CHAPTER THREE

AUSTRALIAN COMMERCIAL ENVIRONMENT - TAXATION

Introduction

3.1 '...A borderless world is evolving as more firms operate globally and markets become increasingly contestable...[There is a] rapidly deepening interdependence of the world economy, sometimes known as globalisation...'.[1] 'These changes present tremendous challenges and opportunities for services exporters. Businesses must focus on competing in global markets and, governments must recognise that they too are facing global competition in terms of the policy framework they provide for business'.[2] Both industry and government need to work together in achieving these objectives.

3.2 Over the past decade Australia has moved down the path from being a protected, inward-looking economy to an open outward-looking economy. This has been achieved through major economic reform and structural adjustment. The reform agenda has embraced financial deregulation, tax reform, trade and investment liberalisation, the non-traded sector (transport, communications and government provided infrastructure and services) and the labour market.

3.3 'When Australia opted for an open economy, the nation committed itself to succeed in an endless race to become, and remain, globally competitive'.[3] This involves both creating a competitive environment, and based on this environment, building competitive businesses. Success is contingent on continual improvement and the integration of policy from a wide range of areas including macroeconomic policies, industrial relations, taxation, microeconomic reform, competition policy, education and trade policy.

3.4 Broad reforms in those areas have been outlined by DFAT and DIST.[4] Export market access issues are discussed in Chapters 2, 5 and 6. Aspects of the Australian commercial environment are discussed in this and the next chapter, covering major issues outlined in the terms of reference, and which the Committee and those providing evidence, considered important. Because the inquiry focused on service exports to Hong Kong and Indonesia considerable attention has been given to issues of concern to exporters to these markets.

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1 *Winning markets: Australia's future in the global economy: A statement by the Minister for Trade.* June 1995. Canberra, International Public Affairs Branch, Department of Foreign Affairs and Trade, p. 9.

2 Mercer, D. op.cit p. 4.

3 *Working Nation: Policies and programs.* op.cit. p. 52.

4 DFAT, Submission, pp. S215-S216; DIST, Submission, pp. S480-S481 & S497-S512.

Taxation

3.5 The tax issues associated with going overseas and exporting successfully are complex. Debate on this matter has progressed considerably since the *Intelligent Exports* report which emphasised that 'local service exporters cited taxation...as among the most negative aspects of their trading environment... [and that] ...the number one benefit received by their competitors offshore is favourable tax treatment...and the willingness of foreign governments to provide subsidies...'.[5]

3.6 The Treasury stressed that '...most people who attempt to quantify tax burdens on cross-border investment or income pick a set of assumptions when picking their case...[and] international comparisons of tax burdens usually ignore important non-tax factors...'.[6] The Treasury rejected most of the *Intelligent Exports* report's tax policy recommendations (on tax incentives, wholesale tax rebates, foreign losses, dividend imputation and compliance costs) aimed at encouraging positive export behaviour[7] and noted:

> Most of these proposals have, however, been considered in other contexts in recent years and a strong case for implementation of any of the tax proposals does not emerge. While the Report suggests that Federal and State governments need to 'fine tune the tax response', the thrust of the Government's tax policy over the past decade has been to broaden the tax base and lower the tax rates rather than attempting to 'fine tune' taxes to cater for special interest groups.[8]

3.7 DIST highlighted the results of a 1995 Economic Planning Advisory Commission (EPAC) study which examined the competitiveness of the real effective tax rates on cross-border and local business investment in the manufacturing sector for selected OECD and Asian countries. It suggested the results are also likely to be relevant to service firms.[9]

3.8 EPAC confirmed that while Australia is a low tax country overall by OECD standards, it places considerable emphasis on income and company tax. Compared with the six newly industrialised Asian economies, Australia is a high tax country. This is largely because Australia offers greater social support and better infrastructure than many other countries in the Asian region. However, the overall tax burden in most of these Asian countries is steadily increasing. Relative to selected Asian countries, Australia is also tax competitive when the overseas investment does not attract the special incentives which are on offer in many of these countries.[10]

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5 *Intelligent Exports*, op.cit. p. 82.
6 Treasury, Transcript 18 September 1995, pp. 892-893.
7 *Intelligent Exports*, op.cit. pp. 83-84.
8 Treasury, Submission, p. S602.
9 DIST, Submission, pp. S501-S502.
10 Economic Planning Advisory Commission, February 1995, *Business taxation in Australia and Asia* by Howard Pender and Steven Ross, Commission Paper No. 4, Canberra, AGPS, pp. vii & x.

3.9 Addressing the tax concession issue, the Treasury noted that:

> Investigations of the relative taxation levels amongst countries and the impact on corporate behaviour have suggested that a strategy of competing for investment by offering business tax concessions involves greater costs and risks for a country like Australia than it does for countries like Hong Kong and Singapore which have far lower revenue needs, have much smaller domestic markets, less locally-owned industry and fewer natural advantages...Ensuring that Australia maintains an internationally competitive tax regime, and remains competitive in non-tax factors as well, is likely to be a better course to follow.[11]

3.10 Several organisations and individuals including the Treasury, DIST, ACSI and Ms Heij, a Research Fellow with the Asia Research Centre Murdoch University,[12] stressed that factors other than tax are more important in locational decision-making by firms and in overseas investment.

