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Outward Investment : The Branch v Subsidiary Decision

Abstract

Over the past five years the Australian international investor has seen a simple foreign investment income exemption system replaced by a foreign tax credit system which has in turn been replaced by the foreign tax accruals system. The current foreign source income regime allows an exemption for certain types of foreign income and subjects other income to a modified foreign tax credit system. The international investor must now distinguish between listed (tax comparable) countries and low tax jurisdictions as well as whether passive or active business income is to be derived to appreciate fully the Australian taxation implications. In addition to an analysis of the investee's country's taxation system, the corporate investor further needs to consider whether investment should be made via way of branch or subsidiary.

Keywords

foreign investment, taxation, branch operations, subsidiary operations, corporate investments

OUTWARD INVESTMENT: THE BRANCH v SUBSIDIARY DECISION



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Over the past five years the Australian international investor has seen a simple foreign investment income exemption system replaced by a foreign tax credit system which has in turn been replaced by the foreign tax accruals system. The current foreign source income regime allows an exemption for certain types of foreign income and subjects other income to a modified foreign tax credit system. The international investor must now distinguish between listed (tax comparable) countries and low tax jurisdictions as well as whether passive or active business income is to be derived to appreciate fully the Australian taxation implications. In addition to an analysis of the investee's country's taxation system, the corporate investor further needs to consider whether investment should be made via way of branch or subsidiary.

Introduction

This paper looks from an Australian point of view at foreign investment via either a branch operation or a subsidiary. In making a decision as to how to invest in and run operations in a foreign country the taxation laws of and relevant tax treaties between the investor and host country are but one aspect to consider. This paper addresses taxation considerations only and the investor should be mindful of a myriad of other factors such as:

- political and economic stability of the host country;
- the cost and availability of resources such as labour, communication networks, financial institutions, professional advisers, etc;
- the complexity and flexibility of the host country's legal system.

It may be assumed throughout the paper that all shares in the foreign subsidiary are owned outright by an Australian corporate structure and the foreign branch is a division of an Australian company.¹ It has also been

¹ Although a foreign branch may be a division of any Australian entity a subsidiary is generally taken to be a subsidiary company which is defined in *The Macquarie Dictionary* as a company where the controlling interest is owned by another company. Thus, because a branch is generally associated with a corporate structure, and most significant foreign investment is made through corporate structures, this paper is limited in scope to a comparison between a corporate branch and a corporate subsidiary.

assumed that income derived by the branch or subsidiary is foreign sourced rather than Australian sourced income.

Objectives

The aim of this paper is not exhaustively to list all differences between branch and subsidiary foreign investment but to provide a basis for a framework which could be used as a reference for comparative analysis of the subsidiary/branch decision.

In this paper an attempt will be made to:

- define what a branch and a subsidiary are at the outset so that the different ways in which they are taxed become more apparent;
- outline how Australia previously taxed foreign income as a background to how foreign branch/subsidiary income is now treated;
- comment briefly on how New Zealand, the United States of America, the United Kingdom and Hong Kong tax Australian branch/subsidiary income;
- discuss what, if any, Australian legislative changes should be made to provide greater parity between foreign source income derived by either a branch or a subsidiary.

This paper largely restricts its analysis to a comparison between the remittance of dividend and derivation of branch profits. It should be noted that foreign profits may also be remitted to Australia in the form of interest, royalties and management fees.

What is a branch or subsidiary?

A branch is simply a part, division, or section of an entity that is set apart to undertake certain responsibilities or tasks.

It thus follows that a foreign branch is generally that part of the entity which carries on business or derives revenue in a foreign country as a unit of an Australian enterprise. Foreign branches are generally subject to tax on income derived from sources within the foreign country in which they are located.²

A subsidiary on the other hand has a separate legal and corporate existence. It differs from a branch in that it is not part of a larger entity, but is a separate entity of which at least 50 percent of its share capital is owned by a parent or holding company.³

2 Taxable income of a branch may be expanded. In the United Kingdom ("UK") branch income includes income earned by the branches from both domestic and UK foreign sources. In the United States ("US") income from US trade or business may include foreign income from sale of goods and certain foreign income.

3 Above n 1.

For the purpose of this paper a foreign subsidiary will be a subsidiary in which the share capital is owned by Australian interests and that is not a resident of Australia. The foreign subsidiary is, as a separate legal entity, generally subject to tax by the host country on its world-wide income.

The main distinction between the two is that a subsidiary has a separate legal existence whereas a branch is merely a unit of a larger entity. This becomes important in three situations.

