permanent feature of the taxation landscape. By removing the tax driven distortion favouring debt funding over equity funding, dividend imputation has been a significant factor in the strengthening of balance sheets of Australian businesses thus facilitating growth in business investment, a major driver of the economy.

Over the fifteen years or so that has elapsed since 1987, the Australian economy has changed significantly. The growth in outward investment by Australian companies and more generally the process of globalisation suggest as an imperative there is a need for the imputation system to be modified so that it does not unnecessarily impede Australian companies competing in a globalised world.

This evolution of the economy has drawn attention to the aspect of imputation which has the effect of altering the taxation of domestic versus foreign income of corporations, by making only Australian (and not foreign) company tax paid available for the granting of imputation credits. In the extreme case, Australian resident shareholders receiving dividends paid are taxed only once on Australian-sourced income, but are taxed twice on foreign-sourced income.

Australia's imputation system is strongly supported by the Minerals Council. However, the current Australian international tax system interface inhibits Australian companies' ability to compete internationally because the imputation system and dividend withholding tax arrangements are biased against Australian companies with global shareholding and global investments. This bias was not a concern when imputation was first brought in. It has evolved in recent years as a consequence of the inevitable evolution of the Australian economy.

Australia is a major capital importing country. However, in addition to that over the past two decades it has also become a major overseas investor – following deregulation – with Australian investment abroad now accounting for about 62 per cent of the level of foreign investment in Australia. It is important to recognise that Australia benefits from investment overseas because of the flow-back of profits, interest and dividends, the development of markets for Australian business (including related services inputs) and the technical managerial and market know-how which is obtained.

Australia effectively double-taxes the foreign income of Australian companies and promotes a tax bias that impacts on the cost of capital. This is because Australia's imputation system penalises Australian companies' attempts to allocate foreign owned income to foreign investors and franked Australian-source income to Australian investors. In this way, Australia's dividend imputation system is suited to a 'closed' economy that does not trade and invest overseas and is less well suited to a small 'open' economy such as Australia's, which is heavily globally integrated. Specifically, Australia's dividend imputation system encourages domestic expansion and not international development. To

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[7] Bureau of Industry Economics (1996), *Dividend Taxation and Globalisation in Australia,* Australian Government Publishing Service, Canberra, page iii.

expand overseas, Australian businesses need to access both domestic and foreign sources of equity capital.

The business community generally and various researchers[8] have identified that there is a bias in favour of domestic investment that can affect the cost of capital for Australian companies undertaking direct investments offshore. This is a position supported by the Minerals Council.

Under dividend imputation, Australian resident shareholders receive franking credits on dividends paid by resident Australian companies only for Australian tax paid. Australian residents do not receive credits for foregoing company tax paid by a branch or offshore subsidiary of an Australian company.

Further, resident individuals or funds investing equity offshore via an Australian resident company may face double taxation.

The Minerals Council agrees that currently there is a bias to favour domestic investment due to the limited application of the imputation system. However, as noted above, dividend imputation is a key feature of the Australian taxation system – the imputation system should remain in place and the Minerals Council does not support a return to the "classical" system, whereby shareholders receive no credit or recognition for tax paid at the company level, whether Australian or foreign.

The Minerals Council notes consideration should be given to addressing the bias to minimise the differences between the tax treatment of foreign source income, gains and losses of Australian investors and similar domestic income, gains and losses.

2.2 Options for reform

2.2.1 Benefits of removing the bias and foreign direct investment offshore

The Minerals Council notes that addressing the bias will bring about economic benefits by improving the cost of capital at the company level and this will be significant for both well-established multinationals as well as the smaller emerging businesses.

2.2.2 Options 2.1 A, B and C in the Treasury consultation paper

Any options considered should be assessed against the tax principles discussed in section 1.3 above and should avoid the creation of further distortions. The Minerals Council does not support corrections that would lead to an overall bias favouring foreign investment rather than domestic income or vice-versa.

The Treasury consultation paper outlines three main options for reform:

- retaining the imputation system while providing shareholder relief for unfranked dividends paid out of foreign source income – Option 2.1 A;
- permitting the 'streaming' of dividends paid from foreign source income by Australian companies – Option 2.1 B; and
- providing franking credits for foreign dividend withholding taxes paid by Australian companies – Option 2.1 C.

Australian taxation rules must keep pace with changes overseas. If that is not achieved, investors considering placing large projects here may be attracted away from Australia to more competitive tax

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[8] See, for example, Wojtek, P. (2000), *The Dividend Imputation System in Australia*, University of South Australia, School of International Business, Adelaide (available at http://blubb.at/wojtek/pobratyn_imputation.pdf); Bowden, Prof., Pham, Mr and Sim, Dr (1991), *Access and Efficiency in the Supply of Foreign Capital to Australia*, Centre for Banking and Finance, University of New South Wales, Sydney; Industry Commission (1996), *Implications for Australia of Firms Locating Offshore Final Report*, AusInfo, August; and Bureau of Industry Economics (1996), *Dividend Taxation and Globalisation in Australia*, Report 96/8, AusInfo, June.

environments. Additionally, a less attractive tax regime here could ultimately constrain the growth of Australia's internationally operating companies if they remain resident in Australia.