3.11 A discussion of the tax issues raised during this inquiry follows. Similar matters were also raised in a recent report commissioned by the Western Australian Government on taxation impediments to exporting and investment into Australia, that is, quarantining,[13] fringe benefits tax (FBT), general complexity, tax treatment of entertainment costs, of tenders and feasibility studies, international transfer pricing, profit repatriation, sales tax and R&D.[14]

Cost of compliance

3.12 A taxation matter that was consistently raised with the Committee was the high compliance costs of Australia's tax regime.[15]

3.13 The Treasury reported that 'The Government has for some time been committed to minimising compliance costs associated with the tax system...'.[16] Treasury cited several examples of action in this area involving consultative, educational, research and legislative review programs. Specific programs included the Program of Continuous Improvement to Reduce Record Keeping Costs of Compliance for Small Business; A Guide to Keeping Your Business Records; the introduction of Taxation Impact Statements; the Tax Law Improvement Project; and the Review of FBT compliance costs.[17]

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11 Treasury, Submission, pp. S605 & S607.

12 Heij, Submission, p. S103; DIST, Submission, p. S502; Treasury, Submission, pp. S605-606; ACSI, Transcript, 3 October 1995, p. 945.

13 This is the process of quarantining expenditure incurred with a view to deriving foreign source income. Such expenditure can only be deducted against foreign source income and cannot be set off against Australian source income, hence the term 'quarantining'.

14 Deloitte Touche Tomatsu, *Taxation impediments*, November 1995. A report commissioned by the Western Australian Trade Advisory Council of the Western Australian Government.

15 See for example: Heij, Submission, p. S104; Treasury, Submission, pp. S604-605; DFAT, Transcript, 6 April 1995, p. 24; WA Dept of Commerce and Trade, Transcript, 12 July 1995, p. 508; Heij, Transcript, 12 July 1995, p. 532; NTEC, Transcript, 31 July 1995, p. 505; NT Dept of Asian Relations, Trade & Industry, Transcript, 31 July 1995, p. 639; and ACSI, Transcript, 3 October 1995, p. 945.

16 Treasury, Submission, p. S604.

17 ibid. p. S605.

3.14 In undertaking those tasks, the Australian Taxation Office (ATO) said it has a Commissioner's advisory panel on which business organisations are represented and in addition representations from private individuals are taken if individuals wish to make them.[18] Although Treasury mentioned one survey in this area being commissioned of small business, more systematic sampling of businesses, especially small businesses, generally is not undertaken.

3.15 The General Manager of the Hong Kong Jockey Club Systems (Australia) noted that it seems to be a little bit more difficult to do business in Australia now than it was 10 to 12 years ago particularly because of changes in the tax regime, such as the FBT. He requested that start-up organisations be exempted from some of the tax rules and regulations for a period of time until they get up to speed. The suggestion was not for a tax holiday, just a temporary exemption in the start-up phase so business is operating in a simpler environment.[19] The difficulties of implementing such a suggestion should not be underestimated and the Committee does not support it.

3.16 The Committee recommends that:

5. the Australian Taxation Office, in its work on compliance costs reduction, undertake a more comprehensive ongoing sampling of the views of individual businesses to ensure its actions are based on an accurate and realistic understanding of business problems and requirements.

Comprehensive tax reform

3.17 ACSI, Clough Ltd and Australian Owned Companies Association Limited (AOCA)[20] all presented strong arguments for comprehensive tax reform. The view was most forcibly put by Don Mercer, President of ACSI, who stated:

> Comprehensive taxation reform is a matter of priority for the services sector. We are now in the bizarre position where thinkers on both sides of politics agree we need to reform the tax system, and to introduce some form of broad-based consumption tax. Yet, both sides publicly believe the electorate will not support one.[21]

3.18 In October 1996, a National Tax Reform Summit was held at which a wide ranging debate on tax reform occurred. While there was still considerable division in opinion on the most effective reforms required, there was agreement that action was needed.[22] Australia's taxation system was also criticised in a report *Leader or Also Ran?: Australia's Competitive Position in the Asia Pacific Region*,[23] released in November 1996. The report warned that Australia had lost ground as a financial services centre and that unless a more

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18 ATO, Transcript, 18 September 1995, p. 899.
19 Cope, Transcript, 7 August 1995, pp. 781-782 & 786-789.
20 Clough Ltd, Transcript, 12 July 1995, p. 439; AOCA, Submission, p. S658; and Mercer, D, op.cit. p. 6.
21 Mercer, D, op.cit. p. 6.
22 ACCI Media Release, 5 October 1995, 'Analysis Shows ACCI and ACOSS have common goals'.
23 Allen Consulting Group & Arthur Anderson, *Leader or Also Ran?: Australia's Competitive Position in the Asia Pacific Region*, November 1996.

competitive tax environment was created and regulatory impediments removed, Australia's position would continue to deteriorate. The report is being examined by government.