- *Funding of the entity.* Equity can be contributed to a subsidiary whereas funds can only be loaned or transferred to a branch.
- *The taxation of profits in the host country.* Most jurisdictions distinguish between how a resident and non-resident entity are to be assessed. As the foreign branch is only a unit of a larger foreign entity the host country will assess a branch as a non-resident. As the subsidiary incorporated in the host country is normally "resident" for taxation purposes it will be assessed as a resident.
- *Remission of profits back to Australia.* By its nature a branch cannot pay dividends and remissions of profits back to Australia is generally seen to be merely an internal arrangement of funds.⁴ Alternatively a subsidiary as a separate legal entity may face withholding and other taxes in remitting profits to foreign shareholders.

The former exemption system

The system prior to 1 July 1987

Prior to 1 July 1987 Australia adopted an exemption system to avoid the double taxation of foreign source income. The now repealed s 23(q) of the Income Tax Assessment Act 1936 ("the Act") exempted Australian residents from most foreign sourced income if that income was not tax exempt in the foreign country where it was derived.

Categories of foreign sourced income to which s 23(q) did not apply were:

- dividends;
- interest and royalties (subject to reduced rates of tax under a Double Tax Treaty (DTA));⁵
- certain foreign source film income (s 26AG);
- income from PNG (other than employment income);
- certain foreign source income from trading ships s 57AM.⁶

4 *Max Factor & Co v F C of T* (1984) 84 ATC 4060. In this case it was held that foreign exchange "losses" between a foreign company and its Australian branch office could never be deductible nor could "gains" be assessable as there was only one entity involved in the transaction.

5 Income Tax (International Agreements) Act 1953 s 12.

6 Hamilton, "International Aspects of Australian Income Taxation" in Kreyer (ed) *Australian Taxation Principles and Practice* (1986) 280.

These types of foreign source income were subject to foreign tax credit procedures. The Australian parent would include in its assessable income the gross amount of payment made and subject to certain restrictions⁷ could claim a credit for foreign tax paid.

Foreign tax credits for dividends received could not generally be claimed by Australian holding companies prior to 1 July 1987 as Australian companies were normally able to claim a full rebate for dividends from non-resident companies.⁸

Thus, generally (other than in a few specific instances listed above) foreign tax credits were only claimed in relation to foreign tax withheld in respect of interest or royalty payments.

Branch income

Section 23(q) provided that in most cases business income earned by a foreign branch would not be subject to Australian tax as this income would be income earned by an Australian resident not exempt from foreign tax. If, however, the foreign country did not seek to assess the Australian branch income such income would be subject to Australian tax.

Under s 23(q) no distinction was made between passive and active income and thus as long as interest income was subject to some tax in a low tax jurisdiction (not subject to a double tax agreement) an Australian branch could receive interest income that had a foreign source almost tax free.

Subsidiary income

Foreign sourced income derived by a subsidiary would not be subject to Australian tax⁹ until it was remitted to Australia.¹⁰

An advantage that the subsidiary structure had over a branch was that subsidiary profits would not be subject to Australian tax if derived in a zero tax country whereas branch profits would be. This difference can be found in the fact that the exemption for branch income, s 23(q), required some tax to be levied in the host country whereas s 23(r), which exempts income derived by a non-resident subsidiary does not.

Summary

The Australian tax liability of a corporate taxpayer differed little between a subsidiary or branch operation in respect of business income earned from foreign sources. As dividend income remitted to Australia was generally

7 Section 160AO(2) of the Income Tax Assessment Act 1936 ("ITAA") limits the claim for credit to the amount of Australian tax payable on the foreign income.

8 ITAA s 46.

9 ITAA s 23(r) exempts income derived by a non-resident from sources wholly out of Australia.

10 ITAA s 46. The operation of s 46 of the Act generally precluded dividend income from being taxed. However royalty and interest income would be assessed

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subject to the s 46 rebate, the Australian tax consequences of a company receiving dividend income from a foreign subsidiary, as opposed to a repatriation of branch profits, were practically identical.

Branch versus subsidiary taxation considerations usually lay not in Australian domestic tax legislation but rather a consideration of the host country's taxation treatment of foreign investment. The two major foreign imposts that required consideration in the branch/subsidiary decision were:

- branch profits tax;
- withholding taxes on foreign subsidiary income.

Branch profits tax, which is often imposed to compensate the host country for dividend withholding tax that is otherwise payable on dividends remitted,¹¹ is levied at varying rates¹² and is imposed on a current basis.