In the Minerals Council's view, providing shareholder relief for unfranked dividends paid out of foreign source income (Option 2.1 A) could appropriately and directly address the bias inherent in the current dividend imputation system.

The Treasury consultation paper uses a non-refundable tax credit of one-ninth of the dividend when an Australian company pays unfranked dividends as an example of how the system could work. The credit would be included in a taxpayer's assessable income. To be eligible, the unfranked dividend would need to be paid out of a designated category of foreign source income.

Whilst the Minerals Council acknowledges that a credit of one-ninth is used as an example only and is targetted at a 10 per cent withholding tax rate, the Minerals Council considers this credit rate to be too low. The credit should be set higher to compensate for both the withholding tax and any underlying tax. The Minerals Council acknowledges that a higher rate could lead to increased complexity in administration and compliance (particularly around eligibility for the shareholder credit and possible 'ordering' rules for the use of credits). An appropriate rate could be based on the current company tax rate in Australia of 30 per cent, which equates to a $^{3}/_{7}^{th}$ credit. Clearly, such an option will require further development before it can be effectively implemented.

In the Minerals Council's view, dividend streaming (Option 2.1 B) would remove an anti-globalisation bias facing Australian transnational companies which wish to use offshore equity in the parent Australian company to fund offshore investment as part of their key growth strategies.

Extension to cover international dividend streaming would be welcomed as recognising the way the world is changing with the increasing globalisation of many industries, including, importantly the Australian minerals industry.

Appropriate extension to allow this would result in increased repatriation of profits to Australia and increasing foreign investment here.

However, the Minerals Council acknowledges that, as noted in the Treasury consultation paper, such a proposal only benefits companies with non-resident shareholders and that the extent of benefit depends on the proportions of non-resident shareholders, foreign source income and level of profit distributions. For this reason, the Minerals Council considers Option 2.1 B should not operate in isolation from other options.

The Minerals Council agrees that providing imputation credits in respect of foreign dividend withholding tax (Option 2.1 C) is unlikely to significantly address the bias against Australian companies investing in foreign operations. The Council notes, however, that this proposal was one of the Review of Business Taxation recommendations accepted by the Government, and has already been factored into the overall revenue neutral business tax reform package which has been implemented progressively since 1999. This implies a potential revenue cost of some $0.2 billion per year has already been factored into the forward budget estimates. If the effect of the imputation bias is to be addressed, this amount (at minimum) should be factored into considerations around the revenue implications of any reforms.

Overall then, the Minerals Council recommends:

- **the dividend imputation system be retained;**
- **a suite of fiscal arrangements be introduced to address the clearly identified bias inherent in the current dividend imputation system; and**
- **this suite of arrangements comprise:**
  - **an appropriately developed variation on Option 2.1 A as outlined in the Treasury consultation paper that provides a credit sufficient to compensate for both the withholding tax and any underlying tax, while accommodating situations where the credit**

rate is higher than the foreign tax paid. Appropriate amendments could include the following:

: the Foreign dividend account system to be converted into a tax paid system;

: an Australian company will be entitled to a credit in its foreign dividend account when it receives a non-portfolio dividend from a foreign company. The credit will correspond to the amount of foreign tax on the dividend and the profits from which it was paid, however the credit will be limited to the Australian tax that would have been imposed on those profits in a domestic context (that is, $^{3}/_{7}^{th}$ of the dividend);

: the credit for Broad Exemption Listed Countries to be limited to $^{3}/_{7}^{th}$ of the dividend and in the case of Limited Exemption Listed Countries and unlisted countries to be based on the actual foreign tax paid but not exceeding $^{3}/_{7}^{th}$ of the dividend;

: an Australian company will be entitled to frank a dividend from its franking account and/or foreign dividend account (at its option); and

: non-resident shareholder that receives a dividend that is franked from the franking account or foreign dividend account will be exempt from withholding tax.

- a dividend streaming system that allowed foreign source income to be streamed to non-residents, outlined under Option 2.1 B in the Treasury consultation paper, which would remove an anti-globalisation bias facing Australian transnational companies that wish to use offshore equity in the parent Australian company to fund offshore investment as part of their key growth strategies.

SECTION 3 — PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

3.1 Controlled foreign company regime

3.1.1 Impact of the current controlled foreign company regime on internationally focused minerals companies

Australia's attractiveness as a location for Australian companies expanding offshore is often adversely affected by the breadth and complexity of the controlled foreign company (CFC) measures.

International tax issues that may affect the attractiveness of Australia as a regional headquarters are the CFC rules, double tax agreements, conduit income arrangements, income repatriated from direct investment offshore and company residency tests.

The CFC rules are overly complex, designed in a different business era and are consequently out of step with modern business practices.