Wholesale sales tax

3.19 The Commonwealth Government imposes a wholesale sales tax (WST) which generally applies to the last wholesale sale of goods that have not previously been used in Australia. The inputs to the service industries are generally taxed under the WST in lieu of a tax on the output of services. The Treasury advised that 'To the extent that WST on outputs is greater than WST on inputs, the services sector as a whole, is more **favourably** treated than the goods producing sector'.[24]

3.20 Treasury also advised that while there is no WST charged directly on exported goods, and goods producers are able to access a range of business input exemptions so as to avoid double taxation, there is also some flow on of sales tax to exported goods and services. It stated this is because:

- some of the inputs of goods producers do not qualify for exemption, for example legal and accounting services;
- there are only limited exemptions for business inputs applying beyond the goods production stage of distribution; and
- the service sector has limited access to business input exemptions with the consequences that exported services may bear input taxation (this WST burden would be the same as that faced if the services were provided domestically) and 'tax cascading' will occur where services which have borne input taxation are used by goods producers and service providers.[25]

3.21 DIST pointed out that '...the effect of cascading on business costs in Australia ranges between 4 per cent to over 9 per cent depending on the particular Commonwealth and State taxes selected'.[26]

3.22 Treasury went on to say that 'Notwithstanding the above, the present WST structure appears to favour exporters at the expense of the remainder of the economy. [It]...estimates that while WST constituted some 1.2 per cent of export costs, it constitutes some 3.7 per cent of the costs of other final demand aggregates of the economy'.[27]

3.23 COSBOA noted that 'Tax generally is trying harder to meet the needs of small business than it used to'.[28] However, COSBOA raised concerns that 'The sales tax is off the exporting but the local and overseas activities work hand in hand'.[29] It believed the rate and timing of sales tax payments are still a burden domestically for small business.

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24 Treasury, Submission, p. S602.
25 ibid. p. S603.
26 DIST, Submission, p. S640.
27 Treasury, Submission, p. S603.
28 COSBOA, Transcript, 6 April 1995, p. 76.
29 ibid. p. 78.

3.24 The Australian College of English and the ELICOS Association Ltd were concerned that at the moment public ELICOS centres which are operating on a commercial basis, in exactly the same way as private centres, are exempt from sales tax.[30] It is noteworthy that some business input exemptions, for example those aircraft and buses purchased by airlines and bus operators, ensure competitive neutrality between the private sector and services traditionally run by government.

Foreign losses

3.25 CMPS&F Pty Limited (CMPS&F) suggested 'Where the offshore subsidiary is effectively 100% owned by the Australian parent the losses should be able to be incorporated with the Australian earnings for the first five years of operation'.[31] A more general policy along these lines was recommended in the *Intelligent Exports* report.[32]

3.26 Treasury advised that:

> At present, foreign losses may be offset only against foreign assessable income...The *Taxation Laws Amendment (Foreign Income) Bill 1990* amended the relevant provisions so that foreign losses in respect of a class of income could be used to offset **any** foreign income of the same class derived in a subsequent year of income.[33]

3.27 Treasury argued that allowing foreign losses to be offset in the same way as a business can offset any initial losses incurred in a new domestic venture against existing profits in calculating their tax liability, would increase the incentive to expand overseas by reducing the financing costs required to support a period of foreign losses.[34] Treasury noted, however, that:

> ...allowing foreign losses to be offset against domestic income would allow some resident taxpayers to pay less than the Australian rate of tax on domestic source income...[It] would also encourage the artificial structuring of offshore businesses to concentrate tax deductible losses in some entities and low-tax profits in other entities. The proposal would also create opportunities for the trafficking of losses to third parties and other forms of tax avoidance...[It is for these reasons that]...no other developed country allows foreign losses to be offset against domestic income unless the related foreign losses are taxed on an accruing basis.[35]

Conclusion

3.28 The Committee notes the Treasury's conclusion that 'no substantive reasons have been put forward' to suggest that the current policy on the treatment of foreign income is

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30 Australian College of English, Submission, p. S51; ELICOS Association Ltd, Submission, p. S164.
31 CMPS&F Pty Ltd, Submission, p. S689.
32 *Intelligent Exports*, op.cit. pp. 117-118.
33 Treasury, Submission, p. S603.
34 ibid.
35 ibid, p. S604.

inappropriate.[36] The question of tax losses incurred overseas is a matter to which the ATO needs to direct further work. With the lack of available data on service exports and an inadequate understanding of the service exports sector, it may be difficult for the ATO to issue definitive Determinations in this area.

Imputation credits for taxes paid in another country

3.29 CMPS&F suggested that:

> The alterations that the ATO could consider is simply to adjust the tax regime to ensure that the Australian shareholder that invests in Australian companies that earn revenue offshore pay only the same amount of tax on dividend income as those earned in Australia. This means the tax paid offshore should also receive a 'franking rebate' equal to the tax rate paid.[37]

3.30 Treasury noted that the Government has also received a number of submissions and representations from taxpayers on this matter.[38] Treasury and the ATO advised:

> Australia, and most other OECD countries that operate imputation systems, do not provide imputation credits for taxes paid in another country...[this] was a deliberate design feature of Australia's imputation system. Australia provides a credit (either explicitly or via exemption) for foreign taxes paid when dividends are repatriated to the Australian corporate level. Providing imputation credits for foreign taxes paid would therefore involve providing imputation credits for corporate tax that was never received by Australia. This would involve a significant cost to revenue if done unilaterally and could have significant potential for avoidance and tax induced distortions if done bilaterally. While taxpayers may be indifferent to the payment of foreign or Australian taxes, the Government (representing the nation as a whole) prefers taxes to be paid in Australia.[39]

36 ibid.
37 CMPS&F, Submission, p. S689.
38 Treasury, Submission, p. S604.
39 Treasury/ATO, Submission, p. S727.

