HISTORICAL DEVELOPMENT OF AUSTRALIA'S INTERNATIONAL TAXATION RULES

BY JOHN AZZI*

[The rapid internationalisation of Australian businesses over the past two decades has created many opportunities for the manipulation of Australia's tax system. The argument canvassed in this paper is that utilisation of the 'corporate veil' doctrine in the taxation arena has facilitated the avoidance of Australia's traditional taxation rules, especially with respect to international transactions. A complete change in approach to the taxation of offshore investments was required. Such a change occurred with the recent introduction of the controlled foreign corporation ('CFC') and foreign investment fund ('FIF') regimes. In developing this argument, the article traces the historical development of Australia's international tax rules and highlights instances of manipulation of those rules which were in existence prior to the CFC and FIF rules. Moreover, the two traditional means by which international double taxation is alleviated, such as the foreign tax credit system (the 'FTCS') and double tax agreements ('DTAs') are also discussed. However, it will be shown that even those measures are susceptible to abuse.]

I INTRODUCTION

The purpose of this paper, as the title suggests, is to trace the historical development of Australia's international tax rules, particularly as they apply to companies. In doing so it will become evident that traditional rules which have been developed to tax income that is derived through international transactions are inadequate since they are subject to manipulation.[1] The basis for such

* B Ec, LLB (Sydney); Solicitor of the Supreme Court of New South Wales.

[1] The reference to 'traditional rules' of taxation is a reference to the parameters of Australia's taxation powers as embodied in, for example, one of the central taxing provisions contained in the Income Tax Assessment Act 1936 (Cth) (the 'Act') — s 25(1). The broad effect of s 25(1) of the Act is that Australian residents are taxed on their worldwide income (ie, whether derived from sources in or out of Australia). This is commonly referred to as the 'residence principle of taxation'. Whereas, non-residents are only subjected to Australian tax liability in respect of income derived in Australia (this is commonly referred to as the 'source principle of taxation'). Underlying either principle of taxation is the need to ascertain the source from which income is derived.

The need to ascertain the source of income in the case of Australian residents arises by virtue of the fact that residents under the foreign tax credit system (the 'FTCS') are entitled to a credit in respect of 'foreign taxes paid' and for which they are 'personally liable' (see s 160AF of the Act). The credit which arises in such a case is utilised to offset the resident taxpayer's Australian tax liability (which is imposed on the resident taxpayer's domestic and foreign source income).

Prior to the introduction of the FTCS, Australia had in existence an exemption system whereby generally, foreign income which was subject to tax in a foreign jurisdiction was exempt from Australian tax (see the now repealed s 23(q) of the Act).

The determination of source of income is also relevant in applying double tax agreement ('DTA') clauses designed to alleviate international double taxation which occurs where the same income is subjected to tax in one or more jurisdictions. More will be said on the role of DTAs later in the paper.

A common factor underlying both residence and source principles of taxation is the recognition of the separate identity of a subsidiary company from its parent company (this is commonly manipulation is largely founded on the fact that such traditional rules observe and enforce the separate entity approach when taxing income derived by Australian multinational corporations. Hence, the need for a complete change in the manner in which Australian residents with overseas investments are taxed. The articulation of this change first occurred in 1988 when the Treasurer, as part of his May Economic Statement released the Consultative Document[2] (the 'CD', which is discussed below). Such a consultative process resulted in the introduction of the controlled foreign corporation ('CFC') regime and the foreign investment fund ('FIF') regime into the Income Tax Assessment Act 1936 (Cth) (the 'Act'), which is the principal Act that the Australian Government relies on to impose tax on profits of companies. It is not intended to discuss the operation of either the CFC or FIF regimes in this paper in any detail.

The Australian CFC and FIF regimes (which were introduced into the Act in 1991 and 1993 respectively) currently tax Australian resident shareholders (in certain circumstances) on their proportionate share of the foreign entity's profits. The closest analogy to this form of taxation that exists in the Act is the treatment of trusts and partnerships for tax purposes. Under the Act, trusts and partnerships are treated as 'pass-through' or conduit entities through which trustees/beneficiaries and partners (who are ultimately taxed on their share of the net income of the trust and partnership, respectively) derive income.[3] Such a concept of taxing shareholders of companies challenges the corporate veil doctrine (or the separate entity approach) ratified by the House of Lords in *Salomon v Salomon & Co Ltd*[4] and which is an inherent part of English and Australian company law. It also enables the Australian Government to impose tax on the profits of a foreign company (which is owned fully or partly by Australian resident taxpayers) without breaching traditional 'jurisdictional limits'[5] on the taxation of foreign source income.[6]

referred to as the 'corporate veil' doctrine). For example, where an Australian resident company wholly owns a foreign subsidiary, the foreign income which the subsidiary company derives will not be caught by Australia's traditional rules of taxation (see s 23(r) of the Act). This analysis of the state of affairs does not extend to the recently introduced controlled foreign corporation ('CFC') regime which as will be shown below attempts to overcome the corporate veil doctrine by integrating the profits of the subsidiary company with the profits of the Australian resident parent company.

2 Commonwealth of Australia, *Taxation of Foreign Source Income: A Consultative Document* (1988).

3 See Divisions 5 and 6 of the Act.

4 [1897] AC 22. The separate entity approach (or the 'corporate veil' doctrine) when applied to a multinational corporation structure which usually comprises of a holding company that is resident in one jurisdiction (say, Australia) and subsidiaries or branches that are resident in a number of other foreign jurisdictions, would dictate that any particular foreign entity within the multinational structure be treated as a separate legal entity from its Australian shareholders.

5 It is readily acknowledged that the CFC rules enable the domestic country to tax the foreign source income of its resident taxpayers who own the requisite interest in a foreign company where such income would otherwise have escaped taxation. To overcome the jurisdictional problems with taxing the earnings of a foreign corporation, the CFC rules tax the domestic shareholder on the income it derives indirectly through foreign companies (especially those resident in tax havens).

6 Foreign source income derived by a non-resident of Australia is generally exempt from Australian tax pursuant to s 23(r) of the Act.

The utilisation of the corporate veil doctrine in the taxation arena has facilitated avoidance of Australian taxation by Australian residents, especially with respect to international transactions. Avoidance of any exposure to the Australian taxation system simply involved the interposition of a foreign company (which was normally resident in a low tax country) between the source of the income and the ultimate beneficial recipient of that income, an Australian resident. Accordingly, the timing of the Australian resident's liability on the foreign income depended on the distribution policy of the foreign company. Where the foreign company retained income rather than distributed it to its shareholders, *deferral* of shareholder (residence country) taxation would occur.[7] In this regard the CFC rules are an important measure in combatting this form of manipulation since the successful achievement of shareholder deferral as described in this paragraph depended largely on the Australian resident having some control over the distribution policy of the foreign company. Where the requisite control or the substantial shareholding requirement is not satisfied then the FIF regime (which is contained in Part XI of the Act) could now be invoked. However, it was always envisaged that the FIF regime would only operate as a backstop to the CFC rules which are contained in Part X of the Act.[8]

By effectively integrating the profits of the foreign entity with the profits of its Australian shareholders, issues of 'international juridical double taxation' (to be referred to throughout the paper as 'international double taxation') arise.[9] This is

7 See Lee Burns, *Controlled Foreign Companies: Taxation of Foreign Source Income* (1992) 1.

8 See Commonwealth of Australia, *Taxation of Foreign Source Income: An Information Paper* (1989) para 13.4 (the 'FSIIP') where the introduction of a FIF regime was first foreshadowed:

> Experiences of other countries that have adopted some form of accruals taxation of foreign source income show that passive investment funds, generally resident in low-tax countries, have been marketed vigorously in recent years. The funds are structured to avoid the control tests or the minimum shareholding thresholds (generally 10 per cent) included in the accruals tax systems so that their income is not subject to accruals taxation. While constructive ownership rules will cover cases where investments are held through related persons (by treating such related persons as one person for the purposes of the threshold requirements), they will not cover the case of unrelated parties — at which these funds are generally directed.

