

Viewpoint

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For a country to be an international holding company location, it must have a number of favourable tax aspects.

Australia as an International Holding Company Location

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Challenge area

An International Holding Company is usually owned offshore and holds the shares in foreign subsidiaries. For a country to be an international holding company location, it must have a number of favourable tax aspects. These aspects are:

- The holding company must not be taxed on foreign dividends.
- The holding company must not be subject to CGT on the disposal of foreign shares.
- The jurisdiction must have limited foreign accruals rules, such as foreign companies (CFC) rules.
- There should be limited withholding taxes on dividends paid by the holding company.
- There should not be any CGT or transfer taxes on the disposal of shares in the holding company.
- The jurisdiction must have a significant treaty network.
- There should be minimal capital taxes or other indirect taxes in relation to the establishment of the holding company.
- An “optional” aspect – not necessary for a holding company but one that makes the jurisdiction more attractive – is that deductions should be allowed for interest and other financing costs by the holding company in respect of its foreign holdings



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New perspectives

The Government's introduced Tax Laws Amendment (2006 Measures No 4) Bill 2006 will mean that non-residents will no longer be subject to capital gains tax (CGT) on the sale of shares in Australian resident companies, except where those companies hold real estate in Australia.

Traditionally, Australia failed to meet many of the requirements of an international holding company location. Where it did not fail was in relation to capital taxes and its treaty network as:

- There are no capital taxes on capital raisings in Australia.
- Australia has always had a large treaty network. This network is continuously increasing, with the number now standing at 47, with new treaties entered into with Russia and Mexico and updates to the older treaties with the USA and the UK.

In relation to the other matters, recent amendments to the tax law and government announcements of further amendments bring Australia to the forefront of the international holding company locations. The one caveat is that many of the favourable rules only apply to holdings in foreign companies with active businesses. Therefore, while Australia will be useful to hold companies actively engaged in business activities, it will not be so favourable to hold companies involved in passive, investment-type activities.

Recent changes to Australia's tax rules

In the past, Australia only went a short distance in fulfilling the various features mentioned above. In relation to foreign dividends received by a holding company, there had been exemptions for non-portfolio dividends received from companies in certain "listed" jurisdictions (56 in total). For dividends from companies in unlisted jurisdictions, they were only exempt from tax to the extent that they related to profits arising in listed countries. However, effective from 1 July 2004, all non-portfolio dividends received by resident companies from foreign jurisdictions (whether listed or unlisted) are now excluded from the assessable income of the resident company.

Also in 2004, and effective from 1 April 2004, the government introduced a CGT exemption in respect of capital gains earned on the disposal of foreign non-portfolio shareholdings. This exemption is limited to companies engaged in active businesses, and requires the calculation of an "active business percentage", being the proportion of the total assets which are active business assets (the company can use average book values or market values when calculating this percentage). If the percentage is higher than 90%, then the entire gain on the disposal of the shareholding will be exempt from CGT. If the percentage is between 10% and 90%, only a portion of the gain (equal to the active business percentage) will be exempt.

Australia's controlled foreign companies (CFC's) regime has always been a stumbling block for locating a holding company within Australia.

The issue that would then arise for a holding company would be how to on-pay this exempt income to its foreign shareholders, as Australia charges withholding taxes on dividends paid to non-residents. It provides an exemption from withholding tax where the dividend is paid out of fully taxed profits. However, if a holding company earns exempt income, as described above, any dividend paid out of these profits would be subject to withholding tax. Recognising this issue, the government introduced the concept of a “foreign dividend account” in 1994, allowing an Australian company to pay a withholding tax exempt dividend to a foreign shareholder out of dividends received from a foreign subsidiary. Recently, it was recognised that this did not go far enough, as only dividends and not other foreign income (such as the exempt capital gains) would be able to be on-paid. Therefore, in 2005, the “conduit foreign income” rules were introduced, which allow the holding company to pay a dividend to its foreign shareholders out of exempt foreign sources. That dividend would not be subject to Australian withholding tax.