Transfer pricing

3.31 It was reported in the press that the Tax Commissioner has described transfer pricing as the tax issue of the decade.[40] According to the ATO:

> [its] approach to the issue of transfer pricing is in accordance with the internationally recognised "arm's length principle". This principle is applied in determining for taxation purposes the prices at which goods and services are transferred between related parties or within enterprises that may have branch operations in one or a number of countries. The principle is aimed at ensuring that revenue authorities receive their fair share of tax revenue on the profits derived by an enterprise in their taxing jurisdiction. It does this by ensuring that goods and services are not transferred at prices which would allow profits to be shifted to a lower tax jurisdiction purely to gain a tax benefit.[41]

The transfer pricing rules generally apply only to transactions or dealings between related parties (associated companies or members of a multinational group) or between branches of the one company in different countries.

3.32 CMPS&F noted that:

> If a company is just beginning to export and is using an associated offshore entity to do so, developing an arms length price is not as easy as it sounds. ... It would be easier if the tax legislation accepted that 'arms length' is going to be different not only for all companies but for all jobs.
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> Because many companies change their pricing structure depending on the nature of the potential client ... a level of leniency needs to be included in order to enable companies to export services competitively.
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> Companies should not be penalised for attempting to trade competitively and enhance exports, especially because tax avoidance is not a prime reason for adjusting bids.[42]

3.33 In response Treasury/ATO advised:

> Arm's length prices for dealings may vary, depending on an array of factors...the principles to be followed in setting prices have been set out in rulings/draft rulings on international transfer pricing... These...recognise that 'arms length' prices will vary according to the

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40 Tabakoff, Nick, 'Tax crackdown on companies', *The Australian Financial Review*, 10 January 1996.
41 ATO, Submission, p. S914.
42 CMPS&F Ltd, Submission, p. S690.

> circumstances of the case but this does not mean that the prices set between related parties should be accepted without question.[43]

3.34 They went on to note:

> Australia is helping at the OECD to ensure that profit shifting and other mechanisms are not used as a means of gaining competitive advantage in international markets...the risk of adjustments being made to transfer prices and penalties being imposed will depend on the efforts made by companies to establish and document the arm's length nature of their prices.
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> Australia is prepared to accept well documented/supportable market penetration strategies where they are consistent with open market behaviour. If the parties enter into the same export deals with unrelated parties in similar circumstances, there could be a case for recognising the 'competitive' prices at which they are dealing.[44]

3.35 In the latter part of 1995 the ATO introduced new transfer pricing rules which some consider placed Australia among the world's strictest regimes.[45]

Provisional tax

3.36 COSBOA raised concerns about provisional tax for small business, particularly the timing of payments. The Chief Executive Officer of COSBOA said 'I do not think Treasury is quite across this...I do not know that provisional tax is as sensitively treated in terms of export activity as sales tax is. Maybe it is something to look at'.[46]

3.37 In response Treasury stated that:

> Exported goods are specifically exempt from sales tax. It would not be possible to provide provisional tax with the same export treatment because of the difficulty in determining what component of provisional tax can be attributed to export activity and what can be attributed to domestic activity. In any case, it would be undesirable to exempt exporters from provisional tax.[47]

3.38 In mid-1996 the government reduced the provisional tax uplift factor to 6 per cent so that small business was no longer assessed for provisional tax on income in excess of what it has earned.[48]

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43 Treasury/ATO, Submission, p. S732.
44 ibid. p. S733.
45 Tabakoff, Nick, op.cit. p. 9.
46 COSBOA, Transcript, 6 April 1995, pp. 78-79.
47 Treasury, Submission, p. S717.
48 Hon Peter Costello, MP, Treasurer, *Budget Speech 1996-97*, 20 August 1996, p. 4.