Withholding tax, on the other hand, is only imposed when dividends (and certain other income) are remitted to Australia. Should dividends not be remitted or the remission delayed a withholding tax liability does not arise.¹³ Thus even a 5 percent branch profits tax imposed immediately could be more onerous than a 15 percent or even 30 percent withholding tax that is either not imposed for many years or never imposed. However, it may not be practical to accumulate profits in a foreign jurisdiction if the host country imposes an accumulated earnings tax. For example the United States imposes an additional penalty tax on companies accumulating income beyond the reasonable needs of the business.

It should however be noted that if dividend withholding tax was paid by the subsidiary a foreign tax credit could not be claimed in Australia for such withholding tax if the dividend was subject to a s 46 rebate. This is because s 160AO(2) does not allow a foreign tax credit to exceed Australian tax payable, which in this case is nil.

The foreign tax credit system

1 July 1989 to 30 June 1990

On 1 July 1987 the foreign tax credit system of assessing foreign source income replaced the former exemption system.¹⁴

This meant that branch income would become assessable in the Australian company's hands and a credit would be received for underlying foreign tax paid.

11 Genz, "The Branch Tax Regulations Part I" (1989) *Tax Management International Journal* 450.

12 Branch profit tax varies from country to country.

13 Unlike Australia in which the corporate year of tax follows the year of income (refer ITAA s 6(1)) many countries such as NZ, US and Hong Kong raise corporate tax in advance under a provisional tax system.

14 The amending Act was the Taxation Laws Amendment (Foreign Tax Credits) Act 1986.

Section 46(1) was also amended so that a dividend rebate was not available in respect of dividends received from non-resident entities.

Income derived from a foreign subsidiary would similarly be assessable when remitted to Australia to the Australian parent and a credit (subject to certain limits) would be allowed for both underlying tax and withholding tax deducted by the host country.

Limitation of credit

The total foreign credit receivable by the Australian corporation was limited to the amount of Australian tax levied on relevant foreign income.¹⁵ Thus if total overseas taxes in the 1990 financial year exceeded 39 percent, the Australian tax credit would be limited to 39 percent. If foreign taxes paid¹⁶ were less than 39 percent, at say 25 percent, a credit would be received for 25 percent paid overseas and a further 14 percent Australian tax would be levied. From a corporate tax planning viewpoint, the greater the Australian tax paid the greater the ability of the Australian company to pass franked dividends to its shareholders. This essentially means that under the foreign tax credit system the total rate of tax paid is the higher of the Australian corporate tax rate or total overseas taxes paid if they exceeded 39 percent.

If all foreign source income earned was remitted to Australia and the timing of tax payments (or receipt of tax credits) was the same, a comparison between a branch and a subsidiary would again be dependent upon whether or not the host country's taxes would be greater for a foreign branch (branch profits tax) or a subsidiary (withholding tax on remission of profits). However, as a subsidiary has the ability to delay remission of profits to Australia and branch profits were taxed on a current basis, a foreign subsidiary was often chosen as the most tax effective structure. This would be especially the case for Australian companies committed to medium to long term foreign investment, in that initial subsidiary profits would be reinvested in the foreign corporation.

The current foreign source income regime

Post 1 July 1990

The main features of the new foreign source income legislation in Part X of the Act (ss 316 to 468) are twofold.¹⁷ They are:

- to assess on an accruals basis most tainted (passive or non-genuine business) income sheltered in low tax jurisdiction;
- to exempt most income derived from substantial interests in comparable tax countries.

¹⁵ ITAA s 160AF.

¹⁶ ITAA s 6AB(2) Refer to s 6AB(2) for a definition of foreign tax.

¹⁷ Treasurer's press release 30 June 1990, statement by the Acting Treasurer, the Hon J S Dawkins MP entitled *Taxation of Foreign Source Income*.

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Thus by introducing a CFC (controlled foreign corporation) system of assessing foreign income Australia, in line with its major trading partners¹⁸ now has sought to differentiate foreign source income as to whether it is:

- derived from or sourced in a tax comparable country or not; and
- in light of the above, whether or not such income is genuine business income.

Central to the new legislation which applied from 1 July 1990 is the concept of a CFC. In broad terms a CFC is a company that five or fewer Australian residents own or are entitled to acquire 50 percent or more of the interests (the greater of paid-up capital or voting rights)¹⁹ in the foreign company. Although the concept of what is a CFC can be a complex matter, which warrants discussion in itself, it is only relevant for the purposes of this paper to say that a foreign subsidiary of an Australian company is a CFC.

By definition a branch cannot be a CFC in that s 340 in part states that "a company is a CFC at a particular time if, at that time, the company is a resident of a listed country or an unlisted country". Thus a branch can not be a CFC by virtue of the fact that it is neither a resident of a listed country or an unlisted country but a part of an Australian company.²⁰ While foreign subsidