COMMENT ON IMPACT OF TAX CHANGES – FOREIGN TAX CREDITS AND DIVIDEND IMPUTATION

By D. J. Tucker*

Peter Wilson has produced an excellent and very practical paper relating to the Foreign Tax Credits System (FTCS) and Dividend Imputation System (DIS) based, obviously, on an intimate knowledge of the experience of operating companies with those systems.

In this commentary the writer has chosen to look from a broader perspective at the impact of the system, with financial markets relevant to mining and petroleum companies more particularly in mind, and at some points of interpretation which seem of relevance to such companies. In doing so the writer hopes not to unneccessarily duplicate lines of thought raised by Wilson. In view of the range of fundamental issues which appear at present the writer has not, as he might have, in this commentary pursued in further detail any of the planning proposals suggested by Wilson. Mention has also been made of some issues relating to the position of individual employees and contracted personnel under FCTS as their taxation liabilities are of basic practical importance in the conduct of any foreign operations.

DIVIDEND IMPUTATION

A fundamental change achieved by the dividend imputation system (DIS) is to give tax paid a value. Hitherto payment of tax carried with it no intrinsic value. A result has been that many companies have been able to sell off their tax shelters. Such transfers have of course been particularly relevant to the financing of mining and petroleum ventures. The market for transfer of tax shelter has not been unlimited and the introduction of DIS will make it tighter.

Similarly for government, DIS will depreciate the value of incentives and concessions offered through the taxation system and further advance the arguments of those who prefer the use of direct grants for such benefits. Another fundamental effect is to give an amount of Australian source income taxed in Australia greater intrinsic value than any amount of foreign source income taxed offshore. This is because no franking credit is available in respect of foreign tax paid. Prior to 3 July 1987 Australia's taxation system was very favourable towards foreign investment.

The general rule, provided for by section 23(q) of the Income Tax Assessment Act (the Act), was that foreign sourced income derived by a resident of Australia was fully exempt from Australian tax provided that tax had been imposed, in some form, in the country of source. Section 23(q) did not however apply to exempt from tax dividends, interest and royalties, and income attributable to them, which had been taxed at source

* LL.B. (Adelaide) Solicitor, S.A.

at rates applicable under one of Australia's Double Tax Agreements, (nor did it apply to non-employment income from Papua New Guinea sources and certain film income). Under section 23(q) the marshalling of income producing sources into low (but not no) tax jurisdictions could effectively attract exemption from tax in Australia.

With respect to a foreign subsidiary section 46 of the Act generally applied to grant an Australian resident parent company a rebate on dividends paid from the profits of the subsidiary. This rebate is of course now deleted and replaced by a credit in respect of foreign tax paid in the circumstances to which section 160AF applies. A resident individual (and a company not eligible for a full section 46 rebate) was, under section 45 of the Act, given credit in respect of foreign sourced dividends based on a formulated comparison between the foreign tax paid and Australian tax which would have been payable on, for example, the foreign source profits out of which the dividend was declared. Royalties and interest received from countries with which Australia had a comprehensive Double Tax Agreement, under sections 12 to 15 of the Income (International Agreements) Act ('the International Agreements Act'), were also subject to a system of credits similar to those for dividends and subject also to technical complexities as to the definition of royalties arising, for example, from the treaty provisions.

In future, as has been explained, that foreign source income will generally be grossed up with the foreign tax to which a taxpayer has been personally liable and the Australian tax on the taxpayer's gross worldwide income will then be calculated with credit given to reduce the amount of Australian tax payable for the lesser of the foreign tax paid in respect of the foreign source income and the amount of Australian tax payable in respect of that foreign income. The foreign tax credit so allowed will not however give rise to a franking account credit.

Taken together these provisions remove the potential tax bias in favour of foreign source income and introduce a bias in favour of Australian taxed income where the income derived is to be distributed to Australian resident shareholders. A similar bias also exists with respect to non-resident shareholders as dividends are to be exempt from withholding tax to the extent to which they are franked.

Of course from the point of view of the foreign shareholder this exemption from withholding tax, in the case of an Australian resident company paying tax on its income, is at a cost, post 1 July 1987, of an additional 3 percent company tax. In the case of an Australian holding company in receipt of foreign source dividend income and paying dividends to non-residents no exemption will apply in the absence of Australian source income and a liability to Australian tax giving rise to franking credits. To the extent to which Australian companies operate as holding companies in this manner continued derivation of foreign source income in Australia appears unattractive. The aquisition of a flow of Australian source income, or dividends bearing franking credits from which to make dividend payments (but of course excluding dividends from non-resident companies which pursuant to section 160AQF(1)(b) cannot give rise to franking credits), entry into other tax capacity transfer

transactions, or restructuring of investments or investment structures to relocate the source of collection and payment of dividends to non-residents will require consideration.