9 It should be noted from the outset that one form of relief against international double taxation is provided by double tax agreements ('DTAs') which Australia has signed with a number of countries. Although the manner in which DTAs seek to alleviate double taxation varies between individual treaties, there are nevertheless, certain characteristics present in each. Each DTA provides for modification of domestic laws by: (i) declaring that taxing rights over certain classes of income (eg business income where there is no permanent establishment in the source State) will be reserved entirely to the country of residence; (ii) declaring that certain other income (eg, income from real property — article 6 of the Convention Between the Government of the United States and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, signed 6 August 1982 (included in Schedule 1 to the Income Tax (International Agreements) Amendment Act 1983 (Cth) — the 'US/Australia DTA') may be taxed in the country in which the income has its source. In such a case the DTA alleviates international double taxation (of an Australian resident taxpayer) by requiring the country of residence (ie, Australia) to grant a credit against its tax for the tax levied by the source country; (iii) declaring that persons who are residents of both Contracting States under their domestic laws, are to be treated as a resident of one only, although this applies only for the purpose of implementing the DTA and not for domestic law purposes. By assigning a single residence to an individual who may regarded as a resident under the residency rules of both Contracting States, DTAs effectively eliminate the dual residence conflict; (iv) providing rules whereby the source of particular items of income can be determined, thus avoiding the dual source conflict; and (v) The 'Mutual agreement procedure'

because the same income could be taxed in the foreign jurisdiction where the income is derived (ie, the source country) as well as in Australia (ie, the country of residence).[10] The discussion in this paper will merely focus on the policy aspects of such measures as opposed to an analysis of technicalities of such measures.

II TRADITIONAL BASES UPON WHICH AUSTRALIA ASSERTS FISCAL JURISDICTION

Australia asserts jurisdiction to tax the Australian and foreign source income of its residents (residence principle of taxation) and the Australian source income of foreign persons (source principle of taxation). While theoretically there are no rules of public international law or domestic constitutional law which encroach on a country's legal authority to levy tax,[11] the residence and source principles are the accepted international norms of taxation, with the source principle taking priority over the residence principle.[12]

If, in addition to the source country taxing certain income, the residence country also asserts its jurisdiction in respect of such income, then international double taxation occurs. There are three types of relief from this form of international double taxation: (i) the 'exemption method' whereby complete exemption from domestic tax is provided in respect of certain foreign source income; (ii) the 'credit method' whereby a credit against the taxpayer's tax liability in the country of residence is allowed for foreign taxes paid by the resident taxpayer; and (iii) the 'deduction method' whereby foreign taxes may be deductible in computing the resident taxpayer's worldwide income in the country of residence.

Some of our most important trading partners (ie, the United States, Japan and the United Kingdom) adopt a credit method. Australia, in following such an international trend, repealed the s 23(q) exemption method in 1987 and replaced it with the credit method. However, since the introduction of the CFC regime, the role of the credit system (known as the foreign tax credit system [the

article (eg, article 24(1) of the US/Australia DTA) provides for the taxation authorities of the two Contracting States to grant relief (on a mutually agreeable basis) where a taxpayer is able to demonstrate actual or potential subjection to taxation contrary to the provisions of the DTA. A discussion of the role of DTAs in the international tax sphere will also be undertaken in chapter 4 which deals with the measures for relief of double taxation and provides an historical account of the development of Australia's international taxation rules.

10 Apart from the residence/source conflict alluded to above, international juridical double taxation can also arise in the following two situations: (i) where a taxpayer is regarded as a resident by more than one country ('dual resident'); (ii) where the source rules of different countries may regard income as having a source within its territory according to its own law ('dual source').

11 See Martin Norr, 'Jurisdiction to Tax and International Income' (1962) 17 *Tax Law Review* 431.

12 Under current international norms, the source country is regarded as having the primary right to tax most types of income and the residence country the residual right to tax, and it is assumed that the source country will leave some room for residual tax by the residence country: see Richard Vann, *Trans-Tasman Taxation of Equity Investment* (1989) 39.

'FTCS'[13]) has been substantially reduced.[14] The position now is that the majority of offshore investment income will be exempt[15] from Australian tax by virtue of the operation of s 23AJ of the Act (which exempts 'non-portfolio dividends'[16] that have been taxed at a comparable rate to the rate applicable if that income had been derived in Australia) and s 23AH of the Act (which exempts foreign branch profits of Australian companies where the company carries on business in a 'listed country'[17] through a 'permanent establishment'[18]).

13 Under the FTCS prior to the introduction of the CFC regime, a credit was available to an Australian resident company under s 160AF of the Act for 'direct' taxes which it 'paid' and for which it was 'personally liable' on dividends received from foreign companies. In the case of an Australian resident company which held, broadly, a voting interest of at least 10% in a foreign company, an 'indirect' credit was also available through the mechanism provided by s 160AFC for foreign 'underlying tax' paid by the foreign company which paid the dividend. The 'indirect foreign tax credit' permitted against the domestic tax on dividends from foreign corporations for the foreign taxes paid by those foreign corporations, was available for unlimited tiers of related foreign companies, subject to 10% minimum shareholding requirements being satisfied.

Moreover, by setting a credit limit equal to the Australian tax payable on the foreign income, s 160AF effectively provides for the calculation of the credit limit on a worldwide basis (ie, on the basis of the taxpayer's total foreign income). Further, it is Australian domestic law which is applied to determine whether the income is foreign sourced or Australian sourced. In calculating the credit limit, foreign income which has not been subject to tax in the foreign jurisdiction is included in aggregate foreign income.

14 The FTCS still retains its relevance generally for Australian taxpayers deriving interest, rents, royalties, passive commodity investment gains, annuities and capital gains from foreign sources. Moreover, the FTCS retains its relevance for taxpayers (particularly individuals and companies with portfolio investments) deriving foreign dividend income which is not exempt from Australian tax and will often have suffered withholding taxes.

15 As the Assistant Commissioner at the time explained, the exemption was included in the CFC rules in order to reduce compliance costs given that little or no Australian tax will be collected in respect of such dividends.

> The tax treatment ... for foreign non-portfolio dividends and overseas branch profits is based on the principles that you see in the existing foreign tax credit system. Under that, a resident company that receives a non-portfolio [*sic*] dividend direct from a related foreign company is entitled to a credit for the withholding tax on the dividend as well as the underlying company tax.
>
> The credit is not available under the foreign tax credit system where a trust or partnership is interposed. The accruals measures simply mirror that approach. Consistent with that ... section 23AJ ... provides that a resident company that receives a non-portfolio dividend direct from a company in a listed country will be exempt from Australian company tax on that dividend. The exemption was granted on the basis that to credit for foreign tax levied at rates comparable to Australia's would have the effect that little or no Australian tax would be payable anyway. The effect ... is simply to reduce compliance costs.

Commonwealth, *Hansard*, Senate, Standing Committee on Finance and Public Administration, 14 December 1990, 45.

16 A 'non-portfolio dividend' means a dividend paid to a company where that company has a voting interest amounting to at least 10% of the voting power in the company paying the dividend: see s 317 of the Act. The 10% minimum threshold requirement is based on the internationally recognised practice which requires at least 10% ownership in the payer company before any control can be said to exist in respect of that company.