Controlled Foreign Corporations

3.39 CMPS&F suggested that:

> The problem with the CFC [Controlled Foreign Corporations] legislation is its complexity. Many tests need to be applied and documentation retained, to ascertain that the CFC legislation does not apply. Perhaps the tests could be reversed or simplified to enable corporations to determine if CFC legislation is going to affect them. This also applies to the FIF [Foreign Investment Fund] legislation.[49]

Price Waterhouse Chartered Accountants (Price Waterhouse) noted with CFC legislation '...there are some terrible inequities that can force people to find it just too hard to do international business'.[50]

3.40 Treasury/ATO stated that:

> ...CFC and FIF rules are detailed because they need to cover a wide range of business activities and the flow of income and profits through complex business structures until their eventual return to Australia...[and] include detailed technical rules to provide for the widest possible range of business activities that can be conducted by an entity on a worldwide basis and...ensure that genuine business activities are excluded from the system.[51]

They also noted other countries have similar rules, Australia's compliance costs compare favourably, features have been included to reduce the compliance costs, and there was extensive consultation prior to their introduction, '...to ensure that the correct balance was achieved between competing objectives of minimising compliance costs and safeguarding the revenue'.[52]

Selective tax concessions

3.41 A number of specific tax concessions were also sought by business. These are discussed below. The detailed responses from Treasury/ATO are provided in the inquiry submissions volumes.[53]

3.42 Price Waterhouse, CMPS&F and a number of other businesses sought greater tax deductibility on entertainment expenses, since doing business in Asia necessitates entertaining on a far greater scale than in Australia. CMPS&F suggested 100 per cent tax deductibility on expenses incurred offshore and Price Waterhouse sought recognition of the principle, simplification of the system and noted that there are limits on the amount that can be claimed.[54]

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49 CMPS&F Pty Ltd, Submission, p. S690.
50 Price Waterhouse, Transcript, 7 August 1995, p. 845.
51 Treasury/ATO, Submission, p. S732.
52 ibid.
53 ibid. pp. S727-S733.
54 Price Waterhouse Chartered Accountants, Transcript, 7 August 1995, pp. 845-846; Austbreed Pty Ltd, Submission, pp. S124-125; CMPS&F, Submission, p. S689.

3.43 Advice from the Treasury/ATO was that:

> Entertainment expenses incurred offshore are, and should be, deductible in the same way as if incurred onshore. It would be inappropriate to provide a higher level of deductibility for offshore entertainment expenses. Combined with the restricted deductibility allowed for onshore entertainment expenses, this could lead to entertainment expenditures occurring offshore simply to take advantage of more favourable tax deductibility.[55]

3.44 On the issue of limits to claims Treasury/ATO stated:

> There is no limit under the *Income Tax Assessment Act 1936* on the deductibility of overseas travel and accommodation costs provided that such costs can be substantiated. Different substantiation requirements apply, however, if travel and accommodation costs are within certain limits.[56]

3.45 Austbreed Pty Ltd was concerned that current Taxation rulings related to overseas travel appear very stringent; some expenditure incurred in developing a business may not be tax deductible; concerns about deductibility when using accommodation other than public accommodation; and noted that obtaining both informal and formal advice on the deductibility of 'extraordinary expenditure' related to such arrangements from the ATO is difficult.[57]

3.46 Treasury/ATO were unclear what 'extraordinary expenses' cover. On information about overseas travel they noted:

> ...the ATO has issued two Income Tax Rulings to the public in relation to the deductibility of such expenses - IT2115 and TR95/24. These rulings deal specifically with the overseas travel costs of a magistrate and of teachers. While not directly relevant to the export of services by business the principles in this area of the law are well established and covered by tax reporting services such as Commercial Clearing Houses (CCH) of Australia and Butterworths...[58]

3.47 They said advice on overseas travel expenses is available from the ATO's 26 branch offices and more formal advice can be sought in the form of Private Binding Ruling requests. A new ATO information sheet dealing with the tax consequences of exporting goods and services has been available on the Internet since early 1996.

3.48 On the issue of non-deductibility of some expenditure incurred in developing overseas business, Treasury/ATO advised:

> This would only be the case where a totally new business operation was being set up overseas. In these circumstances overseas travel and

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55 Treasury/ATO, Submission, p. S727.
56 ibid. p. S728.
57 Austbreed, Submission, pp. S124-S125.
58 Treasury/ATO, Submission, p. S727.

> accommodation expenses may be seen as part of the capital cost of establishing that new business. Expenses will, however, be deductible where they are incurred for the purpose of expanding an existing business.[59]

3.49 CMPS&F suggested that the government might consider a 100 per cent rebate of costs involved in travel and accommodation associated with International Chambers of Commerce and Business Councils which provide opportunities for networking. CMPS&F argued:

> A successful exporter gains less from such meetings than the new exporter and the new exporter is likely to be facing difficult economic circumstances whilst establishing their international business. By lowering the economic cost of attending both parties are more likely to participate in these important networking meetings.[60]

3.50 The response from Treasury/ATO was:

> Travel expenses are deductible to the extent they are incurred in earning assessable income. Should travel to meetings of Chambers of Commerce or Business Councils qualify in that regard, it will be deductible. Rebates are provided in the tax system only in very limited circumstances. It would be inappropriate to provide a rebate for this type of expenditure when other similar expenditures are deductible.[61]

3.51 CMPS&F also suggested that it is often unavoidable that relatively small amounts of 'stewardship' are incurred in doing business overseas. The tax legislation should enable Australian companies to claim expenses incurred in managing their offshore operations, given that the money will effectively return to Australia in the long run.[62] Treasury/ATO stated that 'Expenses in managing offshore operations are deductible, where the expense of managing the same operation onshore would also be deductible'.[63]

3.52 CMPS&F stated that 'The tax exposure of living away from home allowances can be quite complex', and suggest 'specifying dollar values for guidelines per country... particularly for food and accommodation'.[64]

