Parliament of the Commonwealth of Australia

House of Representatives
Standing Committee on Finance and Public Administration

FOLLOW THE YELLOW BRICK ROAD

The Final Report On
An Efficiency Audit Of The
Australian Taxation Office:
International Profit Shifting

March 1991

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Foreword

This is the Committee's third report in relation to international profit shifting. In this report, the Committee has focused on tax avoidance arising from the use of the withholding tax provisions of the *Income Tax Assessment Act* 1936.

The Committee also has considered the operation of the *Cash Transaction Reports Act* 1988. This is the first opportunity which the Parliament has had to review aspects of the recently introduced cash transactions reporting system.

During the inquiry, it became evident that the low priority accorded to the withholding tax area by the Australian Taxation Office has contributed to the problems of tax avoidance highlighted to the Committee. In response, the Committee has made a number of substantial recommendations aimed at strengthening the legislative and administrative framework for combating tax avoidance in this area.

In this report, the Committee also has addressed some of the broader issues relating to the equity of the taxation system which were identified during the inquiry.

With the tabling of its third report on this subject area, the Committee is in a position to conclude that, for some, the road of international profit shifting truly is paved with gold. Adoption of the Committee's recommendations in this report will ensure that those who choose to travel that road at least will have to pay the appropriate toll.

STEPHEN MARTIN, MP
CHAIRMAN

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Members of the Committee in the 36th Parliament

Chairman:	Mr S P Martin, MP
Deputy Chairman:	Hon I B C Wilson, MP
Members:	Mr J N Andrew, MP Mr J H Beale, MP (to 10.10.90) Mr R A Braithwaite, MP Dr R I Charlesworth, MP Mr B W Courtice, MP Mr A J Downer, MP (from 10.10.90) Mr S C Dubois, MP Mr R F Edwards, MP Mr R P Elliott, MP Mr G Gear, MP Mr R S Hall, MP
Secretary:	Mr D R Elder

Members of the Subcommittee in the 36th Parliament

The Subcommittee appointed to undertake the inquiry comprised:

Chairman:	Mr S P Martin, MP
Members:	Mr G Gear, MP Hon I B C Wilson, MP
Subcommittee Secretary:	Mr A A Lomp
Adviser:	Mr L J Hill
Inquiry Staff:	Ms L J Gillies

Terms of reference of the Committee

The Standing Committee on Finance and Public Administration is empowered to inquire into and report on any matters referred to it by either the House or a Minister including any pre-legislation proposal, bill, motion, petition, vote or expenditure, other financial matter, report or paper.

Terms of reference of the Subcommittee

On 26 November 1987, the House of Representatives referred to the House of Representatives Standing Committee on Finance and Public Administration the Auditor-General's efficiency audit report *Australian Taxation Office: International Profit Shifting* for review. In the 36th Parliament, the inquiry was re-referred to the Committee on 6 June 1990 by the Acting Treasurer, the Hon J S Dawkins, MP.

The Committee appointed a subcommittee to conduct the inquiry. Matters to be addressed by the subcommittee included:

- tax avoidance that may arise from the use of the withholding tax provisions of the *Income Tax Assessment Act* 1936 as they relate to tax on dividend and interest earnings within Australia of non-residents;
- the role of the banks in facilitating the movement of funds to counties which are recognised tax havens; and
- the operation of the *Cash Transaction Reports Act* 1988 in relation to international profit shifting.

ABBREVIATIONS

ASCPA	Australian Society of Certified Practising Accountants
ATO	Australian Taxation Office
Committee	House of Representatives Standing Committee on Finance and Public Administration
CTRA	Cash Transaction Reports Agency
CTR Act	*Cash Transaction Reports Act* 1988
FOI Act	*Freedom of Information Act* 1982
ITAA	*Income Tax Assessment Act* 1936
TIA	The Taxation Institute of Australia
Treasury	Department of the Treasury

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Withholding tax arrangements

The evidence on the revenue loss through withholding tax arrangements was inconclusive. The Committee accepts that the more blatant examples of tax evasion, involving packaged schemes as utilised in the 1970s and early 1980s, are not evident in recent times. The efforts of the Australian Taxation Office (ATO) in combating sham arrangements have played an important part in this regard. However, there is sufficient evidence, particularly from field officers of the ATO, to indicate that there continues to be a problem with more sophisticated arrangements which may have all the hallmarks of legitimacy but which ultimately result in a loss to the Australian revenue. (paragraphs 2.48 - 2.49)

It is the view of the Committee that the scope of the revenue loss should not become a major pre-occupation. The problem is significant enough to warrant attention and, accordingly, the Committee has focused in this report on how best to deal with the problem. (paragraph 2.50)

Anti-avoidance measures

The Committee is aware that many of the more sophisticated arrangements established for tax avoidance purposes are structured to appear as legitimate family or commercial dealings, which the general anti-avoidance measures are not intended to cover. The ATO's advice to the Committee that Part IVA of the *Income Tax Assessment Act* 1936 (ITAA) has been utilised in only a few cases to attack the more sophisticated arrangements indicates that there may be limits to the operation of the legislation in this area. (paragraph 2.62)

The Committee considers that specific measures aimed at countering the withholding tax arrangements identified during the inquiry are both warranted and necessary in order to reinforce existing anti-avoidance measures available to the ATO. (paragraph 2.64)

Withholding tax rate

One consequence of the 10 percent withholding tax rate on interest earned by non-residents is that it has provided some Australian residents with the potential to establish arrangements which are aimed at reducing and even evading their income tax obligations. The continued prevalence of some sophisticated

arrangements, as acknowledged by the ATO, indicated to the Committee that there are those in the community who feel that the incentive of a lower tax rate is significant enough and the chances of detection minimal enough to be worth the effort and risk of establishing such arrangements. (paragraph 2.78)

The Committee deliberated on proposals to increase the rate of interest withholding tax and to have differential rates for countries with which Australia has entered into comprehensive double taxation agreements and countries with which Australia has not entered into such agreements. The Committee, however, was unable to evaluate in detail the full economic implications of these proposals. In particular, from the evidence it received, the Committee was unable to assess fully the impact which such a move would have on Australia's ability to attract foreign investment. (paragraphs 2.80 - 2.86)

As there are a number of broader economic implications attaching to the issue of withholding tax rates beyond the tax avoidance matters which were the focus of this inquiry, the Committee considers that a detailed review of the withholding tax system and whether it continues to serve the interests of the Australian economy is overdue. The Committee notes that the Industry Commission currently is conducting an inquiry into the availability of capital. In an issues paper produced for that inquiry, a number of the broader issues relevant to the withholding tax system are raised. As many of those issues are relevant to concerns identified during this Committee's inquiry, it is the view of the Committee that the Industry Commission inquiry should encompass a comprehensive assessment of the withholding tax system. (paragraphs 2.87 - 2.90)

Recommendation 1

The Committee recommends that the Industry Commission, as part of its inquiry into the availability of capital, conduct a comprehensive review of Australia's withholding tax system to determine the extent to which the system in its existing form serves the interests of the Australian economy. Attention should be directed to:

- **the appropriateness or otherwise of retaining the existing rate of interest withholding tax;**
- **the appropriateness or otherwise of having a common rate of interest withholding tax applying to interest income earned in Australia by non-residents living in countries with which Australia has entered into comprehensive double taxation agreements and non-residents living in countries with which Australia has not entered into such agreements;**

- the equity of tax sharing arrangements between Australia and other countries, particularly whether, in light of Australia being a resource exporting country with high levels of foreign debt, it is appropriate that the country of residence of the recipient of interest and dividend income earned in Australia should retain the primary right of taxation on that income, or whether that right should be retained by the country of source of the income;

- the extent to which there is equity of taxation treatment between resident and non-resident individual investors, and between Australian owned and foreign owned enterprises; and

- the adequacy of the thin capitalisation rules in ensuring that Australian business entities are not disadvantaged as a result of debt gearing by foreign entities operating in Australia. (paragraph 2.94)

Pending the outcome of the Industry Commission's inquiry, the Committee considers that, to alleviate the evidentiary burden for the ATO in the withholding tax area, the Commissioner of Taxation should be provided with a discretionary power to impose the top marginal rate of tax instead of the interest withholding tax rate in situations where the Commissioner has reason to believe that the interest income derived by a non-resident from an Australian source relates to an arrangement established by an Australian resident for tax avoidance purposes. The enactment of such a power would provide an appropriate deterrent to withholding tax arrangements without interfering with legitimate business activity. (paragraph 2.91)

Recommendation 2

Pending consideration of the matters for review proposed at recommendation 1, the Committee recommends that the Commissioner of Taxation be provided with a discretionary power to impose the top marginal rate of tax on interest income earned by non-residents, instead of the interest withholding tax rate, in cases where the Commissioner has reason to believe that the interest income derived by a non-resident from an Australian source relates to an arrangement established by an Australian resident for tax avoidance purposes. The increased rate should apply until the non-resident who derives the interest income is able to verify that the interest payment is not related to a tax avoidance arrangement. (paragraph 2.95)

Taxation of discretionary trusts

The use of discretionary trusts for tax avoidance purposes is a negative consequence of the differing approaches which have been adopted towards the taxation of trusts and corporations. While specific measures to counter this avoidance have been suggested to the Committee as an immediate solution, the Committee is of the view that piecemeal measures will not address the broader issues relating to equity of treatment for these different entities. (paragraph 2.108)

Recommendation 3

The Committee recommends that there should be a move towards a system of taxing trusts and corporations in a uniform manner, with tax payable on the trust's net income at the company rate of tax and credit given proportionally to beneficiaries for income tax paid. (paragraph 2.118)

The Committee, of course, recognises that there are a number of broad economic and social implications which need to be examined in any move to alter the existing approach to taxing of trusts. As consideration of these broader issues may delay implementation of the recommendation to tax trusts and corporations in a uniform manner, the Committee sees a need in the interim for specific measures to curtail the use of discretionary trusts in avoidance arrangements involving the withholding tax provisions. (paragraph 2.110)

In this regard, the Committee supports the removal of the tax advantages which can accrue in arrangements which rely on the streaming of interest income to non-residents. Removal of such advantages would strike at the very reason for establishment of these arrangements, ie a lower rate of tax. (paragraph 2.111)

Recommendation 4

Pending the implementation of recommendation 3, the Committee recommends that interest streamed through a trust to non-resident beneficiaries living in countries with which Australia has not entered into comprehensive double taxation agreements should be taxed at the ordinary non-resident rates of tax rather than the withholding tax rate. (paragraph 2.119)

Recommendation 5

Pending the implementation of recommendation 3, the Committee recommends that interest paid by an Australian entity as part of an arrangement to convert trading income to an interest stream which ultimately flows through a trust to non-resident beneficiaries should not be tax deductible. (paragraph 2.120)

The Committee recognises that this legislative amendment may lead to entities arranging their affairs to ensure that the interest income is routed through a treaty country, while still ending up in a non-treaty country. To counter this possibility, the Committee considers that anti-'treaty shopping' provisions should be included in any taxation treaty negotiated by Australia. (paragraph 2.114)

Recommendation 6

The Committee recommends that anti-'treaty shopping' provisions be included in any double taxation agreement entered into by Australia, with existing arrangements to be renegotiated to include inter alia such provisions. (paragraph 2.121)

Payments by borrowers

The Committee concurs with the ATO's view that interest withholding tax should be calculated on the gross interest paid by a resident borrower to an overseas lender. The ATO should ensure that withholding tax payers are aware of this requirement. It also should actively enforce this requirement. (paragraph 2.125)

Recommendation 7

The Committee recommends that the Australian Taxation Office ensure that withholding tax is collected on the gross interest paid to a non-resident. (paragraph 2.126)

Withholding tax administration

The low priority accorded to the withholding tax area by the ATO was evident from the absence of administrative controls which are now being implemented by the ATO. In the view of the Committee, the lack of administrative controls in this area has been an important factor contributing to the continued abuse of the withholding tax provisions through non-resident beneficiary and other tax avoidance/evasion arrangements. (paragraph 3.19)

Non-resident verification

The integrity of the new tax file number system could be jeopardised if more stringent requirements are not placed on those who claim non-resident status to prove that they are actually non-residents. While the provisions of the new *Cash Transaction Reports Act* 1988 (CTR Act) would apply to proof of identity, they would not ensure that the person opening a bank account was a non-resident, and therefore eligible to obtain the lower withholding tax rate applying to interest income earned in Australia. (paragraph 3.25)

Recommendation 8

The Committee recommends that the tax file number system be modified to incorporate non-resident verification procedures, which should require persons/entities depositing funds in Australian financial institutions to provide proof that they are non-residents before they are eligible to have tax deducted at the interest withholding tax rate of 10 percent on interest earned. Where adequate proof is not provided, tax should be withheld at the top marginal rate. (paragraph 3.28)

The non-resident verification system recommended by the Committee also should be used to establish whether a non-resident is acting as a trustee for Australian residents investing in Australian financial institutions. It was apparent to the Committee that the ATO did not have a strategy for examining non-resident investments to determine, to the extent practicable, whether a given investment is in effect beneficially owned by a resident. Such a strategy should be developed. (paragraph 3.27)

Recommendation 9

The Committee recommends that the Australian Taxation Office, through the non-resident verification procedures proposed at recommendation 8, seek to identify whether a non-resident investing funds in Australia is acting in the capacity of trustee for an Australian resident. (paragraph 3.29)

Statistical analysis

In a self assessment environment, it is vital that sufficient meaningful information is available to ATO auditors to facilitate selection of cases for audit, and for identification of those areas of revenue collection where there is greatest risk of evasion and avoidance. In the withholding tax area, the payment of interest income to non-residents is a primary characteristic of the tax avoidance arrangements which have been described to the Committee, including non-resident beneficiary schemes and back to back loan arrangements. Accordingly, interest expenses incurred by individuals and entities should be seen as an important initial source of information for ATO auditors in tracing participants in withholding tax arrangements. (paragraphs 3.35 - 3.36)

Recommendation 10

The Committee recommends that details of interest payments claimed by taxpayers should be itemised in tax returns lodged with the Australian Taxation Office. (paragraph 3.39)

Exchanges of information

The ability to gather information overseas is crucial to any international enforcement program. If there is a perception that there is little chance of tax avoidance arrangements being detected, or of the facts and circumstances surrounding those arrangements coming to light, then this will influence the number of individuals or entities prepared to enter into such arrangements. (paragraph 3.46)

To assist the ATO in overcoming barriers to obtaining information overseas, it is the view of the Committee that the establishment of double taxation agreements should be actively pursued with countries which have comparable tax regimes to Australia. Increasing the network of treaties will make it more difficult for tax evaders to escape the information sharing net. (paragraph 3.50)

Recommendation 11

The Committee recommends that the establishment of comprehensive taxation agreements be pursued actively with countries which have comparable tax regimes to Australia. (paragraph 3.53)

To further facilitate information sharing with treaty countries, the Committee considers that ATO officers should be posted to selected treaty countries to coordinate and, with the approval of the overseas tax authority, collect data on behalf of ATO officers in Australia. Such a move would signal that the ATO is serious in its efforts to chase down information from overseas jurisdictions in order to prevent tax avoidance arrangements. (paragraph 3.52)

Recommendation 12

The Committee recommends that officers of the Australian Taxation Office be posted overseas to facilitate exchanges of information with overseas taxation administrations. (paragraph 3.54)

Prosecution strategy

Prosecution action is an important weapon in the ATO's efforts to combat tax avoidance arrangements. Successful prosecutions provide an effective deterrent to those who would contemplate entering into such arrangements. (paragraph 3.60)

Recommendation 13

The Committee recommends that, where possible, the Australian Taxation Office should pursue prosecution action vigorously against both the promoters of and participants in tax avoidance arrangements. (paragraph 3.63)

The true deterrence value of prosecutions and other enforcement actions of the ATO will be realised only if there is adequate publicity given to such actions. By appropriately publicising its enforcement activities, the ATO can send a clear signal to promoters of and participants in tax avoidance arrangements that the ATO is determined to prevent such arrangements and will penalise those who are involved. (paragraph 3.62)

Recommendation 14

The Committee recommends that the Australian Taxation Office publicise widely any prosecution or other enforcement activities initiated against promoters of and participants in tax avoidance arrangements. (paragraph 3.64)

Overseas charities

The Committee did not receive any substantial evidence that tax avoidance schemes involving trust distributions to overseas charities are being perpetrated in Australia on a significant scale. Nevertheless, it is evident that within the ATO there are some concerns about the potential for tax avoidance in the area of trust distributions to overseas charities. (paragraphs 4.13 -4.14)