17 The term listed country appears throughout the CFC rules and refers to those countries which have a comparable tax system and corporate tax rate to that of Australia (eg, New Zealand, the United States, United Kingdom, Japan, Germany, France, Canada, etc).

18 The term 'permanent establishment' is defined in s 6(1) of the Act to broadly mean a place at or through which a person carries on any business and includes the place where the person is carrying on business through an agent, etc.

The thesis propounded in this paper is that the traditional approach to the taxation of income in view of the rapid internationalisation of Australian businesses has not been successful in averting manipulation of Australia's tax system. Hence the need for a radical re-thinking of how Australia taxes foreign source income derived by foreign subsidiaries which are 'controlled' by Australian resident taxpayers. In doing so it is intended to trace the historical development of Australia's tax rules (in particular, international tax rules). Reference will be made throughout the paper to the two traditional means by which international double taxation is alleviated (eg the FTCS and DTAs). However, it should be noted that even those measures are susceptible to abuse. The primary reason why the FTCS is easily avoided is that prior to the introduction of the CFC and FIF regimes, it was necessary for foreign source income to be repatriated to Australia before the FTCS was invoked. The DTA regime[19] is susceptible to manipulation because it contains provisions which treat the offshore company as a separate entity from the Australian company for the purposes of ascertaining which State has the taxing rights over the income.

III A Brief Historical Account of the Federal System of Taxation

It was not always the case that Australia asserted a jurisdiction to tax income on the basis of the residence and source principles. It was not until the 1930s that Australia exercised a limited jurisdiction to tax the foreign-source income of Australian residents. Therefore, tracing the development of such rules serves to highlight the changing international environment which the Federal Government has had to contend with since it entered the income tax arena in 1915. It also serves the purposes of the thesis in that it will become clearer that the necessity for other measures (*viz* CFC rules) is stronger in light of the inadequacy of the traditional ground rules upon which Australia taxes international income flows to deal with the changing tax environment.

Since the introduction of the Federal income tax in 1915, Australia's jurisdictional principles of taxation have been amended in order to account for the internationalisation of Australian businesses. However, before then, income tax was imposed solely by the respective States of the Commonwealth of Australia.

[19] The design of Australia's DTAs is based on the model produced by the OECD (the 'OECD Convention'). The basic structure of the Convention is described in OECD, *Model Double Taxation Convention On Income And Capital* (1992) 12-4.
For the purpose of eliminating double taxation, the OECD Convention establishes two categories of rules. First, in the case of a number of items of income and capital, an exclusive right to tax is conferred on one of the Contracting States. As a general rule, this exclusive right to tax is conferred on the State of residence. In the case of other items of income and capital, the right to tax is not an exclusive one. In the case of interest and dividends, a limited right to tax is given to the source State subject to the second category of rules, under which the residence State provides relief (either in the form of an exemption or a credit) so as to avoid double taxation.

The first tax on income and land in Australia was imposed by the South Australian Government in 1884.[20] Victoria was the next State to impose an income tax in 1895. The introduction of the tax was necessitated by a burgeoning budget deficit. In the same year and for the same economic reason, the State of New South Wales imposed a land and income tax. In 1899 Western Australia introduced a tax on company dividends and profits which was replaced by a general income and land tax in 1907. Queensland and Tasmania introduced a general income tax in 1902. During the time when the States were imposing income and land taxes, and up until 1915, the Commonwealth Government had derived its revenue from customs and excise duties. However, due to the financial strains caused by World War I, the Federal Government needed to raise additional revenue in order to finance its war efforts. Progressive tax rates were introduced with respect to income from personal exertion (from 1.25% up to a rate of almost 13% for amounts below £7,600, and 25% thereafter). Income from property was taxed under a complex formula with a maximum of 25% for amounts over £6,500; and income from companies taxed at a flat rate of 7.5%.[21]

In 1932, the Ferguson Royal Commission[22] was asked to consider the question of harmonising State and Commonwealth taxing systems. Uniform legislation was recommended which led to the enactment of the Income Tax Assessment Act 1936 (Cth) which is still the major legislation that dictates the taxation of income in Australia. Before then, the Federal Government had continued to levy income tax despite the conclusion of the War in 1918. This situation existed up until 1936 when the Act was passed by the Commonwealth. Similar legislation was also adopted by all the States. However, by 1942 the pressures of war forced the Commonwealth Government to seize sole control of income tax and it introduced the 'Uniform Taxation System', which arose from the draft Uniform Tax Bill developed by the Ferguson Royal Commission. This system was declared constitutional by the High Court of Australia[23] and hence the States were precluded from levying an income tax from that date. Since that time, the States have not resorted to the imposition of income tax.

The Act in its original form, like its predecessors the Income Tax Assessment Act 1915 (Cth) and the Income Tax Assessment Act 1922 (Cth), assessed

[20] The tax rates were modest being a flat rate of 1.25% on income from personal exertion (Taxation Act 1884 (SA) s 10(1)), 2.5% on income from property (s 10(2)), and 0.2% on landholdings (s 8).

[21] See Richard Fayle, 'An Historical Review of the Development of Income Tax in Australia' (1984) 18 *Taxation in Australia* 666, 667; Richard Fayle, 'Controlling Abusive Tax Shelters' (1985) 2 *Australian Tax Forum* 53, 54-7; and Jeffrey Waincymer, *Australian Income Tax Principles and Policy* (1991) 45-7.

It is noteworthy that the Income Tax Assessment Act 1915 (Cth) was 'a remarkably brief document being only 22 pages in length. It limited tax to Australian source income, (s 10) and ... exempted interest on Commonwealth bonds issued for the purpose of the War Loan Act (No 1) 1915, (s 11(e))': Richard Fayle, 'Controlling Abusive Tax Shelters' (1985) 2 *Australian Tax Forum* 53, 56.

[22] Commonwealth of Australia, *Royal Commission Into Taxation* (1934).

[23] See the High Court decision in *The State of South Australia v The Commonwealth* (1942) 2 AITR 273.

Australian source income and to a lesser extent assessed foreign-source income of Australian residents. Some of the notable tax shelter characteristics of the Act in its original form were the exclusion in s 44 of non-Australian source dividends and dividends from capital profits. The Act also provided for Australian tax rebates on business income derived abroad which was subject to foreign tax and a concessional rebate against Australian tax for income derived by UK residents (Division 17 of the Act).[24]

Since the Ferguson Royal Commission, there have been a number of Committees set up to look into the tax system.[25] For example, the Kerr Commission was appointed in 1920 to examine the issue of tax harmonisation between State and Commonwealth tax regimes, tax incidence and tax simplification. The recommendation made by the Kerr Commission led to the first major overhaul through the passage of the Income Tax Assessment Act 1922 (Cth) and subsequent modifications were made in 1924 and 1925.[26]

However, the most comprehensive study into Australia's international tax regime to date is the Asprey Committee Report which was published in 1975.[27] Many of the recommendations of the Asprey Committee were not instituted until some years later, predominantly for political reasons. As it turned out, there was a constitutional crisis which toppled the existing Labor Government from office in the same year that the Report was published.

The Asprey Committee discussed the issue of reform of international taxation in Australia at length. Prior to the Committee publishing their recommendations there were a number of other studies commissioned to examine the Australian taxation system.

It was not until the early 1980s when the Labor Government was re-elected that the recommendations of the Asprey Committee were reconsidered. Such reconsideration led to the publishing of the draft White Paper[28] in 1985, in which many of the recent changes to the tax system were foreshadowed. In the same year a national tax summit comprising government officials and interested

[24] See Richard Fayle, 'Controlling Abusive Tax Shelters' (1985) 2 *Australian Tax Forum* 53, 56-7.