3.53 Treasury/ATO noted under the FBT '...the taxable value of a living away from home allowance (LAFHA) fringe benefit is reduced by any exempt accommodation component and any exempt food component'.[65] They suggested specifying such an amount would be difficult because amounts employees spend on accommodation vary widely according to personal circumstances, costs of determination for all cities and countries; 'varying attitudes of acceptance of amounts by employers, and such an amount would

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59 ibid. p. S728.
60 CMPS&F, Submission, p. S255.
61 Treasury/ATO, Submission, p. S728.
62 CMPS&F, Submission, p. S690
63 Treasury/ATO, Submission, p. S728.
64 CMPS&F, Submission, p. S691.
65 Treasury/ATO, Submission, p. S728.

probably not reflect the value of the component for most employers. Each year the Commissioner of Taxation issues a Tax Determination setting out the reasonable food components to assist employers in calculating the part of the LAFHA that is subject to FBT. As the amounts in the Tax Determination represent a high level of expenditure, employers generally accept these amounts. 'It is also up to an employer to claim a higher amount where that employer can substantiate that a higher amount was expended'.[66]

3.54 CMPS&F suggested professionals who wish to move from their field into export development should be supported by government initiatives. It suggested 'a possible approach [could be] that post graduate qualifications in International Business...be free of fees, or...the cost of training in [that] area receive a 100 per cent tax credit, rather than a deduction'.[67] These types of incentives are also supported by Sly and Weigall (now Deacons Graham and James as of late 1995).[68]

3.55 According to ATO and the Treasury:

> Self education expenses, such as fees for postgraduate courses, may be deductible under the general deduction provisions in subsection 51(1) of the *Income Tax Assessment Act 1936*. For subsection 51(1) to be relevant, there must be sufficient connection between the incurring of the expenses and the production of the taxpayer's assessable income. However, providing a new tax concession in this area would be contrary to the objective of maintaining a broad tax base. Rather than providing a range of tax concessions, the Government provides a substantial level of outlays assistance for the higher education sector.[69]

3.56 The Northern Territory Government pointed out that language skills are fundamental to export promotion. At present the costs of language courses are tax deductable if they relate to the employee's or the company's existing work area, but are not tax deductable if associated with opening up a new field of activity. It appears that the ATO would classify as a capital expense (non-deductable) expenditures connected with language courses taken for the promotion of new export markets overseas. It suggested this anomaly needs to be corrected.[70]

3.57 Treasury/ATO pointed out 'Costs of language courses are not necessarily of a capital nature. Like other areas of professional development, language study can be deductible...A general tax principle is that for any expenditure to be deductible, it must be incurred in the process of gaining assessable income. There is no justification for altering this principle for one class of expenditure...'.[71]

3.58 Minproc Engineering suggested four changes to Section 23AF of the 1936 Tax Act. The suggested changes were:

- amend to make 23AF more relevant and provide competitive advantage;

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66 ibid. p. S729.
67 CMPS&F, Submission, p. S256.
68 Sly & Weigall, Transcript, 7 August 1995, pp. 823-824.
69 Treasury/ATO, Submission, p. S731.
70 NT Government, Submission, p. S573.
71 Treasury/ATO, Submission, p. S731.

- project hopping - ability for staff to move between approved projects;
- change from 91 continuous days to 91 aggregate days during the year;
- include feasibility studies where funded by an overseas contract signatory;
- extension of 23AF beyond zero tax environments in foreign countries.[72]

3.59 Treasury/ATO advised:

> It is not necessary to make changes to section 23AF since:
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> - 'Project hopping' may, in certain circumstances, qualify for an exemption provided the intent of the 91 days continuous foreign service test is met. The administration of section 23AF, in particular the granting of approved project status, is now the responsibility of the Department of Foreign Affairs and Trade;
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> - 1991 amendments to legislation have reduced the length of continuous foreign service necessary to obtain a full exemption of tax, under sections 23AF and 23AG, from 365 to 91 days. Prior to this amendment a proportional exemption was available for continuous service between 91 and 364 days. Any further reduction or a move to abolish the continuity of that service under section 23AF could lead to tax avoidance opportunities...It would undoubtedly lead to calls for a similar treatment to be afforded to section 23AG...There would, of course, be a cost to revenue if either section were to be amended in this way.
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> - Certain feasibility studies are covered by the definition of an eligible project under section 23AF and therefore can be considered for approved project status.
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> - It is not necessary to extend section 23AF beyond zero tax environments as section 23AG operates in a similar manner to exempt from Australian tax foreign earnings (earned in non-zero tax environments) of an Australian resident. Furthermore, it may be that an exemption under section 23AG is easier to obtain as the Australian resident company does not have to obtain approved project status.[73]

3.60 The Australian Owned Companies Association (AOCA) recommended 'That changes should be made to the Income Tax Act as it relates to foreign income earned directly, or through subsidiaries, so that incentives are given and all disincentives are removed'.[74]

3.61 In response the Treasury/ATO pointed out:

> Prior to 1987, 23(q) of the *Income Tax Assessment Act 1936* provided an exemption from tax for foreign source income provided that the income had borne some level of foreign tax. In some circumstances,

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72 Minproc, Submission, p. S681.
73 Treasury/ATO, Submission, pp. S731-S732.
74 AOCA, Submission, p. S658.