It is the view of the Committee that a specific anti-avoidance provision similar to section 78A of the ITAA should be introduced to counter the potential for tax avoidance which exists in relation to distributions of trust income to non-resident charities. The introduction of this measure would signal to those who consider that such tax avoidance arrangements are still effective the clear intention of the Parliament to eradicate the potential for tax avoidance hidden within the guise of donations to overseas charities. (paragraph 4.16)

Recommendation 15

The Committee recommends that the *Income Tax Assessment Act* 1936 be amended to introduce a specific anti-avoidance measure, similar in effect to section 78A of that Act, whereby income tax exemption for trust income distributed to overseas charities would be denied in cases where such distributions form part of a reimbursement arrangement. In such cases, the income should be included as part of the trustee's assessable income. (paragraph 4.17)

Statistics on charities

It was evident to the Committee that in relation to charities, limited information is available on the degree to which the Australian revenue subsidises domestic charities, through tax deductibility for donations, and overseas charities, through exemption from income tax. In the view of the Committee, the

absence of meaningful statistics in this area impacts on the ability of the ATO to assess the extent to which the revenue is at risk from tax avoidance arrangements which may involve distributions to charities. It also limits the ability of policy makers to assess the appropriateness of existing mechanisms for supporting charities within the taxation system. (paragraph 4.22)

Recommendation 16

The Committee recommends that, in order to assess the impact on the Australian revenue of existing tax benefits available for donations to charitable organisations, the Australian Taxation Office collect statistics on:

- **donations for which tax deductibility is claimed under section 78 of the *Income Tax Assessment Act* 1936; and**
- **distributions of trust income to charitable organisations.** (paragraph 4.24)

Recommendation 17

Consequent upon Recommendation 16, the Committee recommends that donations made to organisations listed under section 78 of the *Income Tax Assessment Act* 1936 be itemised in income tax returns lodged with the Australian Taxation Office. (paragraph 4.25)

Detection of international profit shifting

The Committee considers that the ATO has an important role in keeping the Cash Transaction Reports Agency (CTRA) informed of the intelligence which is required by and is useful to the ATO in its pursuit of international profit shifting. The ATO should play an active role in suggesting ways in which there could be improvements to the intelligence gathering processes. (paragraph 5.17)

Recommendation 18

The Committee recommends that, to supplement the Guidelines on Areas of Suspect Activity issued to financial institutions and other cash dealers, the Cash Transaction Reports Agency, in conjunction with the Australian Taxation Office, develop indicators which would assist financial institutions and other cash dealers to identify information which could be reported to the Cash Transaction Reports Agency and subsequently used by the Australian Taxation Office in its investigation of tax avoidance arrangements involving withholding tax. (paragraph 5.19)

Telegraphic transfers

It is evident that telegraphic or wire transfers are the predominant means by which funds are channelled from Australia overseas. The cash transactions reporting system which has been established, though, does not monitor such transfers. The Committee considers this to be a notable deficiency, as it precludes the ATO from an important source of intelligence in its efforts to combat international profit shifting. (paragraph 5.27)

Recommendation 19

The Committee recommends that a system for monitoring and reporting telegraphic/wire transfers of funds be implemented, with the Cash Transaction Reports Agency responsible for the establishment and administration of such a system. (paragraph 5.30)

Non-resident bank accounts

The Committee is concerned that despite all the identification requirements and prohibitions of the CTR Act, there may still be the opportunity for Australian residents to gain a tax advantage by holding funds in accounts which are opened in the names of non-residents. It is the view of the Committee that where a non-resident opens an account which is used exclusively or predominantly by a resident for the benefit of the resident, then this should be regarded as the equivalent to operating a false name account. If this is not reflected in the existing law then an amendment may need to be introduced. (paragraphs 5.32 - 5.34)

Recommendation 20

The Committee recommends that the Cash Transaction Reports Agency ensure that the prohibition on operation of false name accounts in the *Cash Transaction Reports Act* 1988 is broad enough to prevent the practice of Australian residents gaining the benefit of the 10 percent interest withholding tax rate by operating out of non-resident bank accounts. (paragraph 5.36)

Financial institutions and other cash dealers should be advised by the CTRA to be wary of residents operating out of non-resident bank accounts and to report as suspect transactions cases where non-resident bank accounts are operated exclusively or predominantly by Australian residents for their own benefit. This practice could be included as an indicator of suspect activity in the Guidelines on Areas of Suspect Activity issued by the CTRA to financial institutions. (paragraph 5.35)

Recommendation 21

The Committee recommends that the practice of non-resident bank accounts being operated exclusively or predominantly by Australian residents for their own benefit be included as an indicator of suspect activity in the Guidelines on Areas of Suspect Activity issued to financial institutions and other cash dealers by the Cash Transaction Reports Agency. (paragraph 5.37)

CHAPTER ONE

SCOPE AND CONDUCT OF THE INQUIRY

Scope of the inquiry

1.1 On 26 November 1987, the House of Representatives referred to the House of Representatives Standing Committee on Finance and Public Administration (the Committee) the Auditor-General's efficiency audit report *Australian Taxation Office: International Profit Shifting* for review.

1.2 During the 35th Parliament, the Committee tabled two reports on the inquiry. These were *Shifting the Tax Burden?* (November 1988) and *Tax Payers or Tax Players?* (May 1989).

1.3 In the 36th Parliament, the inquiry was re-referred to the Committee on 6 June 1990 by the Acting Treasurer, the Hon J S Dawkins, MP.

1.4 The Committee appointed a subcommittee to conduct the inquiry. Matters to be addressed by the subcommittee included:

- tax avoidance that may arise from the use of the withholding tax provisions of the *Income Tax Assessment Act* 1936 (ITAA) as they relate to tax on dividend and interest earnings within Australia of non-residents;
- the role of the banks in facilitating the movement of funds to countries which are recognised tax havens; and
- the operation of the *Cash Transaction Reports Act* 1988 (CTR Act) in relation to international profit shifting.

Conduct of the inquiry

1.5 The inquiry was advertised in Australia's national daily newspapers. In addition, the subcommittee wrote to individuals and organisations which may have had an interest in the inquiry inviting submissions.

1.6 The subcommittee received 19 submissions. It also received a large volume of documents as exhibits to the inquiry. Lists of the submissions authorised for publication and the exhibits received by the subcommittee are included at Appendix 1 and Appendix 2 respectively.

1.7 Evidence was taken at five public hearings held in Melbourne, Sydney and Canberra in August, October and December 1990. A list of witnesses who appeared at the public hearings is included at Appendix 3.

1.8 The subcommittee also conducted inspections of the Cash Transaction Reports Agency (CTRA) in Sydney and the Withholding Tax Units of the Australian Taxation Office (ATO) in Sydney and Melbourne.

1.9 The transcripts of the public hearings and other evidence authorised for publication have been incorporated in separate volumes and are available for inspection in the Committee secretariat and the Parliamentary Library. References to evidence in the text of this report relate to page numbers in these volumes.

1.10 The evidence received by the subcommittee was directed primarily to those aspects of the inquiry concerning the withholding tax provisions of the ITAA and the operation of the CTR Act. This report focuses on these issues.

1.11 The Committee has decided that the examination of the role of the banks in facilitating movement of funds to countries which are recognised tax havens will be undertaken as part of its broader inquiry into the Australian banking industry. The terms of reference for the Australian banking industry inquiry were announced on 25 October 1990.

CHAPTER TWO

WITHHOLDING TAX

The withholding tax system

2.1 Liability for Australian income tax arises under the *Income Tax Assessment Act* 1936 (ITAA), which contains provisions for determining taxable income. Tax is payable on that income at rates declared by the Parliament.

2.2 The ITAA draws a basic distinction between people (including companies) who are residents of Australia and people who are not residents of Australia. In relation to interest and dividends received from Australia, non-residents generally pay tax under the withholding tax system.

2.3 The withholding tax system provides that a flat rate of tax is deducted at source from non-resident dividend and interest income by the person or institution making the payment. This tax is not subject to assessment as it is a final tax. The system is based on the principle that the country of residence of the recipient of the interest or dividends has the primary taxing rights on that income.

2.4 Since 30 June 1987, dividends paid by resident companies are exempt from withholding tax if they are franked under the imputation system applying from that date. For unfranked dividends, the declared rate of withholding tax is 30 percent of the gross amount. However, Australia has entered into comprehensive double taxation agreements with a number of countries which provide for a lower rate of tax in respect of dividends derived by residents of those countries. With the exception of the Philippines, each agreement generally limits the rate of withholding tax on unfranked dividends to 15 percent.

2.5 Interest paid to overseas lenders by Australian residents, or paid by non-residents who use funds borrowed from overseas in an Australian business, is subject to interest withholding tax if the interest is an outgoing of an Australian business. The declared rate of withholding tax on interest is 10 percent of the gross amount.

Allegations of tax avoidance

2.6 One of the primary considerations for the Committee was the tax avoidance that may arise from the use of the withholding tax provisions of the ITAA as they relate to tax on dividend and interest earnings within Australia of non-residents.

2.7 While the Auditor-General's efficiency audit report was the original catalyst for the international profit shifting inquiry, references to withholding tax in that report relate to administrative arrangements for collection of the tax and to the development of a national withholding tax audit program.[1] These matters are considered at Chapter 3 of this report.

2.8 On the issue of tax avoidance, the Committee's interest in investigating the withholding tax area was triggered by allegations made by Melbourne academic, Ms Barbara Smith. Ms Smith claimed that arrangements or schemes are operating in Australia which allow Australian residents to avoid their taxation obligations by paying 10 percent interest withholding tax instead of personal or company rates of income tax.[2]

2.9 In particular, Ms Smith expressed concern that discretionary trusts are one of the main vehicles for withholding tax schemes. She commented:

> ... it would be naive in the extreme to assume that many trusts and other taxpayers have not set up schemes involving the payment of 10% interest withholding tax.[3]

2.10 Ms Smith stressed that some of the schemes are extremely complex and difficult to detect. She noted that the schemes often involve circuitous routes through various countries, including tax havens, and can often appear as legitimate transactions. Ms Smith argued that while some of these arrangements may be deemed to be within the letter of the existing law, they nevertheless should be regarded as tax avoidance in that less tax is paid than would otherwise be the case.[4]

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1 The Auditor-General, Efficiency Audit Report, *Australian Taxation Office: International Profit Shifting*, November 1987, AGPS Canberra, p.19

2 Evidence p.S64

3 *Evidence p.S62*

4 Evidence p.S275

Evasion, avoidance or minimisation?

2.11 Fundamental to the Committee's deliberations was an understanding of the difference between tax evasion, tax avoidance and tax minimisation.

2.12 It was accepted that tax evasion refers to the non-payment of taxes which are properly payable by a taxpayer in accordance with taxation laws. Tax evasion is a violation of taxation laws and gives rise to penalties, including criminal penalties, and tax liability.

2.13 Tax minimisation and tax avoidance, on the other hand, were considered to be within the framework of the existing law. It was put to the Committee that, in the strict literal meaning, tax minimisation and tax avoidance are one and the same thing. The difference, it was claimed, depends on the context in which the terms are used.[5]

2.14 Tax minimisation is associated generally with the concept of tax planning, where a person is able to organise his or her affairs so that he or she pays less than the maximum amount of tax. As stated by Lord Tomlin in the often quoted case *Inland Revenue Commissioner v Duke of Westminster* 1935 All ER Rep 259:

> Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then however inappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

2.15 In contrast, tax avoidance is associated generally with blatant, artificial and contrived means of minimising tax liabilities. One witness summarised the distinction in the following terms:

> When people use the word 'avoidance' what they really mean is minimising your tax liabilities in a way that is morally unfair or morally not correct. When they use 'minimisation' it is usually a reference to something which one ought to be entitled to do legitimately.[6]

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5 Evidence p.870

6 Evidence p.895

2.16 Through anti-avoidance legislation, tax minimisation arrangements or schemes which are considered to be contrived or morally unfair in effect become tax evasion. In this regard, the Committee already has indicated that it is the duty of policy makers to determine where the line should be drawn between what is acceptable tax minimisation and illegal tax evasion. In its earlier report *Tax Payers or Tax Players?*, the Committee stated:

> There is a need to restore the balance with regard to taxation. It is not between the corporate sector and the individual but rather between those who are able to organise their affairs to be tax effective and those who cannot or choose not to so organise their affairs.[7]

2.17 In this report, the Committee has focused primarily on tax avoidance and minimisation in the withholding tax area to ensure that the existing withholding tax system does not provide some residents who are able to organise their affairs and minimise their overall tax liability with an unfair advantage.

Withholding tax arrangements

2.18 One of the principal withholding tax arrangements described to the Committee involved the use of discretionary trusts to direct interest income to non-residents.[8]

2.19 Under existing legislation, discretionary trusts can be used to direct different types of income to specific beneficiaries. This means that interest income earned by a discretionary trust can be directed specifically to non-resident beneficiaries, thereby attracting only 10 percent withholding tax. While this is accepted as a legitimate practice, it does provide the opportunity for tax avoidance/minimisation.

2.20 Under the alleged arrangement, a resident trust distributes interest income to a non-resident beneficiary, who then lends the funds back to the trust. Withholding tax of 10 percent is levied on the interest so distributed and on any interest which is paid subsequently on the income distribution lent back to the trust. The interest on the loan funds is claimed as a full tax deduction by the resident trust. The net effect of the arrangement is that a low rate of tax is charged on the income, the resident trust retains control of the funds, and a tax deduction is created for the resident trust. Such arrangements often involve a device to convert trading income to

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7 House of Representatives Standing Committee on Finance and Public Administration, *Tax Payers or Tax Players?*, May 1989, AGPS Canberra, p.78

8 Evidence p.S64

an interest stream and are referred to as non-resident beneficiary arrangements. Illustrations of one form of such an arrangement are provided at Figure 1 and Figure 2.

2.21 It was claimed that in such arrangements the funds are often looped through countries with which Australia has taxation treaties and then through tax havens. It was alleged that often the funds do not leave Australia, but are merely journal entries in the books of account.[9]

2.22 The other principal arrangement described to the Committee is known as a back to back loan arrangement.[10] A characteristic of such an arrangement is that a resident invests funds in an overseas financial institution, generally located in a low tax jurisdiction. The financial institution subsequently makes a loan to the resident of an amount equivalent to the funds invested. The loan is for use in an income generating venture. The funds invested by the resident are used as security for the loan. As the funds are located in a low tax jurisdiction, interest on the invested funds accrues tax free or is subject to only low tax. Interest on the loan is paid to the overseas financial institution, less 10 percent withholding tax. The resident offsets the loan interest against other income. The net effect of the arrangement is that the resident gains a financial benefit by creating a tax deduction for interest paid on the loan, while gaining a reimbursement of the interest paid through the accrual of interest earned on the invested funds. The same general principle of back to back loans can be used in a variety of sophisticated arrangements. An illustration of a simple form of such an arrangement is provided at Figure 3.

