Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

13 – 14 February 2013

Question: **AET 59**

Topic: **Sovereign Investment**

Hansard Page: **Page 87-88, 14 February 2013**

Senator HEFFERNAN asked:

Senator HEFFERNAN: Could you note that I have been drinking water and that is all? I have some questions in the tax section for the Markets Group. There is increasing provision by sovereign sources foreign of passive investment capital, some of which, according to the tax office, is certainly from a nonmarket currency—say, Chinese. What impact will that have on our markets if it continues to grow given that it has tax-free status?
Mr Murphy: I am not clear about it. If it is a tax matter, you are better off with Revenue Group.
Senator HEFFERNAN: No, it is a capital market value. It is a provision of capital into Australia from a foreign sovereign source, and if it was in the case of a provincial or the central government of China, it would be a nonmarket currency—right? You understand that?
Mr Murphy: Yes.
Senator HEFFERNAN: This passive investment, which is a question for Treasury but it is an influence in the capital market, with the encouragement of a non-taxable status, which it has—passive investment from a sovereign investor has some non-taxable status, the interest in the revenue earned—what are the implications of that for the distortion of our capital markets?
Mr Murphy: I think I would have to take it on notice.
Senator HEFFERNAN: Is it too—it is something I think about—
Mr Murphy: We could have a general—I think I know where you are coming from. It would be better to—
Senator HEFFERNAN: Just to assist you—
Mr Murphy: Yes, please.
Senator HEFFERNAN: I am chairing the review into the Foreign Investment Review Board national interest test, which is all out of date. In that we have collected evidence that says, for instance, you can distort the capital market, the commodity market and avoid the revenue base if you go about it the right way. It is a global problem: $3 trillion of tax is avoided globally due to the incapacity of countries to be able to audit transfer pricing. There is $600 to $800 billion in the US alone.
What I am thinking about is that if we have increasing dealings with countries, which we appear to be going to have as we are developing relationships with countries like China, and they then keep their sovereign involvement—there will be pressure on them to deplete their sovereign involvement into market involvement—then money that is coming into Australia that has the status of sovereign investment, which, according to the evidence we have received would also have some tax relief involved, the tax office has told us that sovereign passive investment income earned can be tax free under the international convention, and if you had enough of that coming in, much like the distortion of the home unit market there where we had to change the Foreign Investment Review Board rules, wouldn't that distort the capital market?
Mr Murphy: Yes and no.
Senator HEFFERNAN: It might not be a thing for tonight.
Mr Murphy: In a lot of these areas it is going to depend on the quantity and depend on—really you have to get some facts and figures. If the tax office has said that to you—yes, we are responsible for

foreign investment; yes, we are involved with responsibilities for capital markets. We would be very interested in this, and I think we should be reviewing the submissions that have come to your committee and provide some advice.
Senator HEFFERNAN: Thank you for that. I am just an old, worn out cocky, but one of the things you can distort, because of the status, because we have it in a written form from the tax office, is that if you declare in a sovereign investment here, regardless of the capital involved, that the production is for a humanitarian purpose—
Mr Murphy: Yes, I have heard of that.

Answer:

By their nature, taxes are inherently distortionary as they impose a wedge between supply and demand for the factors of production. In addition, taxes that have selective application (or exclusions) either to types of entity or types of investment – tend to result in greater distortion than taxes with general application.

(a) Income arising from Australian commercial business activities of a foreign government investor is subject to Australian tax on the same basis as for any other investor using similar investment structures.

As noted by the ATO in response to a previous question on notice: [1]

> "'The tax implications for arrangements involving transfers of goods or services between parties operating within the Australian tax jurisdiction, or between parties operating in the Australian tax jurisdiction and a different (overseas) tax jurisdiction, depend on the specific facts. As such, the ATO can only provide general advice on this hypothetical scenario.
>
> …
>
> Where a sovereign entity invests in an Australian farm through an Australian company which carries on business here, the company is taxable on its profits.
>
> Where a sovereign entity invests directly (that is, not through an Australian company) in an Australian farm, carries on business in Australia and derives income, Australia's international tax rules can apply to tax that income".

That response also stated that:

> "The Australian Taxation Office has never identified a foreign sovereign entity, with Australian farm assets, purporting to export its produce for non-commercial purposes".

As a result, the tax treatment of foreign sovereign investment in Australian rural property is not expected to give rise to an additional distortion to Australian capital markets.

(b) Under ATO practice passive portfolio investments (ie, investments with less than 10 per cent ownership) of sovereign governments are exempt from interest and dividend withholding tax.

Generally, a 10 per cent interest withholding tax rate applies to interest payments to non-residents, although this rate is reduced or eliminated in some circumstances (such as for certain widely-held securities or as provided for under Australia's bilateral tax treaties).

[1] No.1. The Senate Rural and Regional Affairs and Transport Reference Committee, Inquiry into the Examination of the Foreign Investment Review Board National Interest Test, 16 August 2012

Similarly, while unfranked dividends are subject to a 30 per cent withholding tax rate, this rate is typically reduced (usually to 10 or 15 per cent) as a result of the application of tax treaties. On the other hand, where a fully franked dividend is paid to a non-resident no dividend withholding tax applies.