> this provided an incentive for Australians to invest offshore. However, it also provided an incentive for Australians to avoid Australian tax by deriving passive income...in low tax jurisdictions. The current Australian system for taxing foreign source income seeks to remove the incentive for Australians to derive passive income in low tax jurisdictions. At the same time the system is not intended to interfere with genuine offshore business activities of Australians.[75]

3.62 Austbreed Pty Ltd was concerned that '...income derived from the personal exertion of a registered professional person (such as a veterinarian, medical practitioner etc) cannot be distributed to a non-registered person. [It interpreted] ...this as restricting the shareholding of a company/partnership practising a profession to Australian registered individuals, limiting the participation of overseas qualified individuals and that of others who also contribute substantially'.[76] Treasury/ATO accepted the interpretation by Austbreed and elaborated on the reasons.[77]

3.63 The Australian Mutual Provident Society (AMP) stated that it can only establish a branch in Hong Kong rather than a subsidiary due to Hong Kong regulations regarding foreign life insurance companies entering the market in Hong Kong. The branch situation has adverse consequences for the AMP's tax position in Australia:

> The Australian tax rules circumscribe too narrowly the income that is taxed only in Hong Kong. Therefore some of the income from Hong Kong which, on a business basis, should only be taxed in Hong Kong, is being subject to higher tax in Australia.[78]

The ATO advised it has issued a Tax Determination 96/29 dealing with the calculation of exempt income under section 112C (1) of the *Income Tax Assessment Act 1936*. The Determination relates to what an actuary should take into account in certifying that assets of a life insurance company's permanent establishments in foreign countries are not excessive in relation to liabilities referable to policies issued in the course of carrying on those permanent establishments.[79]

R&D tax concession

3.64 In 1992-93 service industries accounted for $9,027m in expenditure on research and development, which compares favourably with $22,811m expended by all industries (ie, nearly 40 per cent). In looking at the type of research and development undertaken by service firms 'research on computer software represents over half of all service sector R&D' (for 1992-93).[80]

3.65 Complaints from service exporters on the R&D tax concession related to ineligibility to claim for: process improvements (unless the new or improved process is sold

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75 Treasury/ATO, Submission, p. S730.
76 Austbreed Pty Ltd, Submission, p. S124.
77 Treasury/ATO, Submission, pp. S729-S730.
78 AMP, Submission, p. S144.
79 ATO, Submission, p. S920.
80 DIST, Submission, pp. S492-493.

or leased); for market research; and for R&D performed at overseas locations where exporters client focussed R&D is done.[81]

3.66 In August 1995 the former Government announced a major crackdown on the scheme because of problems with claimants not using it for new R&D and its use as an artificial tax device. Further changes were highlighted in the *Innovate Australia* statement including improved registration procedures, limits to register for past R&D expenditures, amendments to the Income Tax Assessment Act and Industry Research and Development Act to provide clearer definitions of R&D thereby reducing uncertainty as to what is eligible R&D.[82]

3.67 In July 1996 the Government ended the practice of syndication in which several parties, not all undertaking the actual R&D, shared the benefits of the concession. In the August 1996 Budget, further changes to R&D tax concessions were announced. The Treasurer, the Hon Peter Costello, MP, advised that:

> ...the R&D tax concession will be reduced to a top rate of 125%. [At that rate]..., the R&D tax concession remains among the most concessional in the OECD and compares more than favourably with concessions provided by our regional neighbours, including Singapore and Malaysia.[83]

3.68 The Government also announced the introduction of a new program, the Strategic Assistance for Research and Development Program, under which $340m will be provided over the next four years '...to encourage highly innovative research and development with emphasis on projects that have support for commercialisation from the private sector'.[84]

3.69 The impact of these changes to R&D tax concessions on the service sector is unclear, as is its impact on Australian companies generally. A survey by Deloitte Touche Tomatsu indicated that 34 per cent of companies who had claimed the tax concessions over the past five years were considering moving R&D operations offshore as a result of the decrease in the concession to 125 per cent. Of the companies surveyed, 21 per cent indicated they would continue R&D activities but would not claim the concession.[85]

Regional headquarters and tax

3.70 ACSI pointed out that where tax is critical for Australia is in attracting corporate treasuries - true regional headquarters (RHQs) - to Australia.

> ...the tax issue is the withholding tax on the management of the flow of funds between subsidiary companies outside the host country. So they are caught here in the domestic tax net, whereas in other

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81 Open Access, Submission, p. S264; DIST, Submission, p. S495.

82 Joint Media Release. the Minister for Industry, Science and Technology, Senator the Hon Peter Cook and the Treasurer, Hon Ralph Willis, MP, *Re-focusing the 150 per cent R&D tax concession*, 6 December 1995.

83 Hon Peter Costello, MP, *Budget Speech 1996-97*, 20 August 1996, p. 8.

84 ibid.