2.23 Two further arrangements were described to the Committee. They involve:

- Australian residents placing some of their funds in bank accounts in the name of non-residents, in order to take advantage of the lower 10 percent withholding tax payable on the interest earned on those funds; and

- the conversion by non-resident taxpayers of unfranked dividend income, subject to either 15 percent or 30 percent dividend withholding tax, to non-resident interest income, subject to only 10 percent interest withholding tax.[11]

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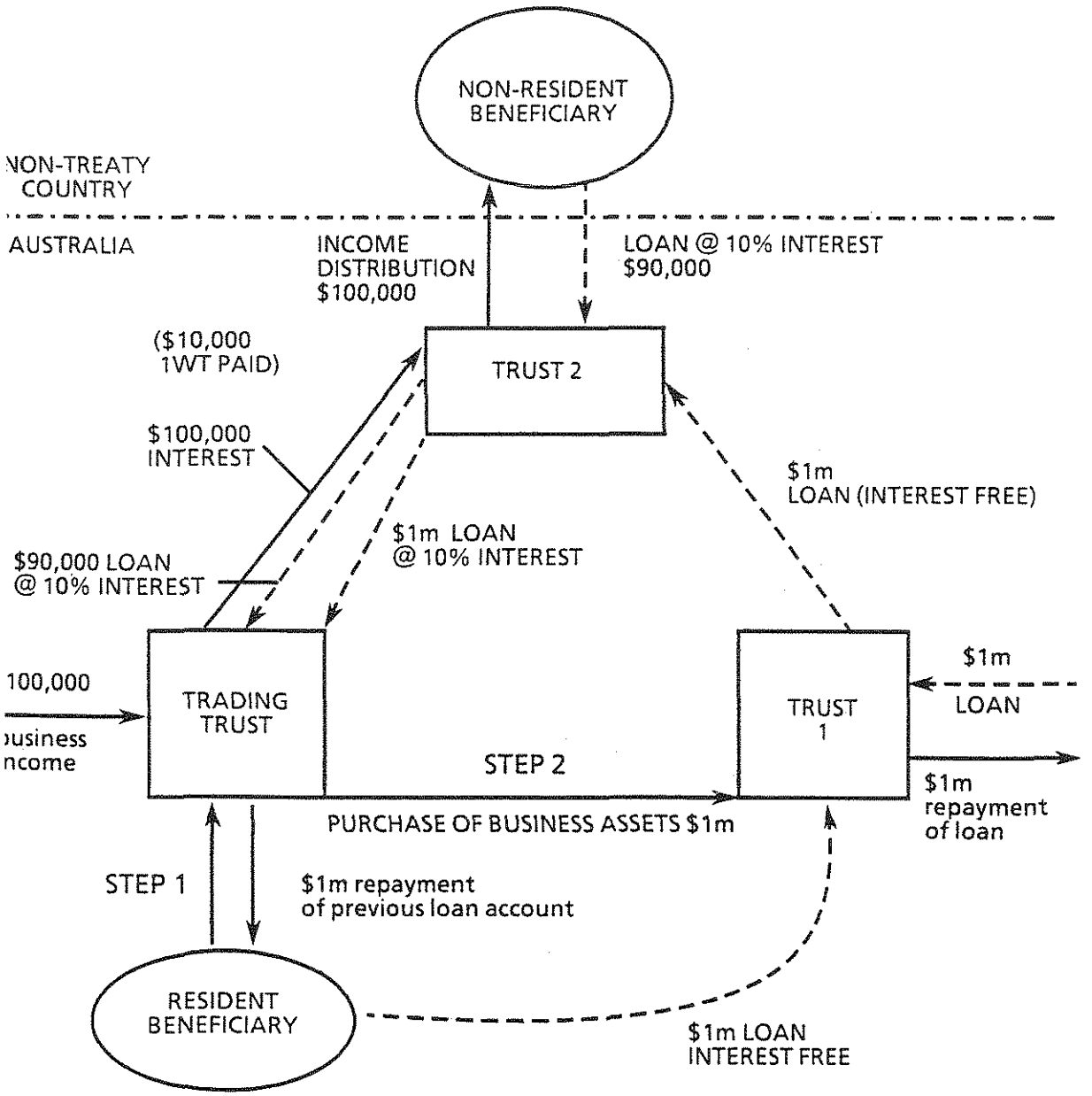
9 Evidence p.S64

10 Evidence p.S64

11 Evidence p.S56

FIGURE 1

NON-RESIDENT BENEFICIARY ARRANGEMENT



NOTE: FUNDS ARE RETURNED TO TRUST 1 either by implementing STEP 1 or STEP 2

FIGURE 1

NON-RESIDENT BENEFICIARY ARRANGEMENT

EXPLANATION

A $1 million dollar loan is obtained. This loan is made interest free to Trust 2. An associated relative of the trust controller is a beneficiary of the trust. The relative is living in a non-treaty country.

A loan is made to the Trading Trust, which is operating a family business and deriving business income.

The funds are returned to Trust 1 by one of two methods:

Step 1 — The resident beneficiary previously had loaned back trust distributions to the trading trust, or originally had transferred business assets to the trust. The resident beneficiary receives a repayment of those loans. The arrangement is structured to minimise stamp duty.

Step 2 — Purchase of business assets. The assets are valued or the arrangement is structured to be free from capital gains tax.

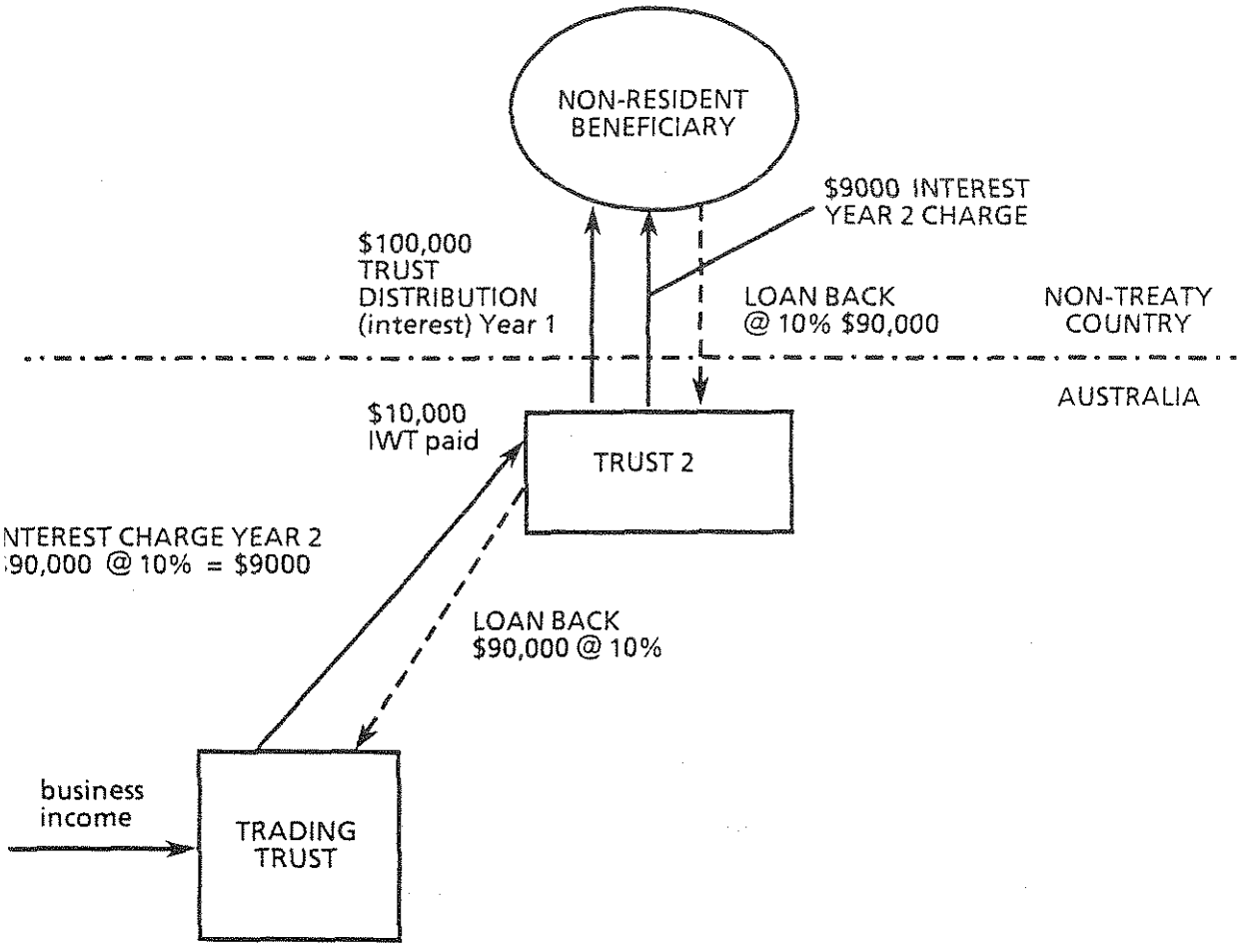
A $100,000 deduction has been created which has been offset against the trading trust's income of $100,000. The $100,000 of interest which is distributed to the non-resident beneficiary is subject to 10 percent interest withholding tax.

If the scheme had not been entered into a potential income tax liability of $48,000, ie $100,000 x .48*, may have been incurred. (*N.B. Medicare and provisional tax have been excluded from this example)

In the next financial year, interest can be charged to Trust 2 on the $90,000 loan received from the non-resident beneficiary. Ultimately the interest can be on-charged to the trading trust.

FIGURE 2

LOAN BACK OF FUNDS by the NON-RESIDENT BENEFICIARY



EXPLANATION

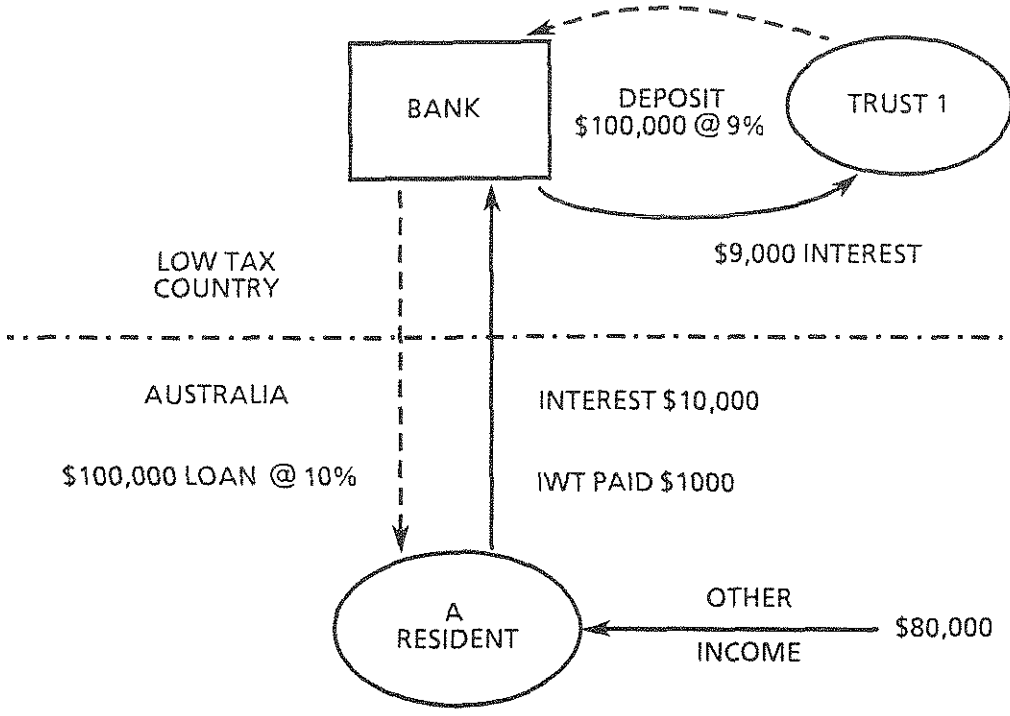
10% IWT on $100,000 = $10,000
Remaining $90,000 loaned back

The income distribution and loan back of funds may be made by actual fund movement or journal entry. The loan back of $90,000 increases the non-resident beneficiary's loan account enabling further interest charges to be made against TRUST 2 income. These charges can flow through and be offset against future business income of the TRADING TRUST.

After every annual income distribution this cycle can be repeated further increasing the non-resident beneficiary's loan balance on which interest can be charged.

FIGURE 3

BACK TO BACK LOAN ARRANGEMENT



NOTE: A is beneficially entitled to income from TRUST 1

EXPLANATION

A's Taxation Position

Paid out (interest)	$10,000	Interest beneficially received	$9,000
Less tax saving	4,925	Less net expense	5,075
(assuming 48% rate plus 1.25% medicare)		Net financial saving	3,925
Net expense	5,075		

TAX PAYABLE

WITHOUT ARRANGEMENT		WITH ARRANGEMENT	
TAX on $80,000	$30,557	Tax on $70,000	$25,757
plus Medicare levy	1,000	plus Medicare levy	875
net tax payable	31,557	net tax payable	26,632

TAX SAVING —	$4,925
Less IWT paid	1,000
Net tax saving	3,925

NOTE: Any provisional tax liability is excluded

2.24 In her submission, Ms Smith asserted that withholding tax schemes have resulted in massive revenue loss over the last decade, possibly amounting to many millions of dollars. She suggested that revenue foregone in 1988-89 alone amounted up to $943 million. Ms Smith arrived at the $943 million figure by calculating the difference between the withholding tax paid and the income tax which would have been paid if the interest had been taxed at the notional rate of 29 percent (ie the lowest marginal rate of tax usually applicable to non-residents).[12]

2.25 The estimates provided in Ms Smith's submission are based on the proposition that a threefold increase in collections of interest withholding in six years can be linked to the prohibition of the so-called 'bottom of the harbour' schemes in 1982, the removal of the tax free threshold also in 1982, and the deregulation of the banks in the early 1980s. Ms Smith argued that when the 'bottom of the harbour' schemes were outlawed, the tax avoidance industry simply moved into the withholding tax area. This, it was suggested, can account for the rapid increase in withholding tax collections since that time.[13]

2.26 To support her proposition, Ms Smith referred to an internal memorandum of the ATO dated 26 October 1988 from the Manager Complex Audit in Melbourne to the Commissioner of Taxation which was obtained under the provisions of the *Freedom of Information Act* 1982 (FOI Act). In that memorandum, it is estimated that the level of tax avoidance involving trust distributions to non-resident beneficiaries could be up to $1.8 billion annually, based on 1987 revenue collections.[14]

Tax Office response

2.27 In response to Ms Smith's claims, the ATO advised that it has been aware of schemes of the kind described by Ms Smith for some time. It noted that two income tax rulings have been issued dealing with non-resident beneficiaries of trusts. These are Taxation Ruling Numbers IT 2344 and IT 2466 issued on 7 August 1986 and 18 February 1988 respectively. The effect of these rulings was to warn taxpayers that income which was purported to be distributed to foreign beneficiaries but in fact remained under the control of an Australian resident would be assessed at penalty rates.[15]

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12 Evidence p.S58

13 Evidence pp.S58-S59

14 Evidence p.S59 and Exhibit 6 p.3

15 Evidence p.S18

2.28 The ATO also indicated that a range of legislative measures have been introduced since 1982 which would have had an impact on this area. These have included:

- removal of the tax threshold for non-residents in 1982;
- amendments in 1986 to remove the Australian entity test exemption which had the effect of increasing the withholding tax base;
- introduction of the thin capitalisation rules with effect from 1 July 1987, which deny deductibility of interest payments by companies, trusts and partnerships where certain debt to equity ratios are exceeded;
- introduction of the debt creation rules with effect from 1 July 1987, which deny deductibility of interest payments in certain capital restructuring arrangements;
- introduction of the controlled foreign companies legislation from 1 July 1990, which will bring to book income which had not been remitted but which had been accruing offshore in non-taxable forms; and
- proposed introduction of the passive investment fund rules, which will supplement the controlled foreign companies measures.[16]

2.29 In addition, the ATO noted that for many years there has been a standing instruction to deal with sham arrangements of the type depicted.[17] This has resulted in the examination of over 2400 trusts and the raising of amended taxation assessments in excess of $80 million.[18] ATO activity in this area has been particularly evident in Melbourne, where a specific audit project group was established to investigate withholding tax arrangements involving trusts.

2.30 The Committee also was advised that a number of the arrangements have been challenged in the courts. Some have resulted in success, such as *East Finchley Pty Ltd v Federal Commissioner of Taxation* 89 ATC 479 and *Faucilles Pty Ltd as Trustee of the John Karidas Family Trust No.2 v Federal*

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16 Evidence p.S18

17 Evidence p.S19

18 Evidence p.S138

Commissioner of Taxation 90 ATC 4003, while others have been unsuccessful, such as *Metropolitan Oil v Federal Commissioner of Taxation* 90 ATC 4624.[19]

2.31 In relation to the analysis undertaken by Ms Smith, the ATO argued that it was not soundly based and had led her into a very exaggerated estimate of revenue loss. The ATO stated that her estimate:

- did not discount for genuine arrangements;
- did not take into account the significant increase in the level of foreign debt in recent years, which would account for large increases in the amounts of interest paid to non-residents and interest withholding tax paid;
- did not take into account increases in interest rates over the period reviewed, which also would have increased the amount of interest and therefore the amount of interest withholding tax paid; and
- did not take into account the relative decrease in dividend withholding tax resulting from the dividend imputation system.[20]

2.32 As for the internal memorandum from its Melbourne office which Ms Smith used to support her position, the ATO indicated that it was prepared as a 'think piece' which required further analysis. According to the ATO, subsequent analysis revealed that the figure was not representative of the national position and was unsustainable.[21]

2.33 The ATO argued that the Melbourne office calculation was flawed because:

- it was assumed that the tax should have been paid at the maximum personal rate, even though withholding tax is collected from a broad spectrum of taxpayers properly taxable on lower rates;
- it disregarded legitimate family and commercial arrangements which, reflecting Australian society origins, produce proper flows of income;

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19 Evidence p.S138

20 Evidence p.S17

21 Evidence p.S20

- it was not adjusted downwards to take account of commercial realities such as increased overseas borrowing and substantial rises in interest rates over the period; and

- it failed to recognise successive changes in the law, such as removal of the zero rate step for non-residents from 17 August 1982, removal of exemptions in respect of the roll-over of loans in 1983, and removal of the Australian entity test exclusion in 1986, which had the cumulative effect of increasing withholding tax collections.[22]

2.34 Despite these criticisms, the ATO acknowledged that 'there is a level of tax evasion going on using devices like those that [Ms Smith] has described'.[23] At the same time, the ATO indicated that when some of the suspicious cases are examined more carefully, it becomes apparent that there are no grounds to challenge them. It was argued that many of the arrangements exist for legitimate commercial or family reasons. The ATO warned:

> Ms Smith's approach would have us ignore those reasons in ascribing a scale to what is going on.[24]

2.35 In reply to the other estimates of revenue loss which were provided to the Committee, the ATO presented its own estimate of the revenue loss involving the withholding tax provisions. Two distinct figures were provided.