Australia's controlled foreign companies (CFC's) regime has always been a stumbling block for locating a holding company within Australia. Similar to the USA's Subpart F Rules, these rules attribute income of a CFC to its Australian resident holding company. Australia has always exempted most income earned by a CFC in what was termed a “broad-exemption listed country” (this list is limited to seven countries, rather than the longer 56 country list mentioned above), only attributing certain types of concessionary-taxed income. However, for countries not on this list, income that fell into three broad categories—passive income, “tainted services income” and “tainted sales income”—would be attributed back to Australia.

There had always been an exception to this attribution—where the “tainted income” represented less than 5% of turnover—but the broad definitions of tainted income meant that it was not always easy for a CFC to pass this test. The definition of tainted sales income had been narrowed in 1992, so that it only relates to income:

- from the sale of goods that had been sold to or purchased from an associated entity which is also an Australian resident or has an Australian permanent establishment; and
- where the CFC does not substantially alter the goods.

Additionally, in 2004, the definition of tainted services income was also narrowed, so that it now only applies to income from services supplied to an Australian resident. It is slightly broader than the definition of tainted sales income, as it does not require the recipient of the services to be an associate of the CFC.

In relation to the financing side of the holding company, under the ordinary provisions of Australia's tax law deductions would not be allowed for interest or other financing costs incurred for the purpose of earning non-assessable income. This concept would have precluded holding companies from claiming tax deductions for interest paid to acquire its subsidiaries or to fund them by way of equity capital. However, in 2003, a specific provision was inserted allowing a deduction by a company in respect of interest incurred in order to derive non-portfolio dividends received from non-resident companies, notwithstanding that the dividend is not taxable in Australia. Therefore, a deduction (limited by Australia's thin capitalisation rules) would be available to the international holding company.



The rules slice a two-edged razor through the CGT provisions.

In relation to other deductions incurred by the international holding company, these are currently quarantined and can only be used against foreign income in the same class. However, in the 2005 Budget, it was announced that the Australia's quarantining rules for foreign losses would be removed. This provides an increased advantage for using Australia as a holding company location, as it enables any losses incurred by the holding company in relation to off-shore operations to be set-off against any domestic income that that holding company might earn. However, this only has limited application, as it will not apply to deductions incurred in relation to earning dividends from the foreign subsidiary (as the dividends are exempt, the deductions are not allowed), except to the extent that the deductions are interest or financing costs.

One further recent change that should be mentioned concerns stamp duty. Many Australian states charged a 0.6% stamp duty on the transfer of shares in companies incorporated in that state (higher duty is charged on companies with significant amounts of Australian land). In a number of states (Victoria, Western Australia, Tasmania) this 0.6% stamp duty has recently been removed, although the duty still remains for land-rich companies. Additionally, many of the other states have announced that they will abolish this duty. This means that an international holding company can be incorporated in any of these states and it is possible to later transfer shares in that holding company free from stamp duty.

Amendments to the CGT regime for non-residents

The amendments to CGT for non-residents were also announced in the 2005 Federal Budget. It took thirteen months for these rules to be introduced into Parliament, in Schedule 4 of the Tax Laws Amendment (2006 Measures No 4) Bill 2006.

The rules slice a two-edged razor through the CGT provisions. Primarily, they reduce the number of categories of assets that will be considered to be "taxable Australian property" (a new term replacing the existing "necessary connection with Australia", which replaced the original 1985 term of "taxable Australian asset"). There are only five items that are now taxable Australian property:

- taxable Australian real property (which includes mining, quarrying and prospecting rights);
- an "indirect Australian real property interest";
- an asset that has been used in an Australian permanent establishment (PE);
- certain options or similar rights; and
- certain assets of ex-Australian residents.

Conspicuous by their absence are shares in Australian companies and units in Australian trusts, which are the subject of this paper. In addition, there is another piece of good news that concerns the CGT status of assets that have been used in an Australian PE. Currently, Australia seeks to tax 100% of any gain derived from the sale of any such asset. The new rules amend this position to decrease the taxable gain to take into account time when the asset was not used in the Australian PE, for instance, where a branch is sold and the assets moved offshore and used in overseas businesses.