It is the intention of the imputation system to give relief to shareholders from the impact of double taxation under the classical system for the taxation of company dividends and thereby to attract equity capital to financial markets. The principal beneficiares of the system are individual shareholders. However it appears these are a minority source of capital at present as against foreign entities, tax exempt funds, insurance companies, government bodies and the like. To finance part of the cost of the system a 3 percent rise in the company tax rate has been imposed which is borne against the returns to all shareholders. In addition individual investors will look to companies to pay maximum dividends and value more highly those that do so. Whilst these factors present opportunities to attract individual investors to capital investment, and reinvestment, for example through dividend reinvestment plans, some of them clearly present difficulties to companies in continuing to attract capital from the major sources as cost effectively as in the past. A third fundamental effect will therefore be the development of new financial products, and perhaps securities markets, devised to overcome these difficulties.

One casualty in this area will be preference share funding in the nature of debt. This is because of the ability now given to the Commissioner of Taxation under section 46D of the Act, to equate dividend payments on preference shares with interest so as to disallow rebates under section 46 or section 46A, and to deny the deduction offered by section 67AA in respect of dividends defined as debt dividends paid out after 7 April 1986 on certain classes of redeemable preference shares. This is not to say that preference shares carrying fixed rates of dividend more particularly structured as committed dividends, or as part of a plan to create separate classes of shares, will not have a place in new financial products to be developed post imputation.

Another casualty is the use of bonus share issues as a substitute form of return to shareholders to dividend distributions from resident companies seeking to utilise the exemption from tax formerly contained in the now removed sections 44(2) and (2D). Again however this is not to say that bonus share issues will not be of value in new structural arrangements and particularly for non-resident companies seeking to limit foreign tax liabilities.

On the other hand instruments like convertible notes, offering returns on debt but with equity options, are likely to be more strongly favoured than in the past, particularly if issued on a subordinated basis so as to approximate equity. Such instruments have potential appeal to both those providers of funds onshore who cannot benefit from imputation credits and offshore providers who obtain no benefit from the company's increased costs of taxation in obtaining imputation credits other than the saving of withholding tax.

As always with major change in the taxation system corporate, and other, groups will be required to review their structural arrangements. Effective from 1 July 1988 public trading trusts established prior to

19 September 1985, and all public trading trusts established since that date, are to be taxed as if companies. Overseas beneficiaries of trusts to which these provisions do not apply, have of course since 1984, when sections 3(11) and (12) were inserted into the International Agreements Act to remove the application of treaty exemptions in respect of industrial and commercial profits not derived through a permanent establishment in Australia, by deeming the overseas beneficiary of a trust whose trustee carries on business in Australia through a permanent establishment in Australia to have a business with a permanent establishment in Australia, been subject to tax on trust distributions.

As already mentioned offshore corporate investors stand only to benefit from imputation by the exemption of withholding tax. As Australia's Double Tax treaties presently stand no credits are to be given to overseas resident shareholders although the United Kingdom, for example, allows credits to Australian resident shareholders for advance corporation tax.

The most obvious alternative is to structure or restructure investment into Australia through debt rather than equity. This has to some extent been anticipated by the thin capitalisation rules announced by the Treasurer on 30 April 1987. Another is for offshore investors to operate through a branch rather than a subsidiary. The repeal of Division 11B of Part III of the Act, the effect of which was to impose 'branch profits tax' on a non-resident company deriving certain income from Australian sources, provides further encouragement in this respect. In a comparison of vehicles capital gains tax considerations as well as such difficulties as the under-utilisation of franking credits and the inability of companies to pass through to shareholders the full benefit of tax preferences will be important. Both trusts and partnerships carry the ability to more flexibly distribute income.

At the shareholder level in the case of trusts it should be noted that the benefit of a franking rebate cannot be passed to a trust in a tax loss position (after the grossing up of franked dividends) and in consequence a potentially available franking credit rebate is lost forever. A franking rebate may be passed on to partners in a parternship despite a partnership loss position.

The amendments made to the existing sections 46, 104 and 105A, in the insertion of the new section 105 abolishing Division 7 undistributed profits tax but introducing transitional provisions relating to undistributed balances defined as the 'phasing out amount' and relating to 'phasing out dividends' paid from that amount will require special consideration, as will the abolition of section 47(3) in relation to distributions on winding up, on any restructuring.