2.36 First, the ATO estimated that the revenue loss from non-payment of interest withholding tax amounted to approximately $95 million to $130 million per annum.[25] This figure represents those individuals and organisations which evade tax by failing to fulfil their statutory obligation to pay withholding tax.

2.37 Secondly, the ATO provided an estimate of the revenue loss arising from the withholding tax arrangements described at paragraph 2.18 of this report involving Australian resident discretionary trusts. It was, however, unable to provide an estimate of revenue loss attributable to the use of non-resident bank accounts by residents.

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22 Evidence p.S20

23 Evidence p.725

24 Evidence p.726

25 Evidence p.S15

2.38 In relation to the non-resident beneficiary arrangements, the ATO used two methodologies to conclude that the maximum potential field of revenue loss lies in the range of $100 million to $250 million per annum, based on 1989/90 figures.[26]

2.39 The first methodology used by the ATO was the same which was adopted to arrive at the estimates already provided to the Committee. In its calculation, the ATO allowed for two factors which it considered could largely explain the level of interest withholding tax collections in 1989/90. These were:

- the growth in income payable on foreign investment in Australia; and

- the proportion paid by the largest interest withholding tax remitters, including the largest corporations, government instrumentalities and financial institutions, which the ATO considered would not have been involved in schemes which employ the withholding tax system to avoid income tax using discretionary trusts, non-resident beneficiaries and the conversion of trading income into interest flows. The proportion paid was estimated to be on average at least 50 percent of total collections.[27]

2.40 The second methodology used by the ATO involved a statistical scoping project relating to trusts, nominees and private companies registered for withholding tax. The ATO conducted stratified random sampling of registered withholding tax payers. This paralleled the scoping audit methodology commonly used in the Business Audit Unit as part of the Project Based Audit Program.[28]

2.41 In arriving at a revenue loss estimate in the range of $100 million to $250 million using the two methodologies, the ATO noted that, on a national basis, 4404 cases would probably be involved in this type of non-resident beneficiary arrangement.[29] It stressed, however, that the figures did not reflect actual evasion. Rather, the ATO indicated that much of the estimate may be attributable to arrangements which satisfy existing law.[30]

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26 Evidence p.S282

27 Evidence p.S282

28 Evidence p.S284

29 Evidence p.S285

30 Evidence p.S282

2.42 The ATO conceded, however, that investigation of cases of this nature is difficult because of the need to obtain evidence that the arrangements constitute a sham. It was noted that often the ATO needs to prove that the documentation provided by the trustee does not represent the true nature of the transaction. As the documentation always involves non-residents, particular difficulties are experienced in obtaining evidence from overseas. The ATO indicated that the difficulties vary from language to finding people. One ATO officer commented:

> ... some of these arrangements involve people who do not exist. We seek to define those people. Collecting evidence from people who do not exist is, of course, difficult. ... In one way or another you have to prove they do not exist. You have to go to local authorities and the like to get affidavits to prove that. In other cases, where people do exist, you have to get evidence from them that they are not recipients of the income. Sometimes, particularly if a member of the family in Australia is involved in the arrangement, they are not disposed to give that sort of evidence or affidavit.[31]

2.43 The difficulties in distinguishing between legitimate and contrived arrangements were highlighted also by ATO auditors during an inspection of the Withholding Tax Unit in Melbourne. The auditors indicated that in many cases even though they suspected that arrangements were established primarily for tax avoidance purposes, the legitimacy of the arrangements was impossible to disprove.

2.44 During these discussions, the Committee was able to ascertain that the figure referred to in the internal memorandum obtained by Ms Smith may have been excessive. However, it was pointed out that the calculation was not made to provide a definitive figure, but rather to draw attention to the difficulties associated with tax avoidance in this area and to illicit a response from the ATO's National office.

Other responses

2.45 Taxation professionals who appeared before the Committee generally concurred with the ATO's assessment of the extent of tax evasion through the use of withholding tax arrangements. The Australian Society of Certified Practising Accountants (ASCPA) indicated that the ATO's figures are more in line with the level of avoidance (used in the context of evasion)

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31 Evidence p.735

which could be expected to exist.[32] Similarly, Melbourne solicitor, Mr Mark Leibler, the Law Council of Australia's representative on the Commissioner of Taxation's advisory panel, stated:

> ... the estimates prepared by the Tax Office seem to me, from a commonsense point of view, to be fairly spot-on.[33]

2.46 The ASCPA, Mr Leibler and The Taxation Institute of Australia (TIA) expressed surprise and scepticism about the larger figure quoted by Ms Smith.[34] They argued that legislative changes over the last six to eight years had helped to eliminate the blatant tax avoidance arrangements which existed in the 1970s and early 1980s.[35] Mr Leibler commented:

> There is a big difference between something which is being promoted and paraded throughout the community in packaged form, as happened in the late 1970s and early 1980s, and the sort of thing we are talking about here.[36]

2.47 It was conceded that the absence of packaged schemes did not mean that techniques involving the withholding tax provisions were not being used. However, the absence of such schemes was considered relevant in terms of quantification of revenue loss.[37]

Conclusions

2.48 The evidence on the revenue loss through withholding tax arrangements was inconclusive. While the ATO was able to provide an estimate in the range of $100 million to $250 million per annum in relation to non-resident beneficiary arrangements, as compared to Ms Smith's estimate of up to $943 million per annum in total withholding tax abuse, the acknowledged difficulties associated with distinguishing between legitimate arrangements and those established to evade taxation obligations meant that the level of revenue loss could not be quantified with precision. Also relevant in this regard was the problem of evaluating the fairness of a tax system under which a small group of taxpayers can take advantage of legitimate arrangements which reduce their tax burden in a manner not available to the vast majority of taxpayers.

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32 Evidence p.872

33 Evidence p.900

34 Evidence pp.758, 868, 872, 900 and S196

35 Evidence pp.763, 875, 890

36 Evidence p.898

37 Evidence pp.898-899

2.49 The Committee accepts that the more blatant examples of tax evasion, involving packaged schemes as utilised in the 1970s and early 1980s, are not evident in recent times. The efforts of the ATO in combating sham arrangements have played an important part in this regard. However, there is sufficient evidence, particularly from field officers of the ATO, to indicate that there continues to be a problem with more sophisticated arrangements which may have all the hallmarks of legitimacy but which ultimately result in a loss to the Australian revenue.

2.50 It is the view of the Committee that the scope of the revenue loss should not become a major pre-occupation. While the estimate of revenue loss contained in the internal memorandum from the ATO's Melbourne office may have been excessive, this estimate served to highlight a problem in the withholding tax area. Ms Smith's submissions to the Committee served a similar purpose. In the view of the Committee, the problem is significant enough to warrant attention and, accordingly, the Committee has focused in this report on how best to deal with the problem.

Anti-avoidance measures

2.51 One of the primary concerns of the Committee was to ensure that adequate legislation is in place which will either deter the use of withholding tax arrangements or which will allow the ATO to act against those who participate in such arrangements. As a first step, it was necessary for the Committee to assess the adequacy of existing anti-avoidance measures in the ITAA.

2.52 The principal measures available to the ATO to counter withholding tax arrangements are contained in Part IVA and section 100A of the ITAA.

2.53 Part IVA, which replaced section 260, contains the general anti-avoidance provisions of the ITAA. In general, it applies where:

- a taxpayer obtains a tax benefit in connection with a scheme or arrangement entered into after 27 May 1981; and
- having regard to the scheme and its surrounding circumstances and practical results, the sole or dominant purpose for entering the scheme was to confer a tax benefit on the taxpayer.

2.54 If a taxpayer has obtained a tax benefit in connection with a scheme to which Part IVA applies, the Commissioner of Taxation is authorised to cancel the tax benefit in whole or in part. The Commissioner can do so by including the income in

question in the taxpayer's assessable income for that year, or by not allowing the whole or part of a deduction which has been claimed.

2.55 Section 100A, on the other hand, is a more specific provision relating to trust reimbursement arrangements. It provides that where a beneficiary's entitlement to trust income arises out of a reimbursement arrangement, the beneficiary will be deemed not to be entitled to that income and the trustee will be assessed at a penalty rate of tax under section 99A.

2.56 When the general anti-avoidance provisions in Part IVA were introduced into the Parliament in 1981, the then Treasurer, the Hon J W Howard, MP, stated that arrangements of a normal business or family kind, including those of a tax planning nature, will be beyond the scope of Part IVA. He indicated that Part IVA seeks to give effect to a tax policy that a general tax avoidance measure ought to:

> ... strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities for the arrangement of their affairs.[38]

2.57 Reflecting this approach is the ATO's attitude to the application of Part IVA, as detailed in Income Tax Ruling IT2466. In that ruling, the ATO advises that, to counter arrangements, Part IVA should be considered in cases where:

- there is no documentation to support the loan and interest transactions;
- the transactions were part of an artificial round robin of cheques not supported by real funds; or
- there is no significant commercial justification for the transactions.

2.58 Where Part IVA is not applicable, the ATO indicates in IT2466 that an arrangement involving a trust distribution to a non-resident beneficiary may still be caught by section 100A. However, it is important to note that, in accordance with subsection 100A(13), an arrangement cannot constitute a reimbursement arrangement if the arrangement was entered into in the course of ordinary family or commercial dealing.

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38 Commonwealth of Australia, Parliamentary Debates (Hansard), House of Representatives, 27 May 1981, p.2683

2.59 Given the difficulties which can arise in distinguishing between legitimate and contrived arrangements, as identified by the ATO and noted at paragraphs 2.42 to 2.44 of this report, the Committee questioned the ATO on whether Part IVA could be regarded as an adequate anti-avoidance measure against the withholding tax arrangements described to the Committee. In response, the Commissioner of Taxation, stated:

> What you have heard from some is because withholding tax is not an assessable income item ... it is outside the scope of Part IVA ... But I believe the true analysis, relevant to what is on the Committee's mind, is ... that Part IVA, as it stands, is apt. ... You have a situation where there is an item of assessable income that but for the scheme would have been included in someone's assessable income.[39]

2.60 Further advice from the ATO, however, indicated that Part IVA has been applied in only a few cases involving the distribution of discretionary trust income to non-resident beneficiaries. The ATO noted that its application has been restricted because of the difficulty in obtaining relevant information.[40]

Conclusions

2.61 Despite the confidence of the ATO about the adequacy of existing anti-avoidance measures, the continued use of techniques or arrangements which take advantage of the withholding tax provisions, as acknowledged by the ATO, suggests to the Committee that there is a perception among some in the community that arrangements can be established which are beyond the scope of Part IVA and section 100A of the ITAA. Supporting this conclusion is the advice of ATO auditors, noted at paragraph 2.43 of this report, that in many cases the legitimacy of suspected avoidance arrangements are impossible to disprove.

2.62 The Committee is aware that many of the more sophisticated arrangements established for tax avoidance purposes are structured to appear as legitimate family or commercial dealings which the general anti-avoidance measures are not intended to cover. The ATO's advice to the Committee that Part IVA has been utilised in only a few cases to attack the more sophisticated arrangements indicates that there may be limits to

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39 Evidence p.932

40 Evidence p.S381

the operation of the legislation in this area. In addition, while the recently introduced legislation on controlled foreign companies and trusts could be applied against back to back loan arrangements, certain family trust arrangements are exempted specifically from the operation of those provisions.

2.63 The Committee notes that when the anti-avoidance provisions in Part IVA were introduced into the Parliament in 1981, the then Treasurer indicated that some arrangements, including some family arrangements, which are beyond the appropriate scope of general anti-avoidance measures ought to be dealt with, if necessary, by specific measures.

2.64 The Committee considers that specific measures aimed at countering the withholding tax arrangements identified during the inquiry are both warranted and necessary in order to reinforce existing anti-avoidance measures available to the ATO. Recommendations on the specific legislative measures which should be introduced are detailed in the remaining sections of this chapter.

Withholding tax rate

2.65 In order to deter the withholding tax arrangements described in the earlier sections of this chapter, one suggestion put to the Committee was to increase the rate of interest withholding tax to 30 percent (ie the same rate imposed on dividends) for non-residents living in countries with which Australia does not have comprehensive double taxation treaties, and a maximum of 15 percent for non-residents living in treaty countries.[41] It was argued that such an increase would provide the following benefits:

- distributions of interest income would not be streamed to non-resident beneficiaries in non-treaty countries, where verification is not possible by the ATO;
- by providing a maximum rate of 15 percent for non-residents in treaty countries, the rate applying to Australia's main trading partners would stay the same, except where a 15 percent rate has already been negotiated, in which case 15 percent rather than the existing maximum of 10 percent would be collected; and

41 Evidence p.S70

> Australian trusts would no longer derive large tax advantages or artificially contrived deductions currently available to them through arrangements involving non-resident beneficiaries.[42]

2.66 Opposing this proposal, the ATO indicated that raising the general rate of interest withholding tax would be out of step with most other countries, would require Australia revisiting all of its double taxation treaties, and would impinge upon normal commercial raising of funds from overseas.[43] It was argued that, as most investment in Australia is for legitimate reasons, it would be inappropriate to raise the interest withholding tax rate across the board simply to strike at a small percentage of activity which may involve tax avoidance. The ATO stated:

> That is a bit like taking a sledge hammer to crack a nut ...[44]

2.67 The same view was voiced by the TIA and the ASCPA. Both organisations indicated that, in their view, raising the rate of withholding tax would increase the cost of borrowing overseas, as the higher rate of tax would be passed from the borrower to the lender.[45] The ASCPA also pointed out that raising the rate of withholding tax would not benefit the Australian revenue, as the higher cost of borrowing would result in higher tax deductions being claimed by Australian businesses. The ASCPA stated:

> We are not necessarily collecting any more revenue because what we are doing is pushing up the deduction that Australian businesses are claiming. If you raise the rate of withholding tax, that raises the cost of the money and in fact the revenue loses out.[46]

2.68 Rather than raising the rate of interest withholding tax, the TIA suggested that the tax should be withdrawn, at least so far as it applies to third party transactions, ie arm's-length transactions involving unrelated parties. The TIA submitted that this would be consistent with world wide trends and would improve capital market efficiencies.[47]

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42 Exhibit 5 p.15

43 Evidence p.S21

44 Evidence p.735

45 Evidence pp.758-759, 878

46 Evidence p.878

47 Evidence pp.S90-S91

2.69 Due to the economic considerations attaching to the proposals put to the Committee on interest withholding tax, the Committee sought the advice of the Department of the Treasury (Treasury) about the implications of changing the withholding tax rate. In response, Treasury indicated that, since the decision in 1967 to introduce withholding tax, Treasury has not engaged in a substantive review of withholding tax rates. Treasury noted that when a new double tax treaty is negotiated, the withholding rates are confirmed. However, the impression given to the Committee was that this confirmation does not constitute an actual review.[48]

2.70 On this point, the ATO advised that every time there is a change of government, the existing taxation treaty policy is reviewed. The ATO noted that withholding tax is reviewed in that context.[49]

2.71 On the basis that no substantive review of withholding tax rates has been conducted since 1967, Treasury indicated that it was unable to provide the Committee with advice on the implications of increasing the rates of interest withholding tax. One Treasury official stated:

> ... I can only engage in speculation as to what the effects might be at this stage, because we have not done that work. I would rather not engage in such speculation because I have very few facts to base any such speculation on.[50]

2.72 As part of its assessment of existing withholding tax rates, the Committee also sought advice on how the Australian system compared to that of similar overseas jurisdictions. The Committee was aware that some countries, such as the United Kingdom and Canada, impose a higher rate of interest withholding tax on non-residents living in countries with which taxation treaties have not been negotiated. The Committee sought to determine whether Australia should be imposing a different withholding tax rate for non-residents living in non-treaty countries as compared to non-residents living in treaty countries.