[25] Other important Reports which have examined the need to reform the taxation system include: Commonwealth of Australia, *Australian Financial System. Final Report of the Committee of Inquiry* (1981) (the 'Campbell Report'); Commonwealth of Australia, *Inflation and Taxation: Report of the Committee of Inquiry into Inflation and Taxation* (1975) (the 'Mathews Committee Report'); Commonwealth of Australia, *Royal Commission Into Taxation* (1923) (the 'Kerr Commission').

It should be noted that one of the most influential and comprehensive reports which examined the tax design features of another jurisdiction (Canada) is Canada, *Report of the Royal Commission on Taxation* (1966) (the 'Carter Committee Report'). That Report endorsed the economic definition of income as the foundation of an income tax system. The Committee affirmed that taxes should be allocated according to the changes in the economic power of individuals and families (see vol 3, 35, 54).

[26] See Waincymer, above n 21, 46.

[27] Commonwealth of Australia, *Taxation Review Committee, Full Report* (1975). The Asprey Committee recognised that ideal tax systems embracing economic neutrality, fairness, simplicity and efficiency were utopian and that the three significant criteria of fairness, efficiency and simplicity in some respects conflict with each other (ibid 12).

[28] Commonwealth of Australia, *Reform of the Australian Tax System: Draft White Paper* (1985).

representative parties was held to consider the proposals outlined in the draft White Paper. At the conclusion of the summit the Treasurer released an economic statement in September 1985, entitled 'Reform of the Australian Taxation System', in which he announced the introduction of a capital gains tax and fringe benefits tax, an imputation system for shareholders, a foreign tax credit system,[29] elimination of deductibility for entertainment expenses and substantiation requirements for employee deductions.

Before turning to examine the development of Australia's international taxation rules, it is noteworthy that the Federal Government in the 1976-77 Budget introduced full personal income tax indexation to take into account unfair consequences of inflation rates on wages and salary. During the mid to late 1970s the consequences of high inflation meant that there was a high nominal (as opposed to real) growth in personal incomes. Such nominal increases meant that taxpayers were unfairly subjected to higher tax rates (in a progressive tax system) without deriving any real benefit from the nominal increases in their personal incomes. Prior to the introduction of full personal indexation and since the post-war period, it was stated that 'the Australian tax structure was not dynamic or innovative, nor firmly grounded in textbook principles of an ideal tax system.'[30] However, this system of full indexation was abolished by 1982. At the time indexation was abolished, it was noted that that system, which was regarded as a substitute for, rather than complement to, tax reform, 'did not stimulate a root and branch overhaul of Australia's tax structure; but there was distinctly more reform than in the preceding thirty years.'[31]

IV HISTORICAL ACCOUNT OF THE DEVELOPMENT OF AUSTRALIA'S INTERNATIONAL TAX RULES

As noted above, when Australia first imposed an income tax, it exercised jurisdiction to tax income only if the income had a source in Australia. In 1930, concerned at the decline in revenue resulting from the depression, Australia began to exercise a limited jurisdiction to tax the foreign-source income of Australian residents. The jurisdiction did not extend to foreign source dividend

29 It should be noted that the Asprey Committee (Commonwealth of Australia, *Taxation Review Committee, Full Report* (1975)) recommended the abolition of the s 23(q) exemption from Australian tax of income 'taxed' in a foreign country, to be replaced with a system which provides a credit for foreign taxes paid to be offset against Australian tax imposed on the same income (ie, the foreign tax credit system). The FTCS was finally enacted into the Act in 1987.

30 David Morgan, 'Personal Income Tax Indexation: The Australian Experience' in John Head (ed), *Taxation Issues of the 1980s* (1983) 71, 83.

31 Ibid 84. During this time the Government also considered a major broadening and deepening of indirect taxation. No action was taken by the Government at the time and the option lapsed until a similar option was canvassed by the Treasurer in the draft White Paper in 1985. The option (known as Approach C in the draft White Paper) was referred to as the 'broad-based consumption tax' which would have extended the base of wholesale sales tax to cover a whole range of consumer goods and services. This option was not supported at the national tax summit and no change to this position has occurred since that time. The absence of a comprehensive consumption tax meant that the Government has had to increasingly rely on existing indirect taxes such as sales tax to raise revenue. As a result there have been significant increases in sales tax since 1981.

income. Nor did it extend to other foreign-source income if that income was subject to income tax in another country.

A *Taxation of Dividends*

In 1941, s 44(1) of the Act which is the principal provision dealing with the taxation of dividends was amended.[32] Broadly, the amendment had the effect that foreign-source dividends of Australian residents were made subject to Australian income tax whether or not they were subject to income tax in another country. Pursuant to a further amendment to s 44(1),[33] an allowance for foreign tax paid on the dividends, where they were derived by an individual, was at first given by way of a *deduction* of the amount of that tax in determining the amount of the dividends subject to Australian tax. This deduction was replaced in 1947[34] by a credit of the amount of the foreign tax, the credit being available against Australian tax on the dividends.[35] The amendments did not address the situation where an Australian resident taxpayer interposes a number of foreign based companies to give the dividend an artificial foreign source by passing the dividends through the interposed companies.

Where the dividends were derived by an Australian resident company, the foreign source dividends were effectively exempt from Australian tax. Under s 46 of the Act, the recipient company was allowed a tax rebate of the amount of the Australian tax on the intra-corporate dividends. The s 46 rebate[36] was available, unlike the s 23(q) exemption, whether or not foreign tax had been paid in respect of such foreign source dividends. The availability of the s 46 rebate merely encouraged Australian companies to generate profits in low or zero tax countries thus infringing the principles of international equity and neutrality.

B *Withholding Tax*

In 1959 Australia introduced a dividend withholding tax regime, so that dividends from whatever source became subject to Australian tax, in the form of a withholding tax, when paid to non-residents by Australian resident companies. This had no bearing on the ability of Australian companies to accumulate profits offshore. In 1968 the withholding regime was extended to interest paid to non-residents, where it was paid by Australian residents or by non-residents carrying on business in Australia.

[32] The amendment to s 44 was inserted into the Act by virtue of s 7 of the Income Tax Assessment Act 1941 (Cth) No 58 (which commenced on 31 December 1941).

[33] This further amendment was inserted into the Act by virtue of s 7 of the Income Tax Assessment Act (No 2) 1942 (Cth) No 50 (which commenced on 6 October 1942).

[34] This amendment was inserted into the Act by virtue of s 7 of the Income Tax Assessment Act 1947 (Cth) No 11.

[35] The history of amendments to s 44(1) was obtained from J Gunn, O Berger and M Maas, *Gunn's Commonwealth Income Tax Law and Practice* (7th ed, 1963) [1203-99].

[36] The purpose of the s 46 rebate is to prevent profits from being subjected to multi-tiered taxation where dividends pass through several companies before flowing to individual shareholders: Commonwealth, *Hansard*, House of Representatives, 27 November 1940, 191, 192.

The existence of the s 23(q) exemption and interest and dividend withholding tax provisions provided opportunities to minimise or avoid Australian tax. For example, if an investor derived income, other than dividends, from a foreign jurisdiction which imposed little tax (and not covered by a DTA) on that income, then it was exempt from subjection to Australian tax by virtue of s 23(q) of the Act. Moreover, the Federal Government, by 'freeing up' the tight exchange controls in December 1983, had created another window of opportunity for Australian investors to avoid or minimise Australian tax.[37] The withholding tax provisions were easily circumvented primarily due to the fact that before those provisions could be invoked it was necessary that a resident had made a payment (of interest or dividends) to a non-resident. The ability to manipulate the residency rules meant that this threshold requirement could be easily avoided.[38]

[37] Prior to that date it was necessary to obtain a tax clearance certificate under Part IV of the Taxation Administration Act 1953 (Cth) before Australian residents could enter into an act or thing with a foreign element (particularly where the foreign element was a designated tax haven country). Without embarking on a detailed examination of Australia's exchange controls (which have since been repealed) it will suffice merely to note the basic operation of that system for the purposes of this chapter.