Dividend paying companies will have to give careful consideration to the different tax status of shareholders. Under section 160AQF dividends paid during a franking year in respect of shares of the same class, even where the dividends are paid under different resolutions and the dividends to which any such resolution relates are paid on only some of the shares of the same class, are defined to constitute a 'combined class of dividends' which are taken to have been paid under the resolution under

which the first of the dividends was paid. Shares are to be taken to be of the same class if they have the same nominal value unless different rights are attached to the shares under the constituent document of the company in respect of the receipt of dividends, receipt of any distribution of capital of the company or the exercise of the voting power of the company.

Taken together these provisions, in sections 160AQG, and 160APE, respectively have been described in the Treasurer's Explanatory Memorandum as an anti-avoidance provision the intention of which is to deter unequal franking of dividends which are in substance part of the one distribution on the same class of shares. Nevertheless there appears reasonable scope for the constitution of shares of different classes so as to permit unequal franking of dividends.

FOREIGN TAX CREDITS

Position of individuals

Sections 23AF and 23AG operate contrary to the general rule with respect to foreign source income which, as previously explained, requires grossing up of the foreign source income with foreign tax paid in an overseas jurisdiction for which an Australian resident taxpayer is personally liable for the calculation of Australian tax, based on the Australian resident taxpayer's worldwide gross income, with credit to be given for the less of foreign taxes paid and the amount of Australian tax payable in respect of the foreign income.

Section 23AG is the more widely applicable provision exempting the foreign service earnings of a resident natural person engaged in foreign service for a continuous period of not less than 365 days. The conditions for exemption in section 23AG(3) reflect the test under section 23(q) requiring that:

- the amount is not exempt for income tax in the foreign country in which it is derived; and
- if there is a liability in that country in respect of that amount the Commissioner of Taxation is satisfied that the tax has been or will be paid.

Where such a resident is engaged in foreign service for a period of less than 365 days but not less than 91 days there is a partial exemption from Australian tax for foreign earnings derived by the Australian resident taxpayer from that foreign service.

Section 23AF provides a similar exemption in respect of foreign remuneration derived by a taxpayer in respect of qualifying service on a particular approved project.

Some observations concerning the drafting of these provisions may be of interest:

(i) Section 23AG is not limited to service after 1 July 1987 but it does not authorise forward counting of intended future service. This contrasts with section 23AF(15) which authorises the Commissioner to allow exemption where of the opinion that, at a later time, circumstances will exist by reason of which the relevant income under that section will be exempt. No mechanism is

contained for bringing such an intended period of service into consideration. It might perhaps be raised by a taxpayer as a question relevant to liability by a document furnished with a return under section 169A(2) although that section does not, on its terms, properly permit the raising of such an issue.

Nor is there any provision like that in section 23AF(16) which permits the Commissioner at any time, upon being satisfied that circumstances which he did not think would exist have come to exist, to amend assessments to ensure the exemption shall be taken always to have applied on the basis that the circumstances did exist.

It is not clear on what basis this denial of exemption on employment income as opposed to income from qualifying service on an approved overseas project has been legislated. It seems clearly unjust and warrants amendment. In the meantime it appears likely the Commissioner will administer section 23AG in much the same manner as section 23AF.

(ii) Under section 23AG(6) a continuous period of service includes periods of absence in accordance with the terms and conditions of that service on recreation leave, other than leave not attributable to the foreign service, or extended leave, or leave without pay, or for accident or illness.

Section 23AF at sub-sections (3)(b), (4), (6), (7) and (8) however deems continuity of service over a much greater range of interruptions or circumstances including periods of travel from Australia, early termination or replacement in unforeseen circumstances, and other short breaks, at sub-sections (3)(d), (5), (9) and (10), and also in other circumstances places limits on the period of continuing service.

The differences in treatment between the two provisions seem, in broad principle, unjustified and, in particular, unnecessarily restrictive in allowing section 23AG exemption. Again it seems the Commissioner will administer the sections similarly notwithstanding these differences.