Changes to the CFC rules will improve the competitiveness of Australian businesses in the international arena, by increasing their capacity to periodically restructure, reduce exposure to unnecessary international tax costs and reduce the cost of managing international tax planning.

The Minerals Council supports the need to identify technical and other policy issues regarding the CFC rules and consideration of options to resolve them. **While a major rewrite of the CFC rules would be supported in the longer-term, the Minerals Council would be keen to see specific pressing issues resolved in a more timely manner**. These specific issues include:

- remove companies operating in broad exemption listed countries and all underlying investments from the operation of CFC rules;
- provide a general exemption for all foreign non-portfolio dividends received by Australian companies;
- improving rollover relief for corporate restructuring;
- redefine the scope of attributable income. In particular, confine the scope of "tainted services income" to truly passive income;
- develop and publish an objective criteria that the Treasury would utilise when classifying countries as broad exemption listed countries, limited exemption listed countries and unlisted countries; and
- other policy and technical issues

3.1.2 Remove companies operating in broad exemption listed countries and all underlying investments from the operation of controlled foreign company rules

Until 1 July 1997, approximately 60 countries, which were deemed to have tax rate and tax system roughly comparable to Australia's were included as "listed" countries in the Regulations to the *Income Tax Assessment Act 1936*. Where a CFC was resident in a listed country, the presumption was that the income earned by a CFC had been fully taxed and should not be subject to tax again in Australia by way of attribution. From 1 July 1997, this listed was reduced to just seven, excluding twenty-two OECD countries from the "list".

One of the purposes of the Broad Exemption Listed Countries (BELC) or Limited Exemption Listed Countries (LELC) regime is to reduce compliance costs for relevant business. However, the BELC/LELC regime does not achieve this aim. While the potential for attribution may be limited, a full CFC analysis is still required to determine that no income is attributable. Additionally, where income is attributable, any tax paid is nearly always offset by the foreign tax credit, therefore imposing a compliance burden on the Australian compliance function with little or, as in most cases, no addition to the revenue.

The Minerals Council recommends the CFC measures in this area be rewritten to ensure that, consistent with their original broad policy intent, they are only applicable to cases of potential avoidance and do not impede genuine business operations.

To achieve this objective, the list of countries deemed as highly comparable should be expanded to include most of the countries with which Australia has a double tax agreement (DTA) and, in particular, Australia's major trading partners in the Asian region. **Entities operating in these jurisdictions should be removed from the accruals regime of taxation**.

Consistent with the international taxation principles outlined in section 1.3, **entities operating in non-comparable tax jurisdictions should also be exempt where the underlying activities of the business are active** (subject to comments below on tainted services income). The determination of the degree of activity in these cases should be supported by the audited accounts with no statutory adjustment and based on a reasonable ratio. An additional measure would be to allow companies to apply for a CFC exemption on an entity-by-entity basis.

3.1.3 Provide a general exemption for all foreign non-portfolio dividends received by Australian companies

Where an Australian company owns shares in a CFC and the CFC sells its assets, the profit derived on the sale of the assets will, with certain exceptions, not be attributed to the Australian company under the CFC rules. In particular, a profit made on the disposal of goodwill will generally not be attributable.

The main exceptions are where the profit is derived from the disposal of intellectual property, tainted assets or tainted commodity investments. "Tainted assets" and "tainted commodity investments" are defined in section 317 of the *Income Tax Assessment Act 1936*.

If the CFC is a resident of a listed country and the Australian company has a non-portfolio interest in the CFC, the profit derived by the CFC from the sale of its assets may be distributed as a dividend that is exempt from tax under section 23AJ of the *Income Tax Assessment Act 1936*, even if the profit has not been attributed under the CFC rules.

Where an Australian company owns shares in a foreign company that is not a CFC and the foreign company sells its assets, the profit derived by the foreign company may be attributed under the foreign investment fund (FIF) rules. However, if the foreign company distributes that profit as an interim dividend, the profit will generally not be attributable (section 530 of the *Income Tax Assessment Act 1936*). Moreover, if the foreign company is a resident of a listed country and the Australian company has a non-portfolio interest in the foreign company, the interim dividend will generally be exempt under section 23AJ.

Where an Australian company makes a profit from the sale of shares in a foreign company, the profit is taxable, even if a profit made from the sale of the foreign company's assets would not be taxable under the CFC or FIF rules. **There is therefore a disadvantage in selling shares in a foreign company instead of assets of the foreign company**. However, in many instances it is commercially desirable to sell shares rather than assets; for example, the foreign company may have a licence or an interest in real property that under the laws of the foreign country is difficult to transfer from the foreign company to another person.

Where an Australian company has a portfolio interest in a foreign company, a profit made from the sale of that interest should be exempt from Australian capital gains tax, particularly if section 23AJ is expanded to apply to all non-portfolio dividends.