2.73 In this regard, Treasury noted that international practice in relation to withholding tax is variable. It advised that nearly all countries which levy withholding tax have a large number of exemptions from the tax.[51]

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48 Evidence p.961

49 Evidence p.942

50 Evidence p.964

51 Evidence p.963

2.74 The ATO confirmed this advice by indicating that while some countries do have a higher rate applying to non-treaty countries, in practice they may impose a lower rate and can even decide to impose no tax at all. The ATO noted:

> When you look at say the Canadian law, where they have 25 [percent] and they have a treaty practice of 15 [percent], they also have exemptions in the law where they give up altogether their right to tax interest in the broader interest of getting the capital in.[52]

2.75 The ATO expressed concern about the administrative costs which would be associated with putting in place a system of differential withholding tax rates for treaty and non-treaty countries. It argued that, as most of Australia's debt flows come from treaty countries, a mechanism for imposing a higher tax for non-treaty countries would have only limited impact in terms of revenue, but would involve a greater administrative burden.[53]

2.76 It was also pointed out by the ATO and Treasury that if there was a differential rate of withholding tax, companies would simply arrange their affairs so that income would be streamed to non-treaty countries through treaty countries.[54]

Conclusions

2.77 The flat rate of withholding tax on interest and dividends earned in Australia by non-residents is in accordance with accepted international practice whereby the country of residence of the recipient of the income has the primary taxing rights on that income. That basic principle is enshrined in the double taxation agreements into which Australia has entered with other countries.

2.78 One consequence, though, of the 10 percent withholding tax rate on interest earned by non-residents is that it has provided some Australian residents with the potential to establish arrangements which are aimed at reducing and even evading their income tax obligations. The continued prevalence of some sophisticated arrangements, as acknowledged by the ATO, indicated to the Committee that there are those in the community who feel that the incentive of a lower tax rate is significant enough and the chances of detection minimal enough to be worth the effort and risk of establishing such arrangements. In this regard, the Committee notes the evidence provided to the Joint Committee on Public Accounts by the New South Wales Police Association as part of that Committee's inquiry into the Business

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52 Evidence p.939

53 Evidence p.936

54 Evidence pp.964, S936

Migration Program and control of visitor entry. In its submission to the Public Accounts Committee, the New South Wales Police Association indicated that the use of lower withholding tax rates has been an identified aspect of money laundering arrangements by organised crime syndicates.

2.79 Clearly, it is the difficulties in obtaining evidence from overseas jurisdictions, particularly though not exclusively from non-treaty countries, which presents one of the principal obstacles for the ATO in its attempts to counter withholding tax arrangements. It is removal of these obstacles which should be a major focus.

2.80 The Committee deliberated on a proposal to increase the rate of interest withholding tax across the board and on a proposal to increase the rate of withholding tax for non-residents living in non-treaty countries alone.

2.81 In considering these proposals, the Committee took account of the experience of comparable overseas jurisdictions. It deliberated, in particular, on the differing treatment accorded to non-residents from treaty countries and non-residents from non-treaty countries in, for example, Canada and the United Kingdom. In this regard, it is significant that while countries such as Canada and the United Kingdom are able to impose a higher rate of withholding tax on non-residents living in countries with which taxation treaties have not been negotiated, this higher level of tax is not imposed automatically and is not imposed across the board. A large number of exemptions exist and in some cases even no withholding tax is levied, for example as part of a deliberate decision to attract investment. Nevertheless, the Committee came to the conclusion that the potential to impose a higher rate of withholding tax allows the tax administrations of those countries to exercise a greater degree of control in ensuring that the withholding tax system is not being abused.

2.82 The Committee, of course, was conscious of the need to ensure that any measures which are introduced do not interfere with legitimate commercial activity and do not create an unwarranted administrative burden for the ATO. The Committee was aware of the potential impact which increasing the rate of withholding tax would have on Australia's ability to attract foreign investment, particularly as Australia traditionally has been a capital importer and is likely to remain so in the longer term. The Committee also was conscious of the increased cost of borrowing which would most likely result from an increase in the withholding tax rate, and took into account the view of the ASCPA that the increased cost of borrowing could result in an overall loss to the revenue because of the increased tax deductions claimed by borrowers.

2.83 As part of its deliberations on increasing the rate of interest withholding tax across the board, the Committee was concerned about the extent to which the current rate impacted on an investor's choice between debt and equity investment. The Committee also was concerned about the overall fairness of the

withholding tax system in terms of the taxation treatment accorded to non-residents investing in Australia as compared to residents investing in Australia.

2.84 On the issue of an increased rate, the Committee saw some merit in having differential rates of interest withholding tax applying to non-residents living in treaty countries, non-residents living in non-treaty countries which have comparable tax regimes to Australia, and non-residents living in non-treaty countries which do not have comparable tax regimes to Australia. Under such a system, a higher rate of interest withholding tax (say double the treaty country rate) could apply to non-treaty countries with comparable tax regimes to Australia, while an even higher rate (say a rate equivalent to the top dividend withholding tax rate) could apply to non-treaty countries which do not have comparable tax regimes to Australia.

2.85 One benefit of a three tier system is that higher rates of interest withholding tax could be applied to non-residents living in countries in relation to which Australia does not have the authority to exchange information. It is to such countries that tax evaders generally would be seeking to channel funds. Under a tiered system of withholding tax rates, there also would be a clear incentive for countries to enter into taxation agreements with Australia.

2.86 The Committee, however, was unable to evaluate in detail the full economic implications of increasing the rate of interest withholding tax and having differential rates for treaty and non-treaty countries. In particular, from the evidence it received, the Committee was unable to fully assess the impact which such a move would have on Australia's ability to attract foreign investment. Accordingly, the Committee has not come to a conclusion on this point.

2.87 The Committee, on the advice of Treasury, understands that this inquiry is the first occasion since the introduction of the withholding tax system in 1967 that detailed consideration has been given to Australia's withholding rates. Clearly, the economic conditions of the 1990s are vastly different from those of the late 1960s. It is of concern to the Committee that greater attention has not been focused previously on whether the withholding rates which were set in the 1960s are still in the best interests of Australia. As there are a number of broader economic implications attaching to the issue of withholding tax rates beyond the tax avoidance matters which were the focus of this inquiry, the Committee considers that a detailed review of the withholding tax system and whether it continues to serve the interests of the Australian economy is overdue.

2.88 The Committee notes that the Industry Commission is currently conducting an inquiry into the availability of capital. The terms of reference for that inquiry require the Commission to:

> ... identify impediments faced by business enterprise in obtaining equity and loan capital that lead to inefficient resource use, and advise on courses of action to reduce or remove such impediments.

2.89 In an issues paper produced for that inquiry, a number of the broader issues relevant to the withholding tax system are raised. In that paper the following questions are asked:

> What net burden should Australian taxes impose on investment and lending by foreigners? How should taxation be imposed? Is remission of withholding tax on fully franked dividends appropriate? Does the current structure of taxes unduly encourage or discourage particular forms of foreign finance?[55]

2.90 As many of the issues identified above are relevant to concerns raised in the Committee's current inquiry, it is the view of the Committee that the Industry Commission's inquiry should encompass a comprehensive assessment of the withholding tax system.

2.91 Pending the outcome of the Industry Commission's inquiry, the Committee is of the view that there is a need to address the specific difficulties identified in relation to the tax avoidance arrangements arising from the withholding tax provisions. To alleviate the evidentiary burden for the ATO in the withholding tax area, the Committee considers that the Commissioner of Taxation should be provided with a discretionary power which would enable the Commissioner to impose the top marginal rate of tax on interest income earned by non-residents instead of the interest withholding tax rate in situations where the Commissioner has reason to suspect that the income in question relates to an arrangement established for the purposes of tax avoidance. The higher rate of tax would be applicable until such time as the non-resident is able to prove to the Commissioner that the arrangement in question is legitimate. The Committee envisages that, in such cases, the ATO would issue the interest payee and payer a notice of intention to impose the top marginal rate of tax instead of the interest withholding tax rate, giving a period of time for the payee to demonstrate that the arrangement in question is legitimate.

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55 Industry Commission, Availability of Capital Inquiry, Issues Paper, February 1991, p.9

2.92 The enactment of a discretionary power for the Commissioner of Taxation to impose the top marginal rate of tax instead of the interest withholding tax rate would provide, in the view of the Committee, an appropriate deterrent to withholding tax arrangements without interfering with legitimate business activity. The difficulties associated with obtaining evidence from overseas would be reduced, as it would be the non-resident taxpayer who would have to provide verification to the ATO that the arrangement in question is legitimate. This will help to eliminate the incentive for Australian residents to enter into contrived arrangements, and also will provide a disincentive to remain in such arrangements. Through such a control, the ATO's ability to counter abuse of the withholding tax system will be greatly improved. This measure also will provide a level control over the withholding tax system similar to that exercised in comparable overseas jurisdictions, as noted at paragraph 2.80.

2.93 As with any discretionary power, it needs to be exercised in a proper and reasoned manner. The Committee envisages that this power would be exercised at an appropriately senior level and on a case by case basis. In this regard, the ATO should consider issuing guidelines on the proposed operation of this power.

Recommendation 1

2.94 **The Committee recommends that the Industry Commission, as part of its inquiry into the availability of capital, conduct a comprehensive review of Australia's withholding tax system to determine the extent to which the system in its existing form serves the interests of the Australian economy. Attention should be directed to:**

- **the appropriateness or otherwise of retaining the existing rate of interest withholding tax;**
- **the appropriateness or otherwise of having a common rate of interest withholding tax applying to interest income earned in Australia by non-residents living in countries with which Australia has entered into comprehensive double taxation agreements and non-residents living in countries with which Australia has not entered into such agreements;**
- **the equity of tax sharing arrangements between Australia and other countries, particularly whether, in light of Australia being a resource exporting country with high levels of foreign debt, it is appropriate that the country of**

residence of the recipient of interest and dividend income earned in Australia should retain the primary right of taxation on that income, or whether that right should be retained by the country of source of the income;

- the extent to which there is equity of taxation treatment between resident and non-resident individual investors, and between Australian owned and foreign owned enterprises; and

- the adequacy of the thin capitalisation rules in ensuring that Australian business entities are not disadvantaged as a result of debt gearing by foreign entities operating in Australia.

Recommendation 2

2.95 **Pending consideration of the matters for review proposed at recommendation 1, the Committee recommends that the Commissioner of Taxation be provided with a discretionary power to impose the top marginal rate of tax on interest income earned by non-residents, instead of the interest withholding tax rate, in cases where the Commissioner has reason to believe that the interest income derived by a non-resident from an Australian source relates to an arrangement established by an Australian resident for tax avoidance purposes. The increased rate should apply until the non-resident who derives the interest income is able to verify that the interest payment is not related to a tax avoidance arrangement.**

Taxation of discretionary trusts

2.96 Another focus of the Committee's deliberations was the taxation of discretionary trusts. A view put to the Committee, as noted at paragraph 2.9 of this report, was that discretionary trusts are one of the main vehicles for withholding tax arrangements. The principal concern was that the flexibility of discretionary trusts, by allowing streaming of particular types of income to particular beneficiaries, is facilitating the establishment of tax avoidance arrangements which rely on interest income being directed to non-residents.[56] That income is subject to only 10 percent withholding tax.

2.97 Other advantages which potentially flow from the use of discretionary trusts include the ability to minimise tax liability on a capital gain by streaming the gain to particular beneficiaries, the ability to bypass recent anti-avoidance

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[56] Evidence p.S123 and Exhibit 9 p.5

measures aimed at dividend selection schemes, and the use of default beneficiary clauses with $2 companies to frustrate the collection of taxation in the event of an audit.

2.98 It was suggested to the Committee that the use of discretionary trusts for tax avoidance purposes could be eliminated if trusts and companies were taxed in a uniform manner.[57]

2.99 In response, the ATO indicated that while discretionary trusts are a flexible vehicle and can be used in different ways for minimisation, avoidance and even evasion purposes, they are not the only structure which can be used in this way. The ATO advised that an overseas company, for example, could be used to convert fully taxed Australian income into income which only attracts 10 percent withholding tax.[58]

2.100 As for the proposal to tax discretionary trusts in the same way as companies, the ATO commented:

> We know, because the Parliament has done it already, that one group of trusts - unit trusts - and there are some similar categories, have been made companies for tax purposes. One knows technically it can be done but there can be wider implications.[59]

2.101 The ATO noted that trusts originated from English law. It advised that normally, for taxation purposes, trusts are treated as transparent, ie the payment to the beneficiary is treated as coming from the same source and retaining the same character as the underlying income derived by the trust. The ATO indicated that in this regard Australia is not out of kilter with other countries generally.[60]

2.102 However, in the United Kingdom, there is a different regime for taxing discretionary trusts, under which there is no transparency.[61] The payment to a beneficiary is treated as a different source of income from that of the underlying income. In general terms, United Kingdom taxation legislation provides that the net income of a discretionary trust is subject to tax at the rate of 35 percent (for the 1990 income year), with the assessment raised against the trustee. The tax paid by the trustee may be available as a credit against the beneficiary's liability for income tax.

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57 Evidence p.S70

58 Evidence p.929

59 Evidence p.930

60 Evidence p.931

61 T W Magney, D C Orrack, et al, 'The Treatment of Trusts under the OECD Model Convention', in Taxation in Australia, Vol.23, No.11, June 1989, p.700

2.103 On the issue of taxing trusts, the Committee also sought the advice of taxation and accounting professionals who participated in the inquiry.

2.104 The ASCPA commented:

> ... to the extent that trusts with non-resident beneficiaries are used in tax avoidance schemes, it may be better to reconsider the legislative treatment accorded to such trusts.[62]

2.105 Mr Leibler suggested that it might be possible to tax at ordinary rates income which is streamed in interest form through a trust. He indicated that such a step would not necessarily interfere with Australia's trading relationships with other countries.[63]

2.106 On the broader issue of taxing trusts and corporations in the same way, ASCPA advocated equal treatment for different entities. ASCPA stated:

> ... we see this somewhat separate structure that we have where corporations are taxed at different rates to non-corporations as something that the Government should move away from.[64]

2.107 In a similar vein, Mr Leibler supported symmetrical treatment for different organisational entities with the aim of revenue neutrality.[65]

Conclusions

2.108 The use of discretionary trusts for tax avoidance purposes is a negative consequence of the differing approaches which have been adopted towards the taxation of trusts and corporations. While specific measures to counter this avoidance have been suggested to the Committee as an immediate solution, the Committee is of the view that piecemeal measures will not address the broader issues relating to equity of treatment for these different entities.

2.109 The Committee agrees that steps should be taken towards taxing trusts and corporations in a uniform manner. This would eliminate the tax avoidance opportunities provided by the flexibility of discretionary trusts. In particular, it would

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62 Evidence p.S102

63 Evidence p.904

64 Evidence p.877

65 Evidence p.907

eliminate income matching for purely tax planning purposes. In addition, this measure, by providing equitable taxation treatment for economic activity undertaken through either a discretionary trust or a corporation, would ensure a revenue neutral vehicle for economic activity.

2.110 The Committee of course recognises that there are a number of broad economic and social implications which need to be examined in any move to alter the existing approach to taxing of trusts. As consideration of these broader issues may delay implementation of the recommendation to tax trusts and corporations in a uniform manner, the Committee sees a need in the interim for specific measures to curtail the use of discretionary trusts in avoidance arrangements involving the withholding tax provisions.

2.111 In this regard, the Committee supports the removal of the tax advantages which can accrue in arrangements which rely on the streaming of interest income to non-residents. Removal of such advantages would strike at the very reason for establishment of these arrangements, ie a lower rate of tax.

2.112 Specifically, the Committee considers that:

- interest streamed through a trust to non-resident beneficiaries living in non-treaty countries should be taxed at the ordinary non-resident rates of tax rather than the withholding tax rate; and

- interest paid by an Australian entity as part of an arrangement to convert trading income to an interest stream which ultimately flows through a trust to non-resident beneficiaries should not be tax deductible.

2.113 Supporting these proposed legislative reforms is an internal memorandum dated 28 August 1990 from the Assistant Deputy Commissioner, Complex Audit in the ATO's Melbourne office to the ATO's National office. In the memorandum, which was obtained under the provisions of the FOI Act and tabled in the House of Representatives on 7 March 1991, it is stated:

> Looking beyond the strategies for organising audit investigations of these arrangements there is a demonstrable need for legislative reform. Subsection 128A(3) was probably inserted into the *Income Tax Assessment Act* 1936 to fulfil Australia's treaty obligations not to tax interest income at a higher rate than that expressed in various

Double Tax Agreements (ie at a maximum rate of 10% or 15%). However the subsection extends this concession to all non-residents. It is submitted that this extension should be repealed.

2.114 The Committee recognises that this legislative amendment may lead to entities arranging their affairs to ensure that the interest income is routed through a treaty country, while still ending up in a non-treaty country. To counter this possibility, the Committee considers that anti-'treaty shopping' provisions should be included in any taxation treaty negotiated by Australia. Such provisions would ensure that persons who do not meet the residency requirements specified in a given treaty are ineligible to obtain the concessions available as a result of that treaty.