Prior to December 1983, exchange control approval was not given for certain transactions with persons resident or located in named tax havens without first receiving a tax clearance certificate issued by the Commissioner of Taxation. The issue of whether or not a person was to be supplied with a tax clearance certificate also affected whether the Reserve Bank (which is the institution having primary responsibility for the operation of the Australian exchange control system) would give its approval to any transaction or unilateral act with a foreign element within the bank's jurisdictional reach.

Banking Act 1959 (Cth) s 39B provides that where the Banking (Foreign Exchange) Regulations (which effectively provide that any transaction or unilateral act with a foreign element within jurisdictional reach must be authorised by the Reserve Bank) contain a provision prohibiting the doing of an act or thing without the Reserve Bank permission, and the act or thing is of a kind specified by the Treasurer in a notice in the Gazette, the Reserve Bank shall not give its authority unless a tax clearance certificate under s 14C of the Taxation Administration Act 1953 (Cth) is first produced.

The Australian Government Gazette, 23 December 1974, specified 5 acts and things which were geographically limited to those which touched the territories listed in the Schedule to the Gazette notice. The Schedule broadly corresponded with the Schedule to the Gazette notice for which a tax clearance certificate was needed which basically contained a list of places that were designated as tax havens for tax clearance certificate purposes. They were:

> Bahamas; Bermuda; British Channel Islands; British Solomon Islands Protectorate; British Virgin Islands; Cayman Islands; Gibraltar; Grenada; Hong Kong; Isle of Man; Liberia; Liechtenstein; Luxembourg; Nauru; Netherlands Antilles; Panama; Switzerland and Tonga.

The acts and things dealt with by the Gazette notice were expressed in wide terms — *viz*; the entry by a person into a contract, agreement or arrangement to which a person (whether acting as principal or through an agent) who is in or is a resident of a scheduled tax haven is a party.

The grounds upon which the Commissioner may refuse to issue a tax clearance certificate were set out in s 14D of the Taxation Administration Act 1953 (Cth). Before issuing the certificate the Commissioner had to be satisfied that the act or thing for which the certificate is sought will not or would not reasonably be expected to involve: (a) tax avoidance or evasion; or (b) the gaining of an Australian income tax benefit or advantage which would not otherwise be available; or (c) the uncollectability of an amount of Australian tax which has become, or would reasonably be expected to become, payable.

[38] A resident of Australia in relation to a company is defined in s 6(1) of the Income Tax Assessment Act 1936 (Cth), as follows:

> (b) a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

Coupled with the freer exchange control rules enabling the transfer of funds abroad without much regulatory interference, it is then not difficult to see how Australian tax could have been minimised or altogether avoided.

C *Anti-Avoidance*

During the 1970s Australian taxpayers were increasingly utilising international transactions to avoid or minimise Australian tax.[39] In responding to the opportunities created for avoidance or minimisation of Australian tax arising from international transactions, the Treasurer announced the proposed repeal of s 23(q) of the Act and the introduction of a FTCS. Subsequently, the Treasurer announced on 25 October 1978 that the proposed repeal of s 23(q) will be abandoned but stated that the Government is 'giving close attention to further measures specifically designed to reduce the scope for avoidance under the existing rules relating to taxation of earnings from international transactions'[40].

The uncertainty surrounding the precise scope of the central management and control concept has given rise to tax planning activities along the same lines as the taxpayer in *Esquire Nominees Ltd v Commissioner of Taxation (Cth)* (1973) 129 CLR 177. One of the questions raised in that case was whether the taxpayer company, whose directors were residents of Norfolk Island who held all the meetings of the company there, was resident in Australia. The Commissioner contended that as the taxpayer habitually responded to advice from Australian accountants, it should be characterised as resident in Australia. In rejecting the Commissioner's contention, Gibbs J did not regard the fact that the Board of Directors habitually responded to instructions formulated in Australia as sufficient evidence that the taxpayer is resident in Australia (185-6). In reaching this conclusion, his Honour stated that he believed that if the directors had been instructed to do something improper or inadvisable they would not have done it. His Honour was of the view that although the Australian accountants had 'power to exert influence, and perhaps strong influence' on the company, they nonetheless did not 'control' the company accordingly, actual management and control of the company and thus its residence was in Norfolk Island (186). Gibbs J's decision on this point was upheld by the Full Court of the High Court on appeal by the Commissioner of Taxation: *Esquire Nominees Ltd as Trustee of Manoulas Trust v Commissioner of Taxation (Cth)* (1974) 4 ATR 75 (*Esquire Nominees*).

Effectively, this has allowed offshore subsidiaries to argue that they are not necessarily resident in the country of their holding company. Consequently, it is not difficult to understand why the *Esquire Nominees* decision has been attributed with inspiring many corporations to set up offshore subsidiaries to engage in business in low tax countries and not to repatriate a significant part of their profits to Australia. The extent of international planning activities based on *Esquire Nominees* has led one commentator to suggest that the accruals system was introduced to counter deferral of Australian tax arising from that decision: see Waincymer, above n 21, 350.

39 In an article written by Mark Leibler in 1979 (Mark Leibler, 'International Transactions in Tax Practice' [1979] *Australian Tax Review* 8), the opening sentence stated that '[t]he purpose of this article is to explore in practical terms methods of applying or introducing "international aspects" in relation to particular transactions with a view to reducing the overall tax burden to which a client would otherwise be subjected.'

The same author in responding to an announcement by the Treasurer to implement aggressive anti-avoidance policies in the international tax arena, commented (Leibler, above n 39, 9) that:

> the suggestion that any such "corrective measures" could largely eliminate tax minimisation in the international arena may well be open to question, given the very limited detection and enforcement procedures open to the Government and, also, given the assumption that a regulatory system will not be introduced if it will have the effect of hindering genuine trading and commercial relationships between Australia, her trading partners and their respective citizens.

40 Ibid 9. One commentator observed that 'Between 1982 and 1986 only 13 final determinations were made in cases where the Taxation office sought to apply existing anti-avoidance provisions to transfer pricing arrangements': Rick Krever, 'The Tax-Haven Crackdown's Limited

A signal event in the counter of tax avoidance was the introduction of the general anti-avoidance measure, Part IVA, into the Act in 1981 to replace its antiquated and arguably lame predecessor, s 260 of the Act. However, the effectiveness of Part IVA in countering the Australian tax benefit obtained from the entry into an international transaction by an Australian resident is largely undermined. This is because as long as the taxpayer can prove to the Commissioner that the dominant or sole purpose in entering into a particular 'scheme' was not to obtain a tax benefit, then Part IVA will not apply. In the subsequent year the Treasurer introduced Division 13 into the Act to counter tax avoidance or tax minimisation arising from the entry into an international transaction by related parties for non-arm's length consideration (ie, transfer pricing transaction). Without embarking on a detailed analysis of the various anti-avoidance measures, it has been noted 'that Part IVA has no application to the withholding tax provisions.'[41]

When applying Division 13 to an international transaction between related parties, a similar limitation arises as that which arises in respect of Part IVA of the Act. It is noted that a transfer pricing transaction can only be attacked if the Commissioner can show that the transaction has not occurred at a fair market price. The difficulty with applying this criteria is in ascertaining what is a fair market price especially where there is no perceived 'market' for the property which has been acquired/supplied under the international transaction, since only the parties to the transaction would acquire/supply such property.[42]

The ability to defer Australian taxation on income earned abroad by foreign corporations (discussed earlier) could allow an Australian resident taxpayer to control the timing of income recognition and foreign tax credit utilisation. Clearly, from the discussion in the immediately preceding paragraphs, it can be seen that there are two main problems with the policy options discussed there to deal with the deferral problem. First, the traditional anti-avoidance measures (ie, Part IVA and Division 13 of the Act) do not allow the Australian Parliament to tax a foreign corporation that has no connection with Australia other than residence of its shareholders; and second, a corporation is treated as a taxable entity separate from its shareholders.