In addition, and consistent with the international taxation principles outlined in section 1.3, where the foreign company is a CFC, the exemption should apply if the CFC passes any of the following tests:

- **the active income test;**

- **the active business test; or**

- **the purpose test.**

Where the CFC whose shares are sold owns shares in other CFCs, the whole of the capital gain should be exempt from tax if all of the CFCs pass any of the above three tests. If any of the CFCs fail all of the above tests, in principle a portion of the profit should be taxable. However, difficult questions of apportionment would arise. Where the foreign company whose shares are sold is not a CFC, the exemption from capital gains tax should apply regardless of what types of assets the foreign company has. This is on the basis that the current law does not tax profits on the sale of underlying assets where those profits are distributed as a non-portfolio dividend to the Australian company.

Such an exemption, combined with an expansion of section 23AJ to cover non-portfolio dividends paid by companies resident in listed or unlisted countries, will mean that Australian multinationals would be able to decide whether to sell shares in foreign companies or assets of those foreign companies without being influenced by Australian tax considerations.

3.1.4 Improving rollover relief for corporate restructuring

Australian rollover relief should be allowed on any capital gains tax (CGT) event between CFCs that are members of the same wholly owned group, regardless of the jurisdiction. Additionally, scrip-for-scrip transactions not involving wholly owned corporate groups should not result in attributable capital gains.

3.1.5 Redefine the scope of attributable income. In particular, confine the scope of "tainted services income" to truly passive income

Given the global nature of the minerals industry, not only do the mineral resources come from many geographical locations, the markets for these resources are also all over the world. Specifically, this requires, and is more often than not a statutory obligation, that a local entity be established to market and administer these operations. As suggested in the Treasury consultation paper, the current definition of Tainted Services Income inhibits this business activity, create a significant compliance burden and on the rare occasion income is attributable, foreign tax credits reduce, (in most cases, completely eliminate) any Australian tax.

Additionally, the transfer pricing rules apply the appropriate anti-avoidance mechanism.

The Minerals Council therefore recommends that service income should be excluded from defined 'tainted' activities where there is an underlying active business.

3.1.6 Develop and publish an objective criteria that the Treasury would utilise when classifying countries as broad exemption listed countries, limited exemption listed countries and unlisted countries

In line with previous comments, the list of comparable countries should be significantly expanded.

To specifically avoid the need to continually update a list of comparable countries, the criteria for review could be set based on objective criteria (for example, two-thirds of the Australian corporate income tax rate) that could be developed and published by the Treasury in consultation with industry.

3.1.7 Other policy and technical issues

The Minerals Council understands the ATO's National Tax Liaison Group has a CFC issue register, which suitably highlights other technical areas of the law that are in need of reform. **The Minerals Council recommends this reform be undertaken as a matter of urgency based on the comments above.**

3.2 Taxing capital gains

In relation to the options raised in the Treasury consultation paper of imposing capital gains on non-residents selling non-resident entities with an effectively connected asset, the Minerals Council notes that this would create a disincentive for foreign investors to acquire entities with Australian based assets and would question the ability of the ATO to administer this issue.

3.2.1 An alternative approach

Option 3.9 in the Treasury consultation paper suggests that all non-portfolio dividends should receive a blanket exemption. As this would provide tax neutrality between retaining profits offshore or repatriation, in line with other objectives and suggestions, and consistent with the principles outlined in section 1.3, **the Minerals Council supports this option**.

3.3 Improving conduit income arrangements

3.3.1 Regional holding companies and capital gains tax

As a general proposition, **the Minerals Council recommends a conduit holding company regime (CHC) be considered to allow the foreign income and gains of regional holding companies to flow through to their foreign shareholders free from the imposition of Australian tax.**

The current legislation is designed so that Australia never taxes the foreign source income of non-residents. The same policy principle should apply to foreign capital gains of Australian companies owned by foreign investors. Various European countries, including the United Kingdom, have introduced schemes for participation exemptions. A participation exemption is a special purpose capital gains tax concession. The exemption is only available upon generally meeting several criteria, such as 'substantial' holdings.

The Council's preferred option would be to provide a general exemption for non-portfolio dividends received from foreign companies (Option 3.9 in the Treasury consultation paper) and for capital gains derived from the sale of non-portfolio interests in foreign companies.

Only if a participation exemption is not possible, which would be simple to administer at both the ATO and the corporate levels, should a CHC regime be considered. To ensure that the CHC concept does not discriminate against investment of less than a 100 per cent, a CHC should be defined to include companies that are incorporated in Australia, with a level of foreign ownership. In addition, where the foreign shareholder company holds its interest in the Australian holding company through Australian holding company, the exempt treatment should not be eroded. To achieve this, the distribution of the exempt income should retain its character in the hands of any interposed entities.

A proportion of capital gains realised by the non-resident investors on disposal of shares in the CHC, corresponding to the unrealised gains on non-Australian assets held by the CHC should also be exempt. We understand the complexity this would create and the detailed valuation that would be required, however we consider that, at the option of the shareholder, such a valuation should be undertaken and an appropriate exemption provided to the non-resident shareholder.