85 Field, N, 'Budget blow pushing R&D offshore: survey', *The Australian Financial Review*, 18 October 1996, p. 3; Saunders, D, 'Cut in R&D tax breaks will hurt, warn Companies', *The Age*, 2 September 1996, p. 4.

> competitive regimes they are not caught; they are regarded as strictly offshore. They just flow through those administrative corporate treasury functions...[they] are very substantial in terms of influence because they make decisions about investment flows. There is a multiplier effect there that is hard to quantify but which, the suggestion is, is very important, very significant.[86]

3.71 Exemptions from tax which have been introduced to encourage the establishment of RHQs in Australia include: exemption from dividend withholding tax for certain foreign source dividends passed through a resident company to a non-resident shareholder; RHQs able to claim certain business expenses as a direct consequence from relocating from overseas as allowable deductions for taxation purposes; and provision of wholesale sales tax exemption for used computer and computer related equipment already owned by the company and imported for the purpose of setting up the RHQ.[87]

3.72 The RHQs concept however has become a generic term[88] and in the case of companies such as Cathay Pacific and American Express, which are running data centres in Australia, rather than corporate treasuries, reported that taxation concessions were important but not the critical factor in their decision to locate in Australia. A consultant for Cathay Pacific noted that it did not consider the above tax advantages as being a concession, but rather a means of bringing the Australian situation up to the status quo of its former location in Hong Kong. Other factors such as a good government and regulatory environment, a good telecommunications environment and vendor support were important.[89] A similar view was expressed by American Express which stressed that for them the critical issue was not the tax concessions but the fact that Australia had a multilingual labour pool available at an acceptable cost.[90]

Double Taxation Agreement - Indonesia

3.73 The Indonesia tax system operates in quite a different environment than that in Australia. Ms Heij explained that the Indonesian tax system is largely a product of the Harvard Law School; it aims to be a simple system and not provide incentives; it lacks clarity; there are no proper objection and appeal processes; tax administrators are poorly qualified; and a lot of time may be spent hassling with tax officials. Dealing with this system requires a broad approach.[91]

3.74 Australia has a Double Taxation Agreement (DTA) with Indonesia which came into law in December 1992 and was applicable from 1 July 1993.

3.75 Major criticisms of the DTA are that the agreement with Australia (15 per cent withholding tax) is not as favourable as the agreements Indonesia has with other countries, such as the Netherlands, UK and Singapore (10 per cent); there are time consuming approval processes which have to be observed if Australian companies are to take advantage of the exemptions from domestic Indonesian taxes guaranteed under the bilateral taxation

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86 ACSI, Transcript, 3 October 1995, pp. 944-945.
87 DIST, Submission, p. S502.
88 ACSI, Transcript, 3 October 1995, p. 944.
89 Harbutt, Transcript, 14 September 1995, pp. 875-876.
90 American Express, Transcript, 14 September 1995, p. 884.
91 Heij, Transcript, 12 July 1995, pp. 532-540.

agreement; and the wording of the agreement might be simpler.[92] ATO said it had made representations that the process should be made simpler for Australian businessmen.[93]

3.76 In commenting on the agreement ATO noted that '...tax treaties are negotiated bargains...In the end both sides have to make some compromises...We could obviously revisit the Indonesian double tax agreement but that would possibly come at a cost that is unacceptable to the Australian revenue at this point in time'.[94] Similar sentiments were expressed earlier by Ms Heij.[95] The difficulties of the situation are appreciated.

3.77 The Committee recommends that:

6. the Australian Taxation Office and Treasury keep the Double Taxation Agreement with Indonesia under active review and at the earliest appropriate time the Government renegotiate a more favourable tax treaty.

92 Telstra, Transcript, 20 April 1995, p. 162; Glennon, Transcript, 12 July 1995, p. 469; AMP, Submission, p. S145; Telstra, Submission, p. S183; and CMPS&F, Submission, p. S690.
93 ATO, Transcript, 18 September 1995, p. 895.
94 ibid. p. 894.
95 Heij, Transcript, 12 July 1995, p. 536.

Training in international tax law

3.78 Ms Heij noted that 'Another problem is the scant expertise of many Australian accountants in international tax matters...This makes companies often dependent on tax advice obtained in Indonesia which is significantly more expensive than in Australia, or they obtain no advice or inadequate advice in Australia'.[96]

Conclusion

3.79 The issues involved with taxation in the export of services are complex. The structure and technicalities of the international taxation system are serious problems for service industries. There are difficulties in knowing what is defined as a service for tax purposes, what is a related expenditure, and generally understanding differing tax laws and their impact on business and trade. Indeed the complexity of the Australian taxation regime is seen by many as the major issue for service exporters.

3.80 From the evidence received, the recurrent theme is not that the levels of tax are too high or the measurement unfair, but the poor definition of the rights of exporters. This could result from the lack of clarity in legislation between nations. Ms Heij raised a relevant point, with respect to Indonesia in particular, that Australian accountants have an inadequate knowledge of the complexities of the international system of taxation. The Committee believes that an understanding of all tax issues involved in the export of services is important in any analysis of the net service trade contribution to the Australian economy.

96 Heij, Submission, p. S104.