(iii) The test for exemption under section 23AG is in one respect stricter than that under section 160AF for credit. Income is to be not exempt for income tax in the foreign country of derivation, and the Commissioner is to be satisfied the tax has been or will be paid. section 160AF is based on foreign tax having been paid without regard for whether the tax is exempt in the country of derivation or where it is paid. Section 23AG in its reference to foreign country of derivation returns to the requirement of section 23(q) to identify the source of income by prevailing Australian tax rules of source.[1] The income must then not be exempt from tax in the foreign country in which it is derived.[2] It appears therefore that for matters potentially within section 23AG and 23AF considerations of source and its

1 See *Federal Commissioner of Taxation v. Efstathakis* 79 ATC 4256.

2 See case P. 60 82 ATC 287 where income paid and subject to tax in the place of payment was exempt in the place of work & so not exempt under s. 23(q).

establishment in a low, rather than no, tax jurisdiction will to the extent which the derivation of income from employment and qualifying service permit remain relevant issues.

Interest Income

Under section 160AF(7) foreign income which consists of income that is interest income is to be treated as a separate class of income. Interest is defined in section 160AE(3) to mean income comprising of interest or a payment in the nature of interest (*cf* section 128A definition referring to an amount in the nature of interest). The effect is to quarantine foreign source income from other foreign source income to prevent the exchange of excess credit applicable to interest income to other income and vice versa.

Section 160AFA, so as to prevent Australian resident taxpayers from changing the character of interest income into dividend income by the interposition of a foreign resident company, extends the effective operation of section 160AF to dividends paid by a foreign company to an Australian resident taxpayer where the net interest income is at least 10 percent of total profit derived during a particular period. Net interest income is defined by section 160AFA(4) to be the interest derived in the relevant accounting period less the deductions allowed or allowable under any law from the income of the company derived in that period that relate exclusively to that interest income, or as in the opinion of the Commissioner, may be appropriately related to that income.

Section 51(6) limits deductions allowable under section 51(1) which relate exclusively to income from a class of foreign income derived by a taxpayer in a year of income from a foreign source and which relate exclusively to income of that class derived from that source, or which may in the opinion of the Commissioner appropriately be related to income of that class derived from that source to the amount of the class of foreign income derived.

Under sections 6B(2) and (2A) trust interest income derived as income other than interest income is deemed to be income attributable to interest income if derived by reason of a resident taxpayer being beneficially entitled to an amount representing interest income or the amount can be attributed, directly or indirectly, to interest income either in the trust or by successive applications of section 6B(2).

By reason of the limitations in these provisions, in particular the exclusion in paragraph (f) of the definition of interest income in section 160AE(3) which provides that interest received by a person during a year of income from a company will not be interest income provided that

(i) at any time during the year of income the company was related to the person or would have been related to the person if the person were an Australian company;

(ii) during the year of income or the preceding year of income, the company had not derived an amount of interest income exceeding 10 percent of the total profit derived by the company during the same year,

several planning options seem available to avoid quarantining of interest. A foreign company with any substantial flow of other income can ensure

that any interest income which it receives is received at least two years before any payment is made to Australian residents, perhaps where more than one foreign company is concerned by organising appropriate levels of payment of interest between companies so as to control the flow of interest with respect to other profits to meet the requirements of the section 160AE(3)(f)(ii) exclusion from the definition of interest income which is to be quarantined as much as possible.

Further possibilities exist through payments in substitution for, but which cannot be classified as, interest and transfer of property in discharge of rights to interest but which are not in themselves payments.

Similarly with respect to section 51(6) it is relevant to observe with respect to the quarantining of expenses that its provisions are limited to amounts claimable under section 51(1) and do not extend to amounts otherwise claimable, for example, expenses of borrowing.

Profit Storing

As foreign source income is subjected to Australian tax upon payment to Australia there is an obvious incentive for profit storing out of Australia, inevitably in tax havens. Similar incentives exist under the United Kingdom system with the result that legislation was introduced in 1984, the controlled foreign companies legislation, the effect of which is to permit the United Kingdom authorities to identify United Kingdom resident controllers of offshore companies and to tax income derived by those companies as if paid in the United Kingdom proportionally amongst the controllers in accordance with their proportion of interest. Similar provisions exist in the United States Internal Revenue Code.

In general less favourable taxation results from foreign source income will flow for Australian resident taxpayers under the FTCS than previously available through section 23(q) and section 46. Review of existing and new structures to cope with the impact of the FTCS will require consideration of the type of entity to conduct overseas operations, for example branch or subsidiary, company trust or partnership, the profitability or otherwise from such operations, the scope for dealing to best advantage with profits, or losses, the types and source of income especially with regard to quarantining of foreign source losses in different classes and sources and the generation of excess credits, the structuring of group companies, and dealing through the group, with excess credits should they arise.