3.3.2 Establishing foreign income accounts

The Council supports the Review of Business Taxation's recommendations 21.1 and 21.4 that the current foreign dividend account (FDA) be replaced by a foreign income account (FIA) (Option 3.11 in the Treasury consultation paper). **However, the Council recommends this be expanded to interact with Option 2.1 B, as explained below.**

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

The Council supports the proposition that relief from DWHT should be extended to all types of foreign income including portfolio dividends, foreign branch profits and capital gains.

To maintain the integrity of any international tax reform, it is imperative that FIA credits be attached to distributions and pass from one entity to another in the same manner as franking credits.

Currently, FDA credits are not attached to dividends and provide relief from Australian DWHT 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. 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 DWHT can be allowed when those distributions are ultimately paid to non-residents. This will require the FIA to be similar in design to the current franking account.

3.3.3 Foreign dividend accounts and interposed entities

Where a dividend sourced from foreign profits is paid between two Australian resident companies, currently a FDA credit cannot arise in the recipient company unless they are 'related' (which requires the companies to be in a wholly owned group). This is a significant shortfall in the current system, and clearly increases the cost of capital where foreign equity investment is less than 100 per cent.

The Council also notes that this is a detriment to joint ventures opportunities operating in and from Australia.

As such, the Council considers that a dividend paid from a FDA account in such a situation should retain its character whereby the appropriate credit arises in the subsequent shareholder until the dividend is paid to non-resident shareholders, regardless of the level of equity interest.

Additionally, with the introduction of the Consolidations regime and the removal of the intercompany rebate on unfranked dividends, **the Council supports the recommendation that company tax on FIA distributions received by a non-consolidated resident entity be either refunded/exempt/rebated in order to remove any mitigation of the FIA benefit.**

3.4 Australia's double tax agreement network

The Minerals Council notes that **Australia should seek to establish a competitive and non-discriminatory network of double tax agreements (DTAs) under which Australia collects an appropriate share of tax revenue on international business.**

At present, Australia has a series of DTAs that can produce inequitable results for Australian companies with foreign subsidiaries. The DTAs typically allow foreign jurisdiction to levy withholding taxes (WHTs) at the rate of 15 per cent on dividends paid to Australian companies from foreign subsidiaries. The trend in Europe and the United States has been to reduce WHT to 5 per cent or even to zero rendering Australia's DTAs (with the notable recent exception of the new Protocol to the Australia/United States DTA) uncompetitive.

In addition, new DTAs are typically taking over five years to negotiate.

3.4.1 The Protocol to the Australia/United States Double Tax Agreement

The Minerals Council supports modernising Australia's DTA network and recognises that the recent Protocol to the DTA with the United States is regarded as a major step forward in this process. However, the Minerals Council notes that while the Australia/United States tax agreement is an improvement to the current agreement process, further consideration needs to be given as to what specific aspects of this agreement form an appropriate basis for future DTA negotiations and whether certain aspects of other DTAs should be incorporated.

The Protocol to the Australia/United States DTA was negotiated between March and September 2001. The Minerals Council played an active role in this negotiation process through its membership of the Tax Treaties Advisory Panel (a Sub-Committee of the National Tax Liaison Group). However, in addition to the consultation and negotiating processes, the legislative and Parliamentary processes has proved quite lengthy, and, although Australia ratified its signature on 3 July 2002, the exchange of instruments of ratification is yet to take place. Consequently, the Protocol is yet to enter into force.

Notwithstanding this, the Protocol is generally regarded as very positive for Australia and implements some of the important issues recommended by business groups. Key developments from the new Protocol will be, from the effective date:

- dividend WHT will be reduced to 5 per cent where a resident of the other state holds at least 10 per cent of the voting power in a subsidiary, and will be eliminated where a dividend is paid by subsidiaries owned at least 80 per cent by certain publicly listed companies or other companies;
- interest WHT will remain at 10 per cent generally but will be reduced to 0 per cent for governments and banks;
- royalty WHT will be reduced to 5 per cent, and equipment leasing will now be subject to branch profits treatment.

While the Protocol to the Australia/United States DTA could act as a model for similar initiatives, there are some remaining concerns. These include:

- the concept of "fiscally transparent entities" has been introduced to Article 7 of the DTA without the concept being adequately defined;
- the 0 per cent rate of dividend WHT requires that a single company holds at least 80 per cent of the voting power in the company paying the dividend. Combined ownership by two or more commonly-owned companies will not qualify for 0 per cent WHT;
- now that equipment rentals (payments for the use of industrial, commercial or scientific equipment) are to be excluded from the royalty definition, there is a new concern over the taxation of rents for "substantial equipment" as business profits; and
- the new Limitation of Benefits Article is does not effectively recognise certain aspects of Australian commercial structures (including dual listed companies).

3.4.2 The future of the Tax Treaties Advisory Panel

The Minerals Council supports effective consultation arrangements with business and other parties in achieving successful and timely agreement negotiations and therefore support options to improve the transparency and effectiveness of current processes.

As noted above, the Minerals Council is a member of the Tax Treaties Advisory Panel (TTAP) and has played an active role in the TTAP since its inception in 1997. The operation of the TTAP has improved significantly since 1997 and the detail and breadth of consultation has been improved. However, there are a number of further areas when improvement could be made to the operation of the TTAP. These include:

- the infrequent nature of TTAP meetings. While the Council does not recommend meetings be held when they are not required or that they be rigidly scheduled, it does see value in more regular (for example, twice a year) meetings, and especially during key periods of DTA negotiations (as was the case with the Australia/United Kingdom DTA renegotiation and, to a lesser extent, the Protocol to the Australia/United States DTA negotiation); and
- the strict confidentiality concerning DTA negotiations. This diminishes the transparency of the negotiation process and the ability of TTAP members to input fully and effectively into the process.

To further enhance consultation arrangements, the Minerals Council therefore recommends:

- **the Tax Treaties Advisory Panel continue to operate as a formal consultation mechanism with Australian industry (including the minerals industry) on double tax agreement matters;**
- **the Panel meet more frequently (for example, twice a year); and**
- **consideration be given to lessening the strict confidentiality arrangements surrounding such consultation.**

3.5 Place of residence: current problems and options for reform

The Australian taxation system taxes all Australian resident companies on their foreign and domestic source income. A statutory test for residency determination has been a feature of the taxation system since 1936. In general terms, a company is a resident of Australia if it:

- is incorporated in Australia; or
- carries on business in Australia and is centrally managed and controlled in Australia; or
- carries on business in Australia and its voting power is controlled by shareholders resident in Australia.

The scope of the test is therefore very broad, involves a high degree of uncertainty, and imposes a limitation on companies that are genuinely carrying on business outside Australia. It also impacts adversely on the Australian economy more generally, but influencing commercial decision-making by Australian multinationals (for example, around decisions such as the use of Australian directors on the boards of foreign subsidiaries).

In addition, the key case law in relation to the central management and control test dates from a case decided in 1946.[9] Clearly, with the use of modern technology such as video conferencing, e-mail, and internet, and changed business practices (such as the use of dual listed companies) it is increasingly possible to participate in management from anywhere in the world, and to do so in a way not contemplated some fifty-six years ago. The Minerals Council consider it to be inappropriate that the use of these technologies (and the efficiencies they provide) alone would give rise to central management and control problems.

The Minerals Council therefore recommends the current residency test be clarified to provide certainty for business and remove impediments to the involvement of Australian management in the business of foreign subsidiaries. This could be achieved by:

- **consistent with Option 3.12 in the Treasury consultation paper, amending the statutory definition of residence to ensure that a company is not be deemed to be carrying on business in Australia simply because it has its central management and control here; or**
- **moving to a simple "place of incorporation" test. Such a test would significantly simpler and more certain than the current test or other alternative, but this would need to be balanced against concerns about tax system integrity.**

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[9] *Malayan Shipping Company Limited v FC of T* (1946) 71 CLR 156 (available at http://www.austlii.edu.au/au/cases/cth/high_ct/71clr156.html)

SECTION 4 — IMPROVING AUSTRALIA'S TAX TREATMENT OF FOREIGN EXPATRIATES

To maintain and develop its competitive position internationally, the Australian minerals industry needs to be able to attract skilled workers to fill shortages and to access new ideas and skills.

The current tax treatment of foreign expatriates who become temporary residents, and the high costs this imposes on business, discourages many businesses from locating in Australia or bringing skilled people here.

Australia has always been considered a high tax country for individuals due to high marginal tax rates that apply at low thresholds. This can make it difficult to convince overseas expatriates to accept employment here. Australian companies, including minerals companies, either have to offer higher salaries to attract those individuals, or compensate them in some way for the increased tax burden. This section sets out some of the major areas of disincentive contained in Australia's current tax treatment of foreign expatriates, and appropriate options for reform.

4.1 Taxation Laws Amendment Bill (No. 4) 2002 and Taxation Laws Amendment Bill (No. 7) 2002

Taxation Laws Amendment Bill (No. 4) 2002 (TLAB 4) was introduced into the Parliament on 30 May 2002. However, following opposition from the non-Government parties, the measures relating to foreign expatriates were excised from the Bill so that other measures contained in TLAB 4 could be passed. These measures were reintroduced in *Taxation Laws Amendment Bill (No. 7) 2002* (TLAB 7) on 23 October 2002.

TLAB 7 contains a number of important measures to address the disadvantages in the current tax treatment of foreign expatriates, through exemptions from Australian tax for temporary residents (including an exemption from Australian tax on foreign source income and capital gains for a maximum period of four years to temporary residents, where that income or gain is not associated with Australian employment or services performed while a resident of Australia. The amendments will also exempt temporary residents from interest withholding tax obligations associated with overseas liabilities).

The Minerals Council strongly supports these measures, which will assist Australian industry (including the minerals industry) to attract key personnel to Australia by reducing the additional extra costs that are typically incurred in employing temporary residents.

As was noted by the Government in introducing TLAB 7, removing disincentives to the temporary employment of skilled overseas workers will be of particular benefit for "skill-intensive" industries (such as the Australian minerals industry), and will assist in attracting and retaining regional headquarters and offices. The measures will also assist industry to attract workers in areas where Australia is experiencing skill shortages.