2.115 In recommending the above changes, the Committee notes that there may be a potential to interpose non-trust entities, for example partnerships, into arrangements with the aim of defeating the intent of the proposed changes. The ATO should be vigilant in this regard and should seek a further legislative response if it is considered necessary.

2.116 In relation to partnership arrangements, the ATO also should consider the extent to which the Committee's recommendation on uniform and equitable taxation treatment of business entities would be applicable to such arrangements.

2.117 As a consequence of the changes being recommended by the Committee, it is likely that the income tax rulings relating to withholding tax arrangements will need to be updated.

Recommendation 3

2.118 **The Committee recommends that there should be a move towards a system of taxing trusts and corporations in a uniform manner, with tax payable on the trust's net income at the company rate of tax and credit given proportionally to beneficiaries for income tax paid.**

Recommendation 4

2.119 **Pending the implementation of recommendation 3, the Committee recommends that interest streamed through a trust to non-resident beneficiaries living in countries with which Australia has not entered into comprehensive double taxation agreements should be taxed at the ordinary non-resident rates of tax rather than the withholding tax rate.**

Recommendation 5

2.120 **Pending the implementation of recommendation 3, the Committee recommends that interest paid by an Australian entity as part of an arrangement to convert trading income to an interest stream which ultimately flows through a trust to non-resident beneficiaries should not be tax deductible.**

Recommendation 6

2.121 **The Committee recommends that anti-'treaty shopping' provisions be included in any double taxation agreement entered into by Australia, with existing arrangements to be renegotiated to include inter alia such provisions.**

Payments by borrowers

2.122 The Committee became aware that a practice has arisen whereby an Australian resident borrowing funds from overseas is required to reimburse the overseas lender the amount of interest withholding tax which is deducted from the interest paid on the borrowed funds. Under such an arrangement, this reimbursement of the lender's withholding tax obligation is distinct and separate from the interest charges specified in the loan agreement and, therefore, would not be included in the withholding tax calculation.

2.123 The Committee was concerned that this practice leads to inconsistent treatment between overseas lenders and is to the detriment of the Australian revenue. As a result of this practice, tax is collected at different 'effective rates' depending on whether the interest rate is expressed as net of or inclusive of withholding tax.

2.124 The ATO indicated that withholding tax should be calculated on the gross interest paid to the overseas lender by the resident borrower. It advised that this issue was examined in the course of the ATO's large case audit program.[66]

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66 Evidence pp.944-955

Conclusions

2.125 The Committee concurs with the ATO's view that interest withholding tax should be calculated on the gross interest paid by a resident borrower to an overseas lender. The ATO should ensure that withholding tax payers are aware of this requirement. It also should actively enforce this requirement.

Recommendation 7

2.126 **The Committee recommends that the Australian Taxation Office ensure that withholding tax is collected on the gross interest paid to a non-resident.**

CHAPTER THREE

WITHHOLDING TAX ADMINISTRATION

Withholding tax collection

3.1 Withholding tax on dividend and interest income is required to be deducted at source by the person or institution making the income payment. The withholding tax which is deducted is required to be remitted to the Commissioner of Taxation.

3.2 Withholding tax is deducted where the payee:

- is shown in the payer's records as having a foreign address; or
- has authorised or directed that the payment be made to himself or herself or to another person at a place outside Australia.

Efficiency audit findings

3.3 The Auditor-General's efficiency audit report of November 1987, *Australian Taxation Office: International Profit Shifting* was the original basis for the Committee's inquiry.

3.4 On the issue of withholding tax, Audit concluded from a review of operations in the ATO's Sydney Office that the Withholding Tax Section initiated minimal follow up on advice it received either internally, or externally from organisations making payments overseas which are subject to dividend and interest withholding tax. Audit stated:

> It was evident that the ATO did not make use of information held by it in the International Units to identify and prevent tax evasion in the Withholding Tax area.[1]

3.5 Audit also noted that there was inadequate computerised support for this area. It considered that the use of computing facilities and some expert analysis and redesign of the operations was essential.[2]

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1 The Auditor-General, op cit, p.19

2 ibid p.19

3.6 In response, the ATO advised that it recognised the need to pay more attention to the development of a national withholding tax audit program. It was noted that preliminary work on the audit program had been completed and that a pilot program was expected to be implemented shortly.[3]

3.7 In its submission, the ATO advised the Committee of the further steps it had taken in response to Audit's findings.

3.8 The pilot program on audit of withholding tax was conducted in two offices and showed that in three out of four cases examined there was a lack of understanding of the law. Recognising that the level of awareness of responsibilities was not as good as it should be, an education program was to be commenced. However, the ATO advised that, due to higher priority tasks, an explanatory brochure on withholding tax had been produced only recently, and consideration was being given to what further action was required.[4]

3.9 The ATO also indicated that withholding tax has been highlighted in the ATO's audit planning processes. It was the subject of audit attention in 12 of the cases audited as part of the large case program for 1989/90. For 1990/91, plans include 10.3 staff years directed at 28 cases specifically selected on this issue.[5]

3.10 On the question of utilising relevant information from outside the withholding tax area, the ATO noted that a cross-group task force has been established to ensure coordination of withholding tax activities across all functional areas of the ATO. The task force is considering the use of a range of sources, including many from outside the ATO, such as the Australian Customs Service, the Australian Federal Police, the CTRA, and overseas taxation authorities.[6]

3.11 On computer systems support, the ATO advised that the withholding tax area has been allocated a place according to the ATO's priorities for modernising and redeveloping each of its functional areas. As the redevelopment is not due until 1993/94, the ATO indicated that an interim redevelopment would take place. A micro computer systems support project has been trialled successfully, and the first phase has been implemented. The remaining phases were to be in place by December 1990.[7]

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3 ibid p.19

4 Evidence p.S15

5 Evidence p.S15

6 Evidence p.S16

7 Evidence p.S16

Administrative arrangements

3.12 In assessing the adequacy of the ATO's administrative arrangements in the withholding tax area, the Committee identified the following matters of concern which remained in spite of the steps taken to address Audit's findings:

- there is no formal registration form;
- the system does not seek to identify those withholding tax payers which are acting in the capacity of trustee;
- there is no automatic follow-up in relation to registered withholding tax payers who cease remitting;
- there is no linkage between the withholding tax system and the ATO's National Taxpayer Computer System; and
- there is an absence of meaningful statistics collected from withholding tax data available to the ATO which could assist in audit risk assessment.

3.13 The ASCPA echoed the concerns about follow-up action in relation to non-remitters. It stated:

> ... the ATO should, in our view, structure its Withholding Tax administration so that once registered, follow-up action should ensure that there is no non-remittance in a subsequent period. This is especially important where the non-remitter is a financial institution using the wrongfully-retained Withholding Tax as a financing tool.[8]

3.14 In response to the above concerns, the ATO advised the Committee of measures which are being considered and implemented in the withholding tax area to improve existing administrative arrangements.

3.15 The ATO will be introducing a registration form for the residents withholding tax system as part of the tax file number system. The new system is to be operational by 1 July 1991. Development of the residents withholding tax system is being undertaken in a way which will include modernisation of the

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8 Evidence p.S99

non-resident withholding tax data base also by 1 July 1991, and modernisation of the accounting aspects of non-resident withholding tax shortly thereafter.

3.16 The new registration form is expected to clearly identify whether payers are making payments in their own right or in the capacity of a trustee. The ATO is also planning to follow-up cases where a registered payer has ceased remitting. This action will assist the ATO in updating its data base, and will also highlight cases where withholding tax payments have not been remitted to the ATO. In addition, the ATO is considering an annual follow-up of payers who cease to remit.

3.17 In relation to collection and analysis of statistics, the ATO advised that, as part of the tax file number legislation, a quarterly report will be required of financial institutions which will identify information on non-resident investors relevant to treaty countries and the ATO. This reporting system is due to commence in July 1992.[9]

3.18 The ATO also informed the Committee that there are future plans to link the payer withholding tax number with the person/entity income tax file number, as well as with other ATO systems, such as sales tax registrations.

Conclusions

3.19 The Committee endorses the proposed changes aimed at tightening the ATO's administration of the withholding tax system. The low priority accorded to the withholding tax area by the ATO was evident from the absence of administrative controls which are now being implemented by the ATO. In the view of the Committee, the lack of administrative controls in this area has been an important factor contributing to the continued abuse of the withholding tax provisions through non-resident beneficiary and other tax avoidance/evasion arrangements.

3.20 There are, however, some matters which warrant further attention by the ATO. These are detailed in the remaining sections of this chapter.

Non-resident verification

3.21 Under the new tax file number legislation, taxpayers who do not notify financial institutions of their tax file number will have tax withheld at the top marginal rate on any interest income which is earned. Non-residents, however, will be exempt from these provisions.

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9 Evidence p.S289

3.22 It was suggested to the Committee, as noted at Chapter 2 of this report, that one tax evasion arrangement which is in use involves Australian residents placing some of their funds in bank accounts which are in the names of non-residents.[10] The interest on these funds is subject to only 10 percent withholding tax. The new tax file number legislation will not impact on such arrangements, because of the exemption for non-residents from the tax file number requirements.

3.23 The ATO advised the Committee that the exemption of non-residents from the tax file number requirements has been identified by the ATO and banks as a problem which could allow residents to avoid the tax file number requirements and shelter interest income from the ATO.[11] Interestingly, the ATO indicated that an increase in the number of registrations for withholding tax has coincided very closely with an advertising campaign for the investment phase of the tax file number arrangements commencing on 1 July 1991.[12]

3.24 In response to this problem, the ATO has established a joint working party with financial institutions with the aim of determining the proof which should be required from taxpayers or investors who indicate that they are non-residents, and who therefore are exempt from the tax file number requirements. The ATO commented:

> If we get that proof of non-residency right ... there will be three choices: either a person has a tax file number; a person proves he is a non-resident; or a person pays the top marginal rate.[13]

Conclusions

3.25 The integrity of the new tax file number system could be jeopardised if more stringent requirements are not placed on those who claim non-resident status to prove that they are actually non-residents. While the provisions of the new CTR Act would apply to proof of identity, they would not ensure that the person opening a bank account or investing in a financial institution was a non-resident, and therefore eligible to obtain the lower withholding tax rate applying to interest income earned in Australia.

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10 Evidence p.S56

11 Evidence p.841

12 Evidence p.842

13 Evidence p.860

3.26 The Committee notes that the ATO has identified the problem and is working with financial institutions towards a solution. Measures in this regard need to be implemented to coincide with the introduction of the tax file number requirements. These measures should ensure that where a taxpayer or investor is unable to provide a tax file number, or unable to provide proof of non-residency, then tax should be withheld at the top marginal rate on interest income earned in Australia.

3.27 The non-resident verification system recommended by the Committee also should be used to establish whether a non-resident is acting as a trustee for Australian residents investing in Australian financial institutions. It would be insufficient to simply verify the non-resident status of an investor, as the investor may be acting in the capacity of trustee for an Australian resident. It was apparent to the Committee that the ATO did not have a strategy for examining non-resident investments to determine, to the extent practicable, whether a given investment is in effect beneficially owned by a resident. Such a strategy should be developed.

Recommendation 8

3.28 **The Committee recommends that the tax file number system be modified to incorporate non-resident verification procedures, which should require persons/entities depositing funds in Australian financial institutions to provide proof that they are non-residents before they are eligible to have tax deducted at the interest withholding tax rate of 10 percent on interest earned. Where adequate proof is not provided, tax should be withheld at the top marginal rate.**

Recommendation 9

3.29 **The Committee recommends that the Australian Taxation Office, through the non-resident verification procedures proposed at recommendation 8, seek to identify whether a non-resident investing funds in Australia is acting in the capacity of trustee for an Australian resident.**

Statistical analysis

3.30 One of the concerns which remained for the Committee was the emphasis placed on the collection and analysis of data on withholding tax by the ATO as part its efforts to combat tax avoidance and evasion. Given the increasing emphasis on self assessment, the Committee was eager to ensure that sufficient attention was being directed by the ATO towards the availability

of meaningful data which could be used by ATO auditors in assessing risk and selecting cases for investigation in the withholding tax area.

3.31 The ASCPA appeared to share the Committee's concerns when it queried the wisdom of the ATO, under the self assessment process, dispensing with the need to disclose the details of the persons to whom interest is paid.[14]

3.32 In its submission, the ATO informed the Committee that it is unable to give a definitive answer on the number of foreign investors receiving income subject to withholding tax. The ATO indicated that although it receives listings of gross interest and dividends payments as part of an annual reconciliation process, much of this is in paper form and cannot readily be processed. It noted that many reports represent very small amounts of income and systematic processing of these could not be cost-justified.[15]

3.33 However, the ATO also advised that an increasing amount of information is being received on magnetic media. Processing of this information has been undertaken as part of the ATO's information exchange arrangements with a number of overseas tax authorities. The ATO indicated that a number of overseas countries actively seek information on foreign investors earning income in Australia, and provide the ATO with corresponding information concerning Australian residents receiving overseas income. Information of this kind is being used in audit projects.[16]

3.34 Relevant also is the planned introduction of the Annual Income Investment Report, as noted at paragraph 3.17 of this report, which is due to be operational by July 1992. This reporting system is expected to provide a wide range of information on non-resident investments in financial institutions.

Conclusions

3.35 In a self assessment environment, it is vital that sufficient meaningful information is available to ATO auditors to facilitate selection of cases for audit, and for identification of those areas of revenue collection where there is greatest risk of evasion and avoidance. This was recognised by the Committee in an earlier report on the ATO, *A Taxing Review* (May 1988), in which it recommended that the ATO 'investigate greater itemisation of income and expenditure on taxation returns having regard to items that would most facilitate audit activities in the self-assessment environment'.

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14 Evidence p.S102

15 Evidence p.S104

16 Evidence p.S104

3.36 In the withholding tax area, the payment of interest income to non-residents is a primary characteristic of the tax avoidance arrangements which have been described to the Committee, including non-resident beneficiary schemes and back to back loan arrangements. Accordingly, interest expenses incurred by individuals and entities should be seen as an important initial source of information for ATO auditors in tracing participants in withholding tax arrangements.

3.37 Under the existing assessment system, though, interest expenses are not required to be itemised in income tax returns. The Committee concurs with the ASCPA in questioning the wisdom of this practice. It is the view of the Committee that interest expenses should be itemised on tax return forms to facilitate audit activities aimed at combating tax avoidance arrangements.

3.38 As for other sources of information on withholding tax, the Committee welcomes developments aimed at improving the ATO's data base on non-resident investment in Australia, particularly the proposed Annual Income Investment Report. The Committee considers that, to be useful in relation to the detection of tax avoidance/evasion arrangements, these sources of information need to be monitored systematically and that, as part of audit case selection processes, particular attention should be directed to higher risk categories of activity. These would include interest payments made to non-residents living in non-treaty countries, particularly those made through discretionary trusts and private companies. The quantum of an interest payment is also a relevant risk factor.

Recommendation 10

3.39 **The Committee recommends that details of interest payments claimed by taxpayers should be itemised in tax returns lodged with the Australian Taxation Office.**

Exchanges of information

3.40 As the tax avoidance arrangements described to the Committee always involve non-residents, the ATO's ability to obtain evidence from overseas is an important factor in its efforts to detect and act against such arrangements. Cooperation between the ATO and overseas taxation administrations is a vital component of the ATO's enforcement strategy.

3.41 Exchanges of information with overseas taxation administrations are governed by comprehensive income tax agreements or conventions, commonly referred to as double taxation agreements. As at 31 January 1990, Australia has entered into 26 double taxation agreements, which include agreements with the majority of Australia's major trading partners.

3.42 Australia's double taxation agreements are based on the Organisation for Economic Co-operation and Development 1977 Model Convention. Generally, the two primary objectives of the agreements are the avoidance of double taxation and the prevention of fiscal evasion.

3.43 The ATO indicated that exchanges of information are either automatic, spontaneous or specific. Automatic exchanges mainly involve details of interest and dividends derived by Australian residents in overseas jurisdictions and vice versa. Spontaneous exchanges arise where, in the course of an audit, the ATO discovers information which is considered to be of value to an overseas jurisdiction. Specific exchanges occur where information regarding a specific taxpayer is requested.[17]

3.44 The ATO noted that automatic exchanges are generally high volume and, because of the paper burden and the very small amounts of income which often are involved, are not as useful as they could be. It advised, however, that these routine exchanges are in the process of becoming automated, which will enable the ATO to maintain accurate statistics and quickly judge the usefulness and cost effectiveness of the information provided.[18]

3.45 In this regard, the ATO advised that it recently provided its first exchange of magnetic data under the provisions of a double tax agreement to the Internal Revenue Service (IRS) in the United States. The data related to details of dividend and interest income derived in Australia by United States residents and will be part of the IRS automatic income matching process. The IRS is to supply the ATO with comparable magnetic data. The ATO also indicated that similar magnetic data has been sent to the taxation administration in Canada. In addition, it was noted that discussions for reciprocal exchanges with other treaty partners have commenced.[19]

Conclusions

3.46 The ability to gather information overseas is crucial to any international enforcement program. If there is a perception that there is little chance of tax avoidance arrangements being detected, or of the facts and circumstances surrounding those arrangements coming to light, then this will influence the number of individuals or entities prepared to enter into such arrangements.