In light of the recent and announced changes to the tax law, Australia is now a serious contender as an international holding company location.

There is one major area where the new rules seek to broaden the Australian tax net. This concerns a new type of “taxable Australian property”, being an “indirect Australian real property interest”. This asset means any interest in an entity, where the entity’s value comes predominantly (that is, more than half) from Australian real property. The rules are drafted in such a way as to enable the tracing through of all interposed entities, and apply to all entities, not just Australian resident entities. There is some relief for passive investors, as portfolio interests (in either the entity being disposed of, or in interposed entities) are ignored. However, for non-portfolio investments in entities owning Australian land, disposals of such investments could well trigger an Australian CGT liability.

However, leaving aside this compliance and enforcement nightmare for the Tax Office, for international holding companies (which are unlikely to hold any land in Australia), puts that last piece in the puzzle, and makes Australia an attractive international holding company jurisdiction.

The way forward

In light of the recent and announced changes to the tax law, Australia is now a serious contender as an international holding company location. It scores positive points in all of the eight categories described above:

- Australian companies are no longer taxable on receipt of dividends received from foreign locations.
- The CGT participation exemption provides an exemption, to the extent that a foreign holding’s assets are active business assets.
- Recent changes to Australia’s CFC rules limit their applicability, particularly where the CFC carries on an active business that does not trade with Australia. However, is still an issue in relation to passive income.
- Conduit foreign income rules allow exempt foreign income to be on-paid with no Australian withholding taxes.
- Where holding company does not own land in Australia, there should now be no CGT on the disposal of shares in that company. Additionally, there is no stamp duty, where the holding company is incorporated in certain Australian states: Victoria, WA, Tasmania (other states are following).
- Australia always has had an extensive treaty network. This is expanding, and older treaties are being updated.
- There have never been any capital taxes or other indirect taxes in relation to the establishment of the holding company.
- Subject to thin capitalization limitations, the holding company can claim deductions for interest and other financing costs incurred in respect of the subsidiaries.

Australia can be used as an international holding company location in two ways. First, it can be used by companies in lower-tax jurisdictions to invest into any of Australia’s treaty partners, enabling (subject to local anti-treaty shopping rules and to the limitation of benefits articles in the USA treaty) the lower treaty rates for dividends flowing out of these jurisdictions.

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Alternatively, companies can invest through Australia into businesses in low-tax jurisdictions. Dividends and capital gains can flow through Australia without any Australian tax. This is useful if dividends paid by Australian companies receive favorable treatment in the home country jurisdiction (for instance, under temporary provisions in the USA's Jobs Creation Act of 2004).

There is one main limitation on the use of Australia, being the requirement that the holding company only own subsidiaries that operate active businesses; it cannot be used to hold investment companies. This is brought out in both Australia's CFC rules and in the CGT participation exemption. The Australian holding company will only be exempt from the CFC rules if the tainted income (broadly, the passive income) represents less than 5% of the foreign company's turnover (note that this requirement is not necessary in relation to CFC's located in the UK, the USA, Canada, France, Germany, Japan and New Zealand). Additionally, the Australian holding company will only be able to obtain the full benefit of the CGT exemption if the active business assets of the foreign company represent more than 90% of the assets of this company. Subject to this proviso, Australia now moves to centre-stage as an international holding company location.

About the author

Nick is the National Tax Counsel of BDO Kendalls. Nick has had extensive experience in advising on corporate tax, international tax and other tax areas. In particular, Nick has worked on inbound and outbound M&A transactions, and on cross-border structuring for individuals and corporations. Nick's specialties are Corporate Tax and Expatriate Taxation.

Nick's areas of experience include conducting corporate tax risk assessments, corporate financing transactions, cross-border investments, corporate reorganisations and transfer pricing. In the expatriate taxation area, Nick advises expatriate executives and other high net wealth expatriates on their complicated arrangements on entering Australia.

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