Reach' (June 1989) *Australian Society* 22, 24. Professor Richard Vann, in highlighting another inadequacy of our transfer pricing rules caused by differentials in company tax rates between our major trading partners noted that:

> To date, the performance of our tax administration in dealing with transfer pricing has been abysmal (to put it at its kindest) and there are good reasons to suspect that recent administrative changes have only addressed current problems rather than anticipated the difficulties that would arise from significant company tax rate differentials directly between trading partners.

Richard Vann, 'International Developments in Tax Reform' in Taxation Institute of Australia, *Consolidation or Change,* 8th National Convention, Sydney, 12-5 April 1988, 77, 85.

41 Richard Fayle, 'Controlling Abusive Tax Shelters' (1985) 2 *Australian Tax Forum* 53, 64.

42 For a fuller analysis of this point see Krever, above n 40, 24-5.

D *Introduction of the FTCS*

Repeal of the s 23(q) exemption which was replaced by a FTCS finally occurred on 1 July 1987. In broad terms s 23(q) provided that income (other than dividends),[43] or profit or gains of a capital nature, are exempt from tax in Australia in the hands of a resident of Australia where they were derived from sources out of Australia and Papua New Guinea, and that income[44] or those profits or gains were not exempt from tax in the country where the income was, or the profits or gains were, derived. In addition, the Commissioner was required to be satisfied, *inter alia*, that where there was a liability for tax in the country where the income or the profits or gains were derived, the tax had been or would be paid.

The introduction of the FTCS saw the withdrawal of the s 46 rebate for dividends paid by a non-resident company. This was part of the general policy of broadening the income tax base so as to include foreign source income derived by Australian resident taxpayers.[45] To counter the negative effect on 'capital import neutrality'[46] which the removal of the s 23(q) exemption and the s 46 rebate would have caused, the Federal Government introduced a FTCS which contains provisions (see ss 160AFB and 160AFC of the Act) to take into account the effective rate of corporate tax (ie, foreign underlying tax) on dividends paid by a 'related'[47] foreign company (ie, indirect credit). However, it has been noted

[43] In the case of dividends received by individuals, a foreign tax credit system was already in operation under s 45 of the Act. On the other hand, in the case of companies, the operation of the s 46 rebate meant that intra-company dividends were exempt whether they were Australian source or ex-Australian source.

[44] Section 23(q) did not apply to certain classes of foreign source income:
(a) dividends and income attributable to dividends as defined by s 6B of the Act:
(b) interest and royalties (and income attributable to them) which had been subject to tax at source at a reduced rate by virtue of a DTA;
(c) non-employment income from Papua-New Guinea sources; and
(d) certain income from films and trading ships which enjoyed special tax concessions.

[45] See Lee Burns, 'Taxation of Distributions of Foreign Companies' in University of Sydney, Continuing Legal Education, *Taxation of Foreign Income — Controlled Foreign Companies and Foreign Trusts* (1990) 2.

[46] Capital-import neutrality exists when firms of all nations pay the same rate of tax on capital earnings in the particular country (and in the home country) for which capital-import neutrality is said to apply. Domestic tax law must not discriminate among investors according to nationality. The most straightforward way to accomplish capital import-neutrality is to exempt foreign source income from domestic taxation. Applying the concept of capital-import neutrality in an Australian context, it is noted that this concept dictates that in order to create a competitive environment for Australian firms investing abroad, foreign source income should only be taxed at the rate facing other investors in that source, arguably the rate of the capital importing country: see generally John Azzi, 'Policy Considerations in the Taxation of Foreign Source Income' (1993) 47 *Bulletin for International Fiscal Documentation* 547, 550-1.

[47] There are two basic tests which must be satisfied so that a resident company and a foreign company can be related for the purposes of the indirect foreign tax credit provisions set out in s 160AFB of the Act. The first requirement is that the companies must be members of a 'group' of companies. A group of companies may be two or more companies forming a chain. At each tier the higher company must hold at least 10 per cent of the voting power of the company below. It is not necessary that the Australian company and the foreign company be directly linked within that chain (see s 160AFB(1)). The second requirement is that the Australian resident company must hold not less than 5 per cent of the voting power of a company that is a member of the group (see s 160AFB(2)).

that the indirect credit will only achieve its goal of promoting international equity and efficiency, if the profits of the foreign company are taxed currently in Australia in the same way as branch profits are taxed. The reason for this is that the separate treatment of a related foreign company from its Australian parent, means that it could defer payment of Australian tax altogether by not repatriating its profits to the Australian company. Moreover, there was a logical inconsistency in having a direct foreign tax credit which treats the foreign company as a separate entity from its Australian related company and an indirect credit which 'looks-through' the structure by consolidating the group's profits.

E *CFC Rules Introduced*

The Federal Government in introducing the FTCS always envisaged the introduction of anti-tax haven legislation to counter international transactions which seek to give Australian source income an artificial foreign source.[48] The anti-tax haven legislation which was conceived in the draft White Paper was given birth in the CD, released by the Treasurer as part of his May 1988 Economic Statement. The measures foreshadowed by the Treasurer in the CD were similar in form to the CFC or accruals legislation which some of our most important trading partners had introduced at the time (ie, Canada, France, Japan, New Zealand, the UK and the US). The proposals outlined in the CD aimed to currently tax interests held by Australian residents in non-resident companies where the foreign company derives income in a low-tax country or that income has benefitted from a designated tax concession in another country. The proposals as they originally stood got around the need for a FIF regime since all interests held in a foreign company were subject to accruals taxation. However, portfolio interests held by Australian residents in public foreign companies (listed on recognised stock exchanges) were exempt under the proposals. An exemption similar to the current s 23AJ exemption was contained in the CD proposals.

Business community response to the CD proposals was generally unfavourable. It was argued that the proposals could seriously undermine Australian investments abroad. The Federal Government then released an Information Paper[49] (the 'FSIIP'), which addressed some of the arguments against the CD proposals put forward by the business community. In particular, the policy options set out in the FSIIP, which took into account some of the criticisms aimed at the CD proposals, contained a control rule whereby only Australian taxpayers holding a non-portfolio interest in a 'controlled foreign company'[50] were subject to the accruals rules. In acceding to the business community's demands, the Federal Government also introduced an active income exemption

48 See Commonwealth of Australia, *Reform of the Australian Tax System* (1985) (the 'draft White Paper') 233.

49 FSIIP, above n 8.

50 The term 'controlled foreign company' is defined in s 340 of the Act and will not be discussed here.

in the FSIIP, whereby Australian taxpayers who satisfied the relevant criteria for assessability under the accruals rules, were exempt from those measures where less than 5% of the gross turnover did not constitute tainted (ie, non-active) income. Another major deviation from the CD proposals, which was incorporated into the FSIIP policy measures, was the introduction of a schedule of designated listed countries which taxed income at comparable rates to Australia.