3.47 International transactions present tax administrators throughout the world with a number of major enforcement challenges, particularly arising from the difficulties associated with collection of evidence overseas. It is these difficulties

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17 Evidence pp.S287-S288

18 Evidence p.S287

19 Evidence p.S287

which need to be targeted to improve the information gathering processes, and to minimise the impact of national boundaries on the efforts of tax administrators in combating tax avoidance/evasion.

3.48 The tax avoidance arrangements investigated by the Committee generally involve the channelling of funds through countries with which Australia has not entered into double taxation agreements, particularly tax havens. The arrangements rely on the fact that, in such countries, Australia does not have the authority to exchange information which would enable an assessment of the true nature of the arrangements.

3.49 The Committee notes that section 264A of the ITAA was recently enacted to assist the ATO in its international enforcement activities. This section imposes an evidentiary sanction in respect to foreign documents or information where there has been a previous failure to comply with an ATO request to provide that information.

3.50 To further assist the ATO in overcoming barriers to obtaining information overseas, it is the view of the Committee that the establishment of double taxation agreements should be actively pursued with countries which have comparable tax regimes to Australia. Increasing the network of treaties will make it more difficult for tax evaders to escape the information sharing net.

3.51 In relation to countries with which Australia already has double taxation agreements, the Committee welcomes the moves to improve the quality of the information sharing processes through automation of those processes. It is important that the ATO continue to pursue vigorously the automation of information exchanges with all countries with which Australia has double taxation agreements.

3.52 To further facilitate information sharing with treaty countries, the Committee considers that ATO officers should be posted to selected treaty countries to coordinate and, with the approval of the overseas tax authority, collect data on behalf of ATO officers in Australia. Such a move would signal that the ATO is serious in its efforts to chase down information from overseas jurisdictions in order to deter tax avoidance arrangements.

Recommendation 11

3.53 **The Committee recommends that the establishment of comprehensive taxation agreements be pursued actively with countries which have comparable tax regimes to Australia.**

Recommendation 12

3.54 **The Committee recommends that officers of the Australian Taxation Office be posted overseas to facilitate exchanges of information with overseas taxation administrations.**

Prosecution strategy

3.55 A further issue identified by the Committee was the importance of prosecution actions as a deterrent to tax avoidance arrangements.

3.56 One of the problems highlighted by the ATO in relation to prosecutions involving the type of tax avoidance arrangements described to the Committee was the difficulties which often are faced in obtaining sufficient evidence to mount a successful prosecution, particularly if that evidence needs to be obtained from overseas. These difficulties have been noted already at paragraph 2.42 of this report. To emphasise this point, the ATO stated:

> There is unfortunately a bit of difference between what we would say is a sham for the purpose of raising assessments where the onus is very much on the taxpayer to substantiate the claim, and what might be necessary on evidence to go to prosecution.[20]

3.57 As an example, the ATO noted that in relation to 500 withholding tax cases examined in Sydney, over half were identified as shams in the sense that the taxpayers were unable to satisfy the ATO that the claims made were not excessive. The ATO indicated that it did not follow necessarily that the ATO would have had sufficient evidence to take those cases on to prosecution.[21]

3.58 The ATO also advised that in Melbourne in particular it has sought to prosecute tax agents who have been the promoters of tax avoidance arrangements. In one case, the Director of Public Prosecutions decided that there was insufficient evidence to pursue the case further, while in another case, where significant evidence had been collected, the matter was still being pursued. In relation to the agents' clients who had entered into the arrangements, the ATO noted that assessments were being raised, but prosecution action had not been initiated.[22]

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20 Evidence p.857

21 Evidence p.857

22 Evidence pp.741-742

3.59 The Committee questioned the ATO about the extent to which actions against tax agents and taxpayers involved in tax avoidance arrangements are publicised. The ATO replied that a full scale publicity campaign had not been mounted in this area.[23] However, it indicated that the ATO's actions in investigating 500 cases in Sydney and raising assessments against a proportion of these would have become known in the professions and would have had the effect of discouraging others from entering into such arrangements.[24]

Conclusions

3.60 Prosecution action is an important weapon in the ATO's efforts to combat tax avoidance arrangements. Successful prosecutions provide an effective deterrent to those who would contemplate entering into such arrangements.

3.61 The Committee acknowledges that a different evidentiary burden exists in relation to raising of assessments as compared to initiation of prosecutions. Nevertheless, it is the view of the Committee that because of the higher deterrence value attaching to prosecutions, the ATO should pursue prosecution action vigorously whenever there is sufficient evidence to warrant such action. Where possible, prosecutions should be initiated against not only the promoters or instigators of tax avoidance arrangements but also the participants in such arrangements.

3.62 The true deterrence value of prosecutions and other enforcement actions of the ATO will be realised only if there is adequate publicity given to such actions. By appropriately publicising its enforcement activities, the ATO can send a clear signal to promoters of and participants in tax avoidance arrangements that the ATO is determined to prevent such arrangements and will penalise those who are involved.

Recommendation 13

3.63 **The Committee recommends that, where possible, the Australian Taxation Office should pursue prosecution action vigorously against both the promoters of and participants in tax avoidance arrangements.**

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23 Evidence p.857

24 Evidence p.740

Recommendation 14

3.64 The Committee recommends that the Australian Taxation Office publicise widely any prosecution or other enforcement activities initiated against promoters of and participants in tax avoidance arrangements.

CHAPTER FOUR

OVERSEAS CHARITIES

Allegations of tax avoidance

4.1 As part of the Committee's investigation of tax avoidance arising from the withholding tax provisions of the ITAA, it was alleged that overseas charities also are being used for tax avoidance purposes.[1]

4.2 Under existing legislation, Australian residents can receive tax deductions for donations made to charitable organisations. Under section 78 of the ITAA, a tax deduction can be claimed for gifts of $2 or more made to organisations either specifically listed in that section or listed under a broad category of organisations included in that section. Alternatively, a gift may be made as a trust distribution of income to an organisation which has an exemption from income tax under section 23e or 23j of the ITAA. This includes religious, scientific, charitable or public educational institutions. As the distribution can be made from the trust's pre-tax profit, the equivalent to tax deductibility is achieved in making the distribution.

4.3 The allegations of tax avoidance made to the Committee related to the distribution of trust income to charitable organisations. Ms Barbara Smith described to the Committee tax avoidance schemes which had been brought to her attention involving Australian resident trusts making distributions to overseas charitable trusts.[2] Under the alleged schemes, trust distributions are remitted offshore to overseas charitable trusts, which return the funds to the original donor, minus a commission. The return of funds is effected either by depositing them in an offshore bank account for use by the donor or by making payments to the donor's international credit card. The net effect of the schemes is that the tax liability of the resident trust is reduced, because the donation is deducted from the trust's pre-tax profit, while the donated funds are reimbursed.

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1 Evidence p.S66

2 Evidence p.S66

4.4 Ms Smith further alleged that the ATO automatically exempted overseas charities from tax if those charities were exempt from tax in their own countries.[3] It was suggested that, as a result, the ATO had little control over the overseas organisation being granted the tax exemption. It was also suggested that some overseas organisations which are exempt from tax in their own country may not be the type of organisation which should be supported by the Australian revenue.

4.5 To support her claims about the problem of trust distributions to overseas charities, Ms Smith once more referred to an ATO internal memorandum from the Manager Complex Audit, Melbourne to the Commissioner of Taxation (previously noted at paragraph 2.26 of this report). In that memorandum, it is noted that the number of trusts distributing income to non-resident charities is increasing. While it was acknowledged that exact figures are difficult to produce, it is estimated that trusts are making distributions to non-resident charities to the extent of tens of millions of dollars annually.[4]

4.6 In the ATO memorandum, it is suggested that:

> Urgent legislation modifications to the exemption provisions of sections 23 and 90 should be initiated to eradicate purported distributions to charitable institutions which appear to have been established or used for the purpose of the avoidance, or to take advantage of the exemption provisions now currently in existence.[5]

4.7 In discussions with ATO auditors from Melbourne, the Committee was able to clarify that the purpose behind the internal memorandum referred to by Ms Smith was to alert the ATO's National office to the potential for abuse in the area of trust distributions to overseas charities.

4.8 To further support her claims, Ms Smith provided a copy of an internal minute of the ATO dated 5 February 1990 from the Second Commissioner of Taxation to the Deputy Commissioner of Taxation, Melbourne, also obtained under the provisions of the Freedom of Information Act. In that document, the Second Commissioner of Taxation noted concerns about tax avoidance arrangements, including those involving distributions of trust

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3 Evidence p.720

4 Exhibit 6 p.4

5 Exhibit 6 p.5

income to overseas charities. While indicating that the ATO would be acting against such arrangements, the Second Commissioner also stated:

> We do not, at this stage, entirely rule out the possibility that a change in the law may be required and is feasible.[6]

Response to allegations

4.9 In response to the above allegations, the ATO advised that it did not have evidence of any significant abuse involving charities returning income to non-residents.[7] The ATO indicated that it conducted extensive inquiries into two overseas charitable bodies which had received significant income from Australian trusts. However, no evidence could be found to substantiate a case that the payments were anything other than gifts.[8]

4.10 The TIA concurred with the ATO's views on the prevalence of tax avoidance schemes involving overseas charities. TIA stated:

> To be quite frank, those types of arrangements we just never see these days. Since Part IVA [of the ITAA] came into existence we just do not see looping and charity type arrangements. That is not to say that some tax agents might believe that they work and suggest to their clients that they should undertake them, but we just do not see them.[9]

4.11 Mr Leibler argued that the alleged arrangements are really reimbursement arrangements, which are illegal. However, Mr Leibler conceded that a specific anti-avoidance provision directed at tax avoidance arrangements involving overseas charities could be introduced to combat less blatant cases of avoidance.[10]

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6 Exhibit 32 p.57

7 Evidence p.950

8 Evidence p.S19

9 Evidence p.763

10 Evidence p.917

4.12 In regard to the concern that it was abrogating responsibility in relation to granting of tax exemptions, the ATO indicated that the test for tax exemption of overseas charities is double-barrelled. It involves determining whether the organisation is a charity by Australian standards, and then whether it is exempt from tax in its own country.[11]

Conclusions

4.13 The Committee did not receive any substantial evidence that tax avoidance schemes involving trust distributions to overseas charities are being perpetrated in Australia on a significant scale. From the available evidence, it cannot be concluded that an increase in funds directed by resident trusts to overseas charities, as pointed out in an internal memorandum of the ATO, signals an increase in tax avoidance activity.

4.14 Nevertheless, it is evident that within the ATO there are some concerns about the potential for tax avoidance in the area of trust distributions to overseas charities. This potential is clearly enhanced by the fact that the tax avoidance arrangements described to the Committee generally involve non-treaty countries, which creates difficulties for the ATO in relation to obtaining evidence against such arrangements.

4.15 The Committee notes that in the late 1970s charity schemes involving domestic charities were used as a tax avoidance mechanism. The then government acted against these schemes by introducing a specific anti-avoidance provision in section 78A of the ITAA.

4.16 It is the view of the Committee that a specific anti-avoidance provision similar to section 78A should be introduced to counter the potential for tax avoidance which exists in relation to distributions of trust income to non-resident charities. The introduction of this measure would signal to those who consider that such tax avoidance arrangements are still effective the clear intention of the Parliament to eradicate the potential for tax avoidance hidden within the guise of donations to overseas charities.

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[11] Evidence p.949

Recommendation 15

4.17 **The Committee recommends that the *Income Tax Assessment Act* 1936 be amended to introduce a specific anti-avoidance measure, similar in effect to section 78A of that Act, whereby income tax exemption for trust income distributed to overseas charities would be denied in cases where such distributions form part of a reimbursement arrangement. In such cases, the income should be included as part of the trustee's assessable income.**

Statistics on charities

4.18 A broader issue arising from the Committee's investigation of tax avoidance involving charities was the extent to which the ATO is able to establish to what degree the Australian revenue, through tax deductions and exemptions from income tax, subsidises charitable organisations.

4.19 In this regard, the ATO indicated that it is unable to provide any precise figure on the amount of revenue which has been distributed by Australian resident trusts to overseas charities.[12] In addition, statistics are not available on donations to charitable organisations listed under section 78 of the ITAA. Under the self-assessment system, such donations are not required to be shown as a separate deduction item on income tax returns.

4.20 The ATO pointed out that while section 78 donations could be listed as a separate item on income tax returns, and statistics could be maintained in this regard, the keeping of such statistics has a cost which needs to be weighed up against the benefits which are to be gained.[13]

Conclusions

4.21 The collection and analysis of meaningful statistics has an important purpose in taxation administration. It provides a basis from which an assessment can be made of cases to be selected for audit activity, as well as an assessment of the areas of revenue collection which may be most at risk from tax avoidance arrangements. From a broader perspective, it provides policy makers with a base of information which can assist in assessing the appropriateness and adequacy of existing laws and administrative arrangements.

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12 Evidence p.S379

13 Evidence p.952

4.22 It is evident to the Committee that in relation to charities, limited information is available on the degree to which the Australian revenue subsidises organisations listed under section 78, through tax deductibility for donations, and other charities, through exemption from income tax. In the view of the Committee, the absence of meaningful statistics in this area impacts on the ability of the ATO to assess the extent to which the revenue is at risk from tax avoidance arrangements which may involve distributions to charities. It also limits the ability of policy makers to assess the appropriateness of existing mechanisms for supporting charities within the taxation system.

4.23 The Committee accepts that costs of collecting and analysing data need to be weighed up against the benefits. Given that there is a perception within the ATO that distributions to overseas charities have become increasingly popular, and given that there are concerns about the potential for tax avoidance in this area, the Committee considers that improved collection and analysis of statistics by the ATO in relation to charitable donations is warranted.

Recommendation 16

4.24 **The Committee recommends that, in order to assess the impact on the Australian revenue of existing tax benefits available for donations to charitable organisations, the Australian Taxation Office collect statistics on:**

- **donations for which tax deductibility is claimed under section 78 of the *Income Tax Assessment Act* 1936; and**
- **distributions of trust income to charitable organisations.**

Recommendation 17

4.25 **Consequent upon Recommendation 16, the Committee recommends that donations made to organisations listed under section 78 of the *Income Tax Assessment Act* 1936 be itemised in income tax returns lodged with the Australian Taxation Office.**

CHAPTER FIVE

CASH TRANSACTION REPORTS ACT

Operation of the Act

5.1 One of the issues addressed by the Committee was the operation of the *Cash Transaction Reports Act* 1988 (CTR Act) in relation to international profit shifting.

5.2 The CTR Act is a Commonwealth Government initiative to monitor the movement of currency within Australia and into and out of Australia. The CTR Act provides the basis by which suspicious financial activity and major cash transactions are to be reported to the Cash Transaction Reports Agency (CTRA). The CTRA has been created to receive reports, and to analyse and disseminate information relating to those reports to taxation and law enforcement authorities in Australia.

5.3 The cash transactions reporting system replaces a system of tax screening arrangements and foreign exchange controls. Tax screening arrangements ceased to operate from 1 July 1990.

5.4 The objective of the cash transactions reporting system is to detect and inhibit tax evasion, money laundering and other financial fraud and crime.

5.5 The CTRA package comprises two elements:

- reporting of suspicious and large cash transactions to the CTRA by banks, other financial institutions, financial corporations and gambling institutions; and
- identification and verification requirements for new account holders, coupled with a prohibition on operating false name accounts.

5.6 The information to be collected basically comprises:

- reports on cash movements into and out of financial institutions and other cash dealers of $10,000 or more;
- reports on cash movements into and out of Australia of $5000 or more; and
- reports by cash dealers on suspicious financial activity.

5.7 To assist financial institutions to understand and identify suspect transactions, the CTRA has produced guidelines which set out a list of techniques which may be used or activities which may be undertaken to launder money, evade taxation or commit offences against Commonwealth law. The examples included in the guidelines are not exhaustive but are intended as a general guide for determining a basis for reporting suspect transactions.