4.2 Foreign source investment income exemption

The Minerals Council strongly supports the moves to provide a four year foreign source income exemption for temporary residents, the proposed extension of the exemption from the FIF rules and relaxation of super preservation rules.

4.3 Foreign workdays

The Treasury consultation paper suggests not moving to a system of exempting foreign workdays from Australian tax similar to that available in the United Kingdom and Singapore. The basis for this is to avoid "a tax bias favouring employing temporary residents". **The alternative view is that exemption of foreign workdays provides a significant incentive to come to Australia and in certain cases removes double tax (that is, some countries will tax individuals on days worked in the country regardless of residence status).** In any case, consistent with the principles outlined in Section 1.3, it should be explicit that foreign tax credit is available where double taxation occurs.

4.4 Double tax agreements and the capital gains tax treatment of departing residents

There are two alternatives available:

- the suggestion that DTAs are used as the main method to alleviate double taxation for departing residents. As this solution could take a considerable amount of time to come to fruition, **the Minerals Council recommends that the position not be pursued. A better answer would be to remove the departing CGT rule altogether** – it is a significant disincentive to remain in Australia beyond five years. Countries such as the United States and United Kingdom do not have such rules, making Australia internationally uncompetitive; or

- if the above suggestion is not acceptable, Option 5.1 raised for consultation in the Treasury consultation paper is whether residents departing Australia should provide security for deferred CGT liability.

Clearly, this second alternative would be impossible to administer and maintain compliance, unfair to the individual (who after all has not actually sold an asset) and would inevitably mean employers being forced to step in to fund the security payment.

Further, if not acceptable the calculation of gain should be based on the relevant foreign currency of the asset. This gain is then taxed and converted into Australian dollars. This should avoid the taxation of gains that relate principally to foreign exchange movement and would never be taxed in the home country and would never be seen by the expatriate as an economic gain.

4.5 Removing double taxation of employee share options

The proposed solution to double taxation is via agreements/the OECD approach to sourcing options according to where the individual has been during the period between grant and exercise. However, this is not a practical approach – that is, it requires detailed knowledge of an individuals whereabouts to determine tax treatment. In addition, it can be difficult to determine to which duties an option relates (for example, does it relate to past or future performance?). **The Council's preferred approach is that taxation in expatriate situations is determined by the residence status of the individual at grant.**

This is the approach adopted in the United Kingdom (that is, very broadly if resident in the United Kingdom at grant, liable to United Kingdom tax at exercise regardless of location at exercise, with double tax relief where appropriate). This is logical, as it takes the view that an option granted whilst resident in a particular country is granted in respected of employment in that country and as such is therefore taxable in that country on exercise. This is also far more practical for employers and employees.

4.6 Providing administrative support for foreign expatriates and employers

As with other areas of taxation system administration, suitably qualified ATO staff would facilitate in the understanding of the ATO interpretation for the current and future expatriate employment taxation issues.

SECTION 5 — OTHER ISSUES NOT RAISED IN THE TREASURY CONSULTATION PAPER

5.1 Offshore exploration expenditure

Minerals companies face challenges peculiar to their industry. Exploration to discover economically recoverable ore bodies is an unavoidable first step. Then resource development, proximity to markets, infrastructure and political risk all figure in investment decisions. Overall, however, it is geology that dictates the geographic location of mines. Furthermore, because the resource begins to deplete as soon as mining commences, minerals companies cannot survive without committing to investment in new projects.

As noted in section 1.2, until recently many countries had mineral (including exploration) regimes that were not attractive to international investment. However, that is all changing and many of these countries, particularly in South America, Africa and Asia, are now actively inviting international participation in their minerals industries. Despite this new competitive reality, the attractiveness of the Australian continent for world-class mineral deposit exploration remains strong.

One area of non-deductible business expenditure (or "black hole") concerns overseas exploration expenditure that cannot be deducted against Australian income. There is therefore an incentive for Australian minerals companies to conduct foreign exploration activities through a branch of an overseas entity where the overseas entity has income against which worldwide exploration may be offset for taxation purposes.

The same benefit is not available for an Australian entity unless the entity concerned derives foreign source income from mining or other business activities, but not from exempt income (such as from listed countries).

On the other hand, the United States, for example, allows non-United States exploration expenditure to be deductible against United States mining income.

The Minerals Council therefore recommends Australian tax law be amended to allow non-Australian exploration expenditure to be deductible against Australian mining income.

5.2 Royalty withholding tax implications of chartering and similar arrangements

The ATO released draft taxation ruling TR2002/D11 *Income tax: the royalty withholding tax implications of chartering and similar arrangements* on 25 September 2002. The ruling applies to charters of industrial, commercial and scientific equipment such as ships, cranes and aircraft. The examples in the ruling focus on the shipping industry.