The FSIIP was quickly followed by one amending legislative Bill after another.[51] Originally, the accruals system of taxing foreign source income was contained in the draft Bill, which was released on 17 December 1989. There was, however, a second draft Bill released on 29 June 1990, which attempted to address some of the problems associated with the original draft. The Bill which was introduced into Parliament by the Minister Assisting the Treasurer, the Hon Simon Crean MP, on 13 September 1990, was substantially the same as the second draft Bill released on 29 June 1990. Since then the draft Bill has been passed by both Houses of Parliament and on 8 January 1991 it received Royal assent and therefore was incorporated into the Act on that date.[52] At the same time the Federal Government had introduced Division 6AAA into the Act which provided an accruals system of taxation of certain non-resident trust estates similar to the accruals system for the taxation of CFCs, where funds are transferred to the foreign trust at less than full market value. Discussion of the transferor trust provisions contained in Division 6AAA will not be undertaken in this paper.

However, not all of the announced changes were included in the accruals legislation. Some of the amendments still to be introduced will be the result of close monitoring of avoidance techniques that are being developed to frustrate the intent of the measures. Already, the Federal Government has passed two amending Bills[53] which further refine the accruals legislation.

The growing use of accruals basis taxation by developed capital exporting nations has also given rise to the potential for double taxation where the use of indirect ownership rules by countries that adopt accruals legislation could include the income of a particular foreign entity being subject to more than one country's legislation. At the time the accruals basis regime was being proposed

[51] See Taxation Laws Amendment (Foreign Income) Bill — Draft Bill (the 'Draft Bill'); Taxation Laws Amendment (Foreign Income) Bill 1990 ('Bill 1990'); and Taxation Laws Amendment Bill (No 6) 1990 which contained amendments and additions to Bill 1990.

[52] The accruals rules are now contained in Part X of the Act. However, it should be noted that the introduction of the draft Bill had not been uncontroversial. It is noted that no allowance had been made for the fact that offshore entities may pay tax through a myriad of means other than the direct imposition of an income tax (eg sales tax or VAT or customs duty which are not included in the income tax base for the purposes of comparing the tax rates of the foreign jurisdiction with the Australian income tax rate). The exposure of such entities to an income tax at a rate comparable to that levied in Australia is the sole criteria adopted by Treasury in determining whether an Australian taxpayer is exposed to the new rules: see generally Tony Clemens, 'Outline of the Foreign Source Income Rules', paper presented to a University of Sydney, Continuing Legal Education seminar, 19 November 1990) 3.

[53] Taxation Laws Amendment Bill (No 6) 1990, which received Royal Assent on 24 April 1991; and Taxation Laws Amendment Bill (No 2) 1991 which was introduced into Parliament on 18 April 1991, and received Royal Assent on 27 June 1991.

for Australia in May 1988, a real solution to such a dilemma had not been propounded. It was merely suggested that if such a situation were to occur, primary taxation rights would need to be considered in order to prevent the multiple taxation of the income of a foreign entity. It was not until December 1990 that a statutory solution to the problem was proposed in the Taxation Laws Amendment Bill (No 6) 1990 (which received Royal assent from the Governor-General on 24 April 1991) in the form of clause 456A. That clause provides relief from double taxation where amounts derived by a CFC have been taxed under the accruals system of another country.

The new measures for the taxation of foreign source income contained in the CFC legislation were not introduced as part of a revenue-raising exercise, but rather as an attempt to tax all foreign source income either in Australia, or if taxed overseas, at a comparable foreign rate of tax.[54] The basic structure of the CFC legislation is that (i) foreign source income (calculated according to Australian tax law) will only be *attributed* to residents with a substantial interest of 10% or more in a foreign company ('attribution rule'); (ii) only the income of a CFC will be subject to attribution ('control test'); (iii) the operation of the attribution test varies according to the residency status of the CFC ('jurisdictional coverage'); and (iv) the operation of the attribution test further depends on the type of income derived by the CFC ('active income exemption').

F *FIF Regime Introduced*

The third major piece of legislation[55] introduced by the Federal Government in its program to develop a comprehensive regime for taxing foreign source income (and foreshadowed in the Government's 1991-92 Budget announcement) is the FIF regime which was designed to currently tax portfolio interests held by Australian residents in an FIF. In effect the FIF regime was designed to act as a backstop to the CFC regime which only taxes non-portfolio interests held by Australian residents in a CFC.

The necessary initiating legislation for this program was the Income Tax Assessment Amendment (Foreign Investment) Bill 1992 (the 'FIF Bill') which was introduced into Federal Parliament on 25 June 1992. Subsequent to the introduction of the FIF Bill the Government announced that it would be conducting a review of the FIF Bill and that submissions could be made on it. Professor Brian Arnold, a noted international tax academic from the Faculty of Law, University of Western Ontario, Canada, was appointed to consider the FIF Bill and to make recommendations to the Federal Government. Subsequent to the

[54] See FSIIP, above n 8, 3. In articulating this policy the Government has, it is submitted, overstated the effect of the new CFC measures where it said that the CFC measures will address the tax deferral problem where CFCs are used to shelter income from Australian tax by accumulating it in low-tax or tax free jurisdictions (see the Explanatory Memorandum to the Income Tax Assessment Amendment (Foreign Investment) Bill 1992, 1). For example, CFCs which pass the active income exemption will still be able to shelter their passive income in a low-tax country so long as it does not constitute more than 5% of gross turnover.

[55] The first, as noted previously, being the FTCS and the second, the CFC regime.

release of Professor Arnold's report on 9 October 1992, the Government withdrew the FIF Bill and re-introduced a new version of the Income Tax Assessment Amendment (Foreign Investment) Bill 1992. Professor Arnold's report endorsed the fundamental policy approach adopted by the Government in the FIF Bill and acknowledged the need for such measures.

The report contained 52 recommendations. The Government agreed to immediately implement 37 of them. Of the 15 recommendations not addressed by the Federal Government, eight are still under review while the Government has decided not to proceed with the remaining seven.[56] However, most of those recommendations covered complex areas where Professor Arnold recommended further study, rather than immediate action.

Many of the recommendations generally were designed to streamline the operation of the FIF measures with a view to reducing administration and compliance costs and did not require any alteration to the fundamental policy and structure of the approach contained in the FIF Bill. The recommendations were fairly minor and technical in nature, except for:

(a) the recommendations to switch back to a 'black list' of activities to be taxed under the FIF measures,[57] and
(b) the treatment of losses on a more favourable basis than previously contemplated.[58]

The FIF measures will act as a backstop to the accruals rules especially in relation to the avoidance opportunities created by the attribution rule by proposing measures which would address those cases where Australians have small interests (or non-controlling interests) in offshore entities. It is noted that the FIF measures aim to reduce the scope for deferral of Australian tax where Australian residents hold interests in foreign entities that fall outside the scope of the accruals rules. The measures seek to catch low taxed or untaxed income which has been accumulated offshore and which is later converted into indexed capital gains upon disposal of the interest in the foreign entity. An interest in a foreign entity for the purposes of the FIF measures could be either a share; an option to acquire a share; a right to acquire a share; a convertible note or any similar instrument.[59] Moreover, the FIF measures will focus on the entire investment

[56] See Commonwealth of Australia, Treasurer, Press Release No 153, *Foreign Investment Fund (FIF) Legislation: Government Response to Consultant's Report* (9 October 1992), which sets out the 37 recommendations agreed to by the Government and the remaining recommendations under review.

[57] The black list was inserted to cover certain investment, real estate, financial services, banking and insurance businesses. The Government acknowledges that the white and black list are conceptually equivalent, however, the practical advantages of operating a short, stable black list had persuaded the Government to adopt that approach: ibid 2.