5.8 In its submission, the CTRA noted that, although it is still in the establishment stage, since January 1990 it has received some 3000 suspect transaction reports which have brought to light the following matters:

- low to medium level tax cheating in the cash economy;
- a large number of alleged social security frauds;
- people hiding money in false name accounts;
- higher levels of tax cheating and fraud;
- unusual transactions, often in cash and suggestive of criminal activity associated with drug money laundering;
- international telegraphic transfers that were just under the previous Reserve Bank/ATO reporting requirements, or which were unusual having regard to the customer's business, occupation and other factors; and
- laundering of cash associated with criminal activity and tax evasion.[1]

5.9 The CTRA advised that approximately 80 percent of all reports are being referred to the ATO, with a proportion of those and the remaining matters being referred to law enforcement agencies for additional consideration. It was anticipated that approximately 7000 to 8000 suspect transaction reports would be referred to the CTRA by cash dealers in the first 12 months of reporting.[2]

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1 Evidence pp.S4-S5

2 Evidence p.S5

Detection of international profit shifting

5.10 The CTRA submitted that the provisions of the CTR Act have assisted in opening a window into the Australian financial system which will help the ATO and law enforcement agencies with their enquiries into international profit shifting. It was noted that some international telegraphic transfer transactions have been reported to the CTRA in the form of suspect transactions. It was suggested, however, that this may be only the 'tip of the iceberg' in international profit shifting activities.[3]

5.11 On its ability to detect the types of tax avoidance arrangements described to the Committee and noted in Chapter 2 of this report, the CTRA indicated that it is unlikely that the nets of information intelligence which have been established will impact on the offshore movement of funds through such arrangements. The Director of the CTRA stated:

> These nets have their role in relation to the cash economy and in relation to money laundering - particularly cash money laundering - but I think they have their limitations.[4]

5.12 The CTRA advised that in its reporting system it has not seen evidence of the types of arrangements being investigated by the Committee. It noted that such arrangements may be highly sophisticated and probably would not be recognised in many of the cash systems which deal with large numbers of people. The CTRA indicated that these arrangements would not be caught in the reporting system as they often would not involve cash transactions. The CTRA commented:

> ... the type of thing that has been put to the Committee by Barbara Smith and others and has been discussed is not often cash. If it does exist it will be well and truly in fairly sophisticated corporate mechanisms and therefore it may not be recognised by the tools that we are using.[5]

5.13 The CTRA noted that some pilot work is being conducted with the help of the Australian Merchant Bankers' Association and the major banks to see whether it is possible to develop better mechanisms for detection of suspect activity in the corporate sector of banking.[6]

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3 Evidence p.S7

4 Evidence p.778

5 Evidence p.780

6 Evidence p.779

Conclusions

5.14 The cash transactions reporting system provides a valuable source of intelligence for the ATO and law enforcement agencies in their efforts to combat tax evasion and other crimes. The benefits of the system will be revealed more visibly once it has been operational for some time.

5.15 The value of the system to the ATO in combating international profit shifting, particularly through the withholding tax arrangements being investigated as part of this inquiry, depends to a large extent on the intelligence which is able to be gathered. This in turn depends on the ability of financial institutions and other cash dealers to identify areas of suspect activity. In this respect, the guidelines which have been produced for financial institutions by the CTRA are a necessary and valuable document.

5.16 It is clear, though, from the evidence provided by the CTRA, that, because of the sophistication of the withholding tax arrangements described to the Committee, the likelihood of such arrangements being detected and reported through the cash reporting mechanisms which are currently in place is minimal.

5.17 In this regard, the Committee considers that the ATO has an important role in keeping the CTRA informed of the intelligence which is required by and is useful to the ATO in its pursuit of international profit shifting. The ATO should also play an active role in suggesting ways in which there could be improvements to the intelligence gathering processes.

5.18 It is the view of the Committee that, in the withholding tax area, the ATO should work with the CTRA towards the development of indicators which would assist financial institutions and cash dealers to identify information which could be reported to the CTRA and subsequently used by the ATO in investigating tax avoidance arrangements which take advantage of the withholding tax provisions. These indicators should supplement the guidelines on areas of suspect activity already produced by the CTRA.

Recommendation 18

5.19 **The Committee recommends that, to supplement the Guidelines on Areas of Suspect Activity issued to financial institutions and other cash dealers, the Cash Transaction Reports Agency, in conjunction with the Australian Taxation Office, develop indicators which would assist financial institutions and other cash dealers to identify information which could be reported to the Cash Transaction Reports Agency and subsequently used by the Australian Taxation Office in its investigation of tax avoidance arrangements involving withholding tax.**

Telegraphic transfers

5.20 The reporting system established by the CTR Act focuses on cash movements and transactions.

5.21 It was suggested to the Committee that, because of this focus, the system is deficient in its application to non-cash funds remitted to other countries. The TIA noted that the system only applies to the physical transfer of foreign currency. As an example, the TIA indicated that the system would not apply where A$1 million was remitted to a tax haven, as the transfer would not be made in the form of notes and coins nor in the form of foreign currency. It was argued that, in this respect, the system is narrower in its scope than the former tax screening system.[7]

5.22 The CTRA confirmed that the existing reporting system does not involve monitoring of telegraphic or wired transfers, although it was noted that some telegraphic transfer transactions have been reported to the CTRA in the form of suspect transactions.[8]

5.23 The CTRA advised, however, that the Attorney-General has asked it to consider whether it would be possible to include in the existing intelligence net a system for monitoring wired transfers.[9] So far discussions have been held with senior tax enforcement officials on how such a system would work and what benefits it would bring.[10]

5.24 The preliminary view of the CTRA is that a system for monitoring telegraphic transfers is feasible. It was considered that the principal benefit would be in obtaining intelligence which would provide a starting point for the ATO and law enforcement agencies to follow a trail of profit or money movement. The CTRA stated:

> ... one of the things that could be done would be to monitor wired transfers so that they have them all in front of them. Then, if a tax auditor is trying to look at some scam and wants to see whether there has been offshore transportation, they have a data base in front of them which effectively comes out of the bank and the swift telegraphic transfer system which tells them where to start.[11]

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7 Evidence p.S88

8 Evidence p.S7

9 Evidence p.780

10 Evidence p.781

11 Evidence p.781

5.25 The CTRA noted that, in its understanding, 85 percent of non-cash fund transfers are remitted offshore through the telegraphic transfer system.[12]

5.26 Before a system of monitoring wire transfers can be put in place, the CTRA indicated that consideration needs to be given to whether minor fund transfer mechanisms, such as telexes, would be included. In addition, discussions are required in relation to the cooperation of financial institutions, and on technical issues. Most importantly, though, the CTRA considers that there needs to be a commitment from government to the establishment of such a system, and legislation needs to be introduced.[13]

Conclusions

5.27 It is evident that telegraphic or wire transfers are the predominant means by which funds are channelled from Australia overseas. The cash transaction reporting system which has been established, though, does not monitor such transfers. The Committee considers this to be a notable deficiency, as it precludes the ATO from an important source of intelligence in its efforts to combat international profit shifting.

5.28 The capture and analysis of telegraphic transfer data would add a significant dimension to the ability of the ATO and law enforcement agencies to strike at the major incentive behind international organised crime - financial gain. In addition, the intelligence provided by this data should enhance the ATO's ability to detect and investigate international profit shifting arrangements of the kind focused on by the Committee in its earlier reports on international profit shifting, *Shifting the Tax Burden?* (November 1988) and *Taxpayers or Tax Players?* (May 1989).

5.29 The Committee, therefore, welcomes the consideration being given by the CTRA to a system of monitoring telegraphic transfers, and is encouraged by the CTRA's preliminary view that such a system is feasible. The Committee sees the need for a positive commitment to the introduction of a system of monitoring telegraphic/wire transfers in order that such a system can be implemented as soon as practicable.

Recommendation 19

5.30 **The Committee recommends that a system for monitoring and reporting telegraphic/wire transfers of funds be implemented, with the Cash Transaction Reports Agency responsible for the establishment and administration of such a system.**

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12 Evidence p.782

13 Evidence pp.781-782

Non-resident bank accounts

5.31 One allegation made to the Committee, as noted at paragraph 2.23 of this report, was that Australian residents are holding funds in bank accounts in the names of non-residents in order to take advantage of the lower 10 percent withholding tax payable on the interest earned on those funds. The ATO admitted that it was aware that this practice was occurring, but that it did not know the extent of the problem.

5.32 The new identification requirements of the CTR Act in relation to opening of bank accounts will make it more difficult for residents to open bank accounts in the names of non-residents. However, these provisions do not appear to deter a non-resident from opening an account in accordance with all the correct procedures and then allowing a resident to operate that account. While the CTR Act also includes a prohibition on the operation of false name bank accounts, it is debateable whether an account in the name of a non-resident operated by a resident would fall into this category if the non-resident actually exists.

Conclusions

5.33 The Committee is concerned that despite all the identification requirements and prohibitions of the CTR Act, there may still be the opportunity for Australian residents to gain a tax advantage by holding funds in accounts which are opened in the names of non-residents. If an account is opened by an actual non-resident, and that non-resident allows a resident to operate out of that account, it is likely that existing prohibitions will not prevent the resident from gaining the benefits of the lower withholding tax rate applying to interest earned on funds in that account.

5.34 It is the view of the Committee that where a non-resident opens an account which is used exclusively or predominantly by a resident for the benefit of the resident, then this should be regarded as the equivalent to operating a false name account. If this is not reflected in the existing law then an amendment may need to be introduced.

5.35 To assist in the detection of such cases, financial institutions should be advised by the CTRA to be wary of residents operating out of non-resident bank accounts and to report as suspect transactions cases where non-resident bank accounts are operated exclusively or predominantly by Australian residents for their own benefit. This practice could be included as an indicator of suspect activity in the Guidelines on Areas of Suspect Activity issued by the CTRA to financial institutions.

Recommendation 20

5.36 The Committee recommends that the Cash Transaction Reports Agency ensure that the prohibition on operation of false name accounts in the *Cash Transaction Reports Act* 1988 is broad enough to prevent the practice of Australian residents gaining the benefit of the 10 percent interest withholding tax rate by operating out of non-resident bank accounts.

Recommendation 21

5.37 The Committee recommends that the practice of non-resident bank accounts being operated exclusively or predominantly by Australian residents for their own benefit be included as an indicator of suspect activity in the Guidelines on Areas of Suspect Activity issued to financial institutions and other cash dealers by the Cash Transaction Reports Agency.

STEPHEN MARTIN, MP
CHAIRMAN

MARCH 1991

APPENDIX 1

SUBMISSIONS

No.	Name of individual/organisation
1	Cash Transaction Reports Agency
2	Australian Taxation Office
3	Ms Barbara Smith
4	Mr T E Kempster
5	The Taxation Institute of Australia
6	Australian Society of Certified Practising Accountants
7	Australian Taxation Office - supplementary submission
8	Ms Barbara Smith - supplementary submission
9	Cash Transaction Reports Agency - supplementary submission
10	Australian Taxation Office - supplementary submission
11	Ms Barbara Smith - supplementary submission
12	Ms Barbara Smith - supplementary submission
13	Mr Mark Leibler
14	Mr Geoffrey Manners
15	Ms Barbara Smith - supplementary submission
16	Australian Taxation Office - supplementary submission

17	Ms Barbara Smith - supplementary submission
18	The Department of the Treasury
19	Australian Taxation Office - supplementary submission

APPENDIX 2

EXHIBITS

No.	Description
The following documents were provided by Ms Barbara Smith:	
1	Article on withholding tax from 'Financial Planning' March 1990
2	Occasional paper entitled 'Withholding tax on interest and dividends'
3	Income tax rulings
4	Press clipping
5	Occasional paper entitled 'Interest withholding tax, its rapid increase as a percentage of total tax revenue, and implications of interest payments and discretionary trust distributions to non-residents in Australia'
6	Australian Taxation Office memorandum
7	Article on withholding tax from 'CCH Journal of Taxation', August/September 1990
8	Occasional paper entitled 'Withholding tax collections'
9	Occasional paper entitled 'Tax planning, avoidance and evasion and non-residents'
10	Document entitled 'Practical applications for the use of tax havens'
11	Article on international transactions from 'Australian Tax Review', March 1979
12	Document entitled 'Tax havens in the Asian/Pacific region'
13	Occasional paper entitled 'Donations, charities, s.23 and tax avoidance schemes'
14	Document entitled 'Two forgotten aspects of Australia's external debt - the increasing AUD debt and interest withholding tax'

15 Article entitled 'Post Keating strategies for small business and professionals'

16 Press clipping

17 Press clipping

18 Document on Australian bearer bonds

19 Document on 99 year floating and fixed rate notes

20 Press clippings

21 Document entitled 'The law relating to taxation of trusts'

22 Alfred Zion, *The Merchants of Melbourne*, Arioso Pty Ltd, North Balwyn, Victoria 1984

23 Transcript of radio interview

24 Letters dated 1.6.90 and 12.6.90

25 Letter dated 8.5.90

26 Undated letter

27 Letter dated 28.7.90

28 Document entitled 'How to structure tax-effective offshore investments'

29 Press clippings

30 Graph on withholding tax

31 Example of round robin transaction

32 Australian Taxation Office memoranda

33 Occasional paper entitled ' Insurance with non-residents, captive insurance companies and tax avoidance'

34 Document entitled 'How to use Pacific tax havens'

The following documents were provided by the Australian Taxation Office:

35 Graph on Australia's foreign debt 1980/81 to 1989/90

36 Graph on Australia's withholding tax collections 1980/81 to 1989/90

The following document was provided by Ms Barbara Smith:

37 Letter dated 24.5.90

The following document was provided by the Australian Taxation Office:

38 Briefing paper for the subcommittee's inspection of the Withholding Tax Unit in Sydney on 3.10.90

The following documents were provided by Ms Barbara Smith:

39 Graphs on interest

40 Press clippings

41 Occasional paper entitled 'Complex tax arrangement'

42 Press clippings

43 Transcript of *Metropolitan Oil Distributors (Sydney) Pty Ltd v Federal Commissioner of Taxation*, 90 ATC 4624

44 Letter dated 20.8.90

45 Paper entitled 'Implications of extending the system of taxing companies to trusts'

46 Press clippings

47 Draft White Paper entitled 'Reform of the Australian Taxation System', June 1985

48 Press clipping

The following documents were provided by the Australian Taxation Office:

49 Taxation statistics 1987/88

50 Briefing paper for the subcommittee's inspection of the Withholding Tax Unit in Melbourne on 1.11.90

The following documents were provided by the Cash Transaction Reports Agency:

51 Draft regulations relating to account opening

52 Draft Guideline No.3: Account opening - verification of identity procedures

53 Draft application for declaration as an identifying cash dealer

54 Draft account opening 100 point check list

55 Draft account opening 100 point check list special provisions

56 Guideline No.1 - Enclosure: Areas of suspect activity - banks, building societies, credit unions

The following documents were provided by Ms Barbara Smith:

57 Address by Mr Frank Costigan, QC to the Australian Institute of Bankers, 7.7.86

58 Occasional paper entitled 'Australian withholding tax on interest and dividends, its use and misuse'

59 Document entitled 'How $130 billion grew into $2103 billion in 30 years ...'

60 Press clippings

61 Comparison of withholding tax rates

APPENDIX 3

WITNESSES AT PUBLIC HEARINGS

Witness/organisation	Date(s) of appearance
Australian Society of Certified Practising Accountants	
Mr Frank Burke Research Consultant	31.10.90
Mr Keith William James Chairman National Tax Advisory Panel	31.10.90
Mr Michael Fuller McKenna Executive Director	31.10.90
Australian Taxation Office	
Mr Trevor Percy Winston Boucher Commissioner of Taxation	3.12.90
Mr Michael D'Ascenzo Assistant Commissioner Self Assessment (also appeared in the capacity of Assistant Commissioner Complex Audit and International)	8.8.90 4.10.90 3.12.90
Mr Richard Charles Matthews Assistant Commissioner Revenue Collection Systems	4.10.90
Mr Vincent Thomas Mitchell First Assistant Commissioner Taxpayer Audit	8.8.90 4.10.90 3.12.90
Mr Brian Martin Nolan Second Commissioner of Taxation (appeared in the capacity of Acting Commissioner of Taxation)	8.8.90 4.10.90
Mr Andrew Veilands Business Manager Revenue Collection Systems	8.8.90

Cash Transaction Reports Agency

Mr William John Coad Director	4.10.90
Mr Neil James Jensen Director's Representative	4.10.90

Department of the Treasury

Mr Robert John James Section Head Business Structures Section	19.12.90
Mr Gregory John Smith Assistant Secretary Business Taxation Branch	19.12.90
Mr Mark Matthew Leibler	31.10.90
Ms Barbara Mary Smith	8.8.90 4.10.90

The Taxation Institute of Australia

Mr Richard Harvey Buchanan President	4.10.90
Mr Karl Geoffrey Petersson Technical Director	4.10.90