The draft ruling sets out when the ATO can apply royalty withholding tax (RWHT) to payments made to non-residents for the 'use of' ships under demise charters (including bareboat charters) and time charters. The draft applies to Australian resident taxpayers that charter ships from non-residents. It also applies to non-residents conducting business in Australia through a permanent establishment that makes payments to non-residents. This latter aspect is of particular concern as it may catch charter vessels for movement of mineral product from one country to another but which do not visit Australia.

The minerals sector is a major charterer of shipping and is involved in the largest bulk minerals shipping task of any country in the world. Approximately 380 million tonnes of dry bulk minerals are exported annually. This earned export income of around $42 billion dollars in 2001-02 and represented about 34 per cent of Australia's total merchandise exports and 26 per cent of total exports of goods and services.

The Minerals Council notes the draft tax ruling is flawed in its technical analysis of maritime law and if released in its present format would represent a dramatic change of direction in interpretation by the ATO.

The key issue to be addressed is whether a time charterparty is a 'contract for services' to the charterer or a contract that confers on the charterer the 'use of or the right to use' the relevant ship. The Council contends that the correct view is that a time charterparty transaction is a contract for services and accordingly not subject to the RWHT provisions.

If the ATO adopted its proposed course of action as outlined in TR2002/D11 it would upset the long standing view and administrative practice that time charterparty transactions were subject to the freight tax provisions contained in Division 12 of the *Income Tax Assessment Act 1936*, and not RWHT.

The onus for paying any potential taxes would be radically shifted from the owner, (master or agent of the owner) to the payer of the time charterparty amount, namely Australian business.

Of even greater significance is that the potential tax liability would be imposed at a significantly higher rate. Division 12 imposes an effective tax liability of 1.5 per cent while the impost of the RWHT provisions ranges from 10 to 30 per cent. A further 'sting in the tail' is that the underlying time charterparty payment would not be eligible for income tax deductibility until the Australian resident had paid the RWT. In addition, as Australia is typically a price taker for chartered vessels, there would likely be a tax on a tax. This means the RWHT provisions ranging from 10 to 30 per cent would in fact represent an 11 per cent to 43 per cent **tax on business inputs**.

The approach being proposed by the ATO would therefore severely jeopardise the international competitiveness of Australian exporters. Other key trading and shipping nations (Belgium, Brazil, Canada, Singapore, United Kingdom and United States) do not impose RWHT on transactions of a similar nature.

As the relevant tax legislation has not been amended the ruling would effectively become an authoritative statement by the ATO that time charterparty payments would constitute a royalty and be subject to RWHT, including any amounts apportioned or dissected as being referable to the services performed by the master and crew.

This seems to run counter to the position taken in the recent Australia/United States DTA, where the Royalty definition was amended to remove the reference to equipment and the *Income Tax Assessment Act 1936* was also amended to accommodate the DTA changes. The reason given by the Government in the Explanatory Memorandum was (at paragraph 2.67)

> *The exclusion of payments for the use of equipment from the Royalties Article reflects that source country taxation on a gross basis may be excessive given low profit margins.*

This means that normal source rules apply and such payments would only be taxed in Australia where a Permanent Establishment existed (such as a branch).

The Council notes that the Commissioner of Taxation, following discussions between representatives from industry and the ATO, will not be applying the ruling retrospectively as appeared to be the position as outlined in paragraph 27 of TR2002/D11. **The Council strongly supports this course of action. This proposed retrospective application of the ruling for nine years is of very considerable in principle concern to industry.**

It should be noted that the ruling should only be applied to new contracts entered in to post the finalisation of the ruling otherwise taxpayers potentially impacted by the ruling will not have certainty in determining their business affairs nor time to restructure.

The Minerals Council therefore recommends that the draft ruling TR2002/D11 be withdrawn and replaced with a more appropriate ruling developed in consultation with industry. The ruling should only be applied to new contracts entered in to post its finalisation otherwise taxpayers potentially impacted by the ruling will not have certainty in determining their business affairs nor time to restructure.

ATTACHMENT 1 — BCTR PRINCIPLES OF TAXATION

1. The tax system should be simple, transparent and should minimise uncertainty.

2. The design, administration and operation of the tax system should be undertaken with full and effective consultation with relevant stakeholders including the business community.

3. The tax system should fairly balance the need to protect the taxation revenue base with the principles of a good tax system, i.e. efficiency, fairness (horizontal and vertical equity), simplicity, clarity, certainty and low compliance costs.

4. The tax system should enhance competitiveness by providing a climate conducive to improved investment in Australia and from Australia for Australian-based entities and individuals.

5. Indirect taxation at the State and Territory level should be more efficient and competitive.

6. The pattern of Federal/State financial relations should be transparent, efficient and sustainable.

7. The tax treatment for savings should be consistent with an overall savings policy that encourages the sustainability of strong, ongoing growth.

8. The tax, and social security, treatment of personal income and fringe benefits should conform to the principles of fairness, efficiency and simplicity.

9. The tax system should avoid the double taxation of business income and provide relief for all business expenses.

10. The tax system should not impede organisational restructuring.