[58] In accepting Professor Arnold's recommendation to relax the excessively restrictive FIF loss quarantining rule contained in the FIF Bill, the Government agreed to adopt Professor Arnold's proposal that a FIF loss should be deductible against any assessable income (and not just future income of the same FIF), but only to the extent that a taxpayer has been subject to taxation previously in respect of income from that FIF. The rationale for this relaxation of the quarantining rule lies in reducing an excessive compliance burden and record keeping requirement: ibid 2-3.

[59] See s 483 of the Act.

activities of the foreign entity. Australian investors do not necessarily have to contrive or control FIF distribution policy for deferral to occur.

In designing the FIF measures the Federal Government has adopted measures capable of bringing to account all income and realised gains held at lower tiers in a multi-tiered investment structure. Therefore, the new FIF measures will tax unrealised gains and losses which can be carried forward indefinitely to be offset against the same FIF income. Calculation of gains and losses is based either on the market value method, deemed rate of return method or recalculation method. It does not serve the purposes of this paper to embark on a detailed analysis of the bases for calculating gains and/or losses incurred by a FIF.

The concept behind the calculation of the attributable income of a CFC, is one of lifting the corporate veil for certain income and gains of the CFC (*viz* the tainted income). This is because the CFC for the purposes of the accruals rules is considered to be the alter ego of the attributable taxpayer. On the other hand, the concept behind the calculation of the attributable income of the FIF measures is analogous to anticipating a distribution of profits or realisation of gains. Thus, the potential for taxation of unrealised gains arises. However, the government concedes that attributable taxpayers of a FIF will, in many cases (due to lack of control over the FIF), have limited or no access to relevant information and therefore it has given an undertaking that the calculation of the attributable income will be an extremely simplified version of that required under the Act.[60]

V CONCLUSION

In the course of tracing the historical development of Australia's international taxation rules up until the most recent changes to the international tax regime, it became evident that most of the changes were introduced to counter tax avoidance and tax minimisation opportunities. The deregulation of the Australian dollar in December 1983, and the consequent freeing-up of capital movements into and out of Australia made the prevailing s 23(q) exemption unsatisfactory from a policy perspective. It was encouraging Australians to invest overseas and derive foreign source income in low-tax jurisdictions. Offshore investments were becoming tax rather than profit driven. Moreover, the limitations with the transfer pricing provisions contained in Part III Division 13 and Part IVA of the Act meant that Australians could give income an artificial foreign source and hence benefit from the s 23(q) exemption.

Consequently, the Government announced in 1985 the introduction of the FTCS to replace the s 23(q) exemption. The Government also indicated that the FTCS alone could not counter all offshore tax avoidance as it would only apply when Australian residents actually received income from foreign sources. This implicitly encouraged the retention of funds offshore through controlled and often non-controlled entities and thus the deferral of Australian tax on such income. Accordingly, measures additional to the FTCS were required to address

60 FSIIP, above n 8, 70.

this glaring deficiency. The additional measures were the CFC and FIF rules which, as noted earlier, were introduced in 1991 and 1993, respectively.

Where domestic tax is deferred, for example, by non-repatriation of funds, then there is no need for any measures to relieve international double taxation. Double taxation usually arises upon distribution of the foreign profits, say, in the form of dividends, when they are subject to domestic taxation. The double taxation in this case only arises in an economic sense, not a legal sense, since legally, the domestic taxpayer is treated as a separate entity from the foreign subsidiary. However, a logical inconsistency arises in respect of the allowance of an indirect credit under the FTCS. By allowing a credit for the foreign underlying tax, the FTCS is effectively treating the 'group' companies as a single entity which is inconsistent with the overall policy of the FTCS of treating the two companies as separate legal entities.

The Federal Government was aware of the limitations with the FTCS since at the same time proposals for its implementation were being announced, proposals for anti-tax haven legislation were also being foreshadowed. Without such legislation (ie, CFC and FIF regimes) Australia's assertion of fiscal jurisdiction was seriously undermined since it was still possible under the FTCS to manipulate residence based source rules (and thus giving Australian source income an artificial foreign source) by entering into international transactions for that purpose. This resulted in loss of revenue to the Treasury since it was possible under the FTCS to accumulate income offshore and only repatriate the same to Australia when it was advantageous from a tax point of view to do so.

The theory behind DTAs has come under increasing attack recently. It is observed that the problem of accumulation of profits in tax havens is not affected by the existing treaties. Since Australia has generally only negotiated DTAs with other non-tax haven countries, they cannot maintain the integrity of the domestic base in relation to subsidiaries of Australian companies operating in tax haven countries through the exchange of information provision of a particular bilateral treaty. The increasing importance of 'treaty shopping'[61] has also contributed to the demise of DTAs as an effective anti-evasion provision.

Moreover, it is suggested that the accruals legislation which was recently implemented in Australia is contrary to the assumptions of existing bilateral tax treaties and that such bilateral treaties, which are based on the OECD Model Treaty 1977, are 'increasingly inefficient, irrelevant and inflexible.'[62] The reason why it is argued that the existing double tax treaties are contrary to the accruals legislation is because such treaties uphold the separate entity approach. Articles 4 and 9 of the OECD Model provide examples of the separate treatment of parent and subsidiary. Article 4 is intended to define the meaning of the term 'resident of a Contracting State'. There are no 'look-through' provisions in that

61 'Treaty shopping' is a term used to describe situations in which a taxpayer seeks to take advantage of the benefits of a tax treaty between two countries, usually by establishing a corporation in one of the countries.

62 Richard Vann, 'Foreign Treaties: Schizophrenia Rules' (1991) 25 *Taxation in Australia* 724, 725.

article (similar to the third test of residence of a company under s 6(1) of the Act) which attribute residence of a company to the residence of its controlling shareholders (see articles 4(2) and 4(3)). Similarly, article 9 — the 'Associated Enterprises' article — specifically deals with parent and subsidiary groups under common control and provides that the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities of associated enterprises re-write the accounts of the enterprises if, as a result of the special relationship between them, the accounts do not show the true taxable profits arising in that State (see article 9(1)). In doing so, the article specifically acknowledges the separateness of the two enterprises. So much so that article 9(2) provides for an adjustment to be made in the case where the re-writing of the enterprises' accounts results in economic double taxation (ie, taxation of the same income in the hands of different persons).

Therefore, the conclusion that one can draw from the discussion in Parts I and II of this paper, is that most of the amendments to Australia's international taxation rules have not equipped the government with the necessary arsenal in its attack on tax haven use by Australian taxpayers to facilitate deferral of Australian tax. This failure to counter such practices is most visible in cases where offshore entities are utilised by Australian companies to derive passive income which is accumulated abroad. The reason why this is the case can most strongly be argued on the basis that all of the measures discussed in this paper reinforce and apply the corporate veil doctrine for their operation. Hence the need for a complete change in approach to the taxation of such offshore entities. The need for such a change was first foreshadowed by the Asprey Committee. The Committee's recommendations were acted upon by the Labor Government in 1985 in the form of the draft White Paper. The proposals outlined there were developed into tangible proposals in the CD which were subsequently modified in the FSIIP. The result of this process of consultation was the introduction of the CFC regime in 1991 and the FIF regime in 1993.

The primary reason why these latter measures appear to have succeeded in reducing the level of manipulation of Australia's tax rules is because the approach adopted in the CFC legislation and the FIF rules ignores the separate entity doctrine by consolidating the profits of the foreign company with the income of its controlling domestic shareholders (in the case of the accruals rules) and non-controlling shareholders (in the case of the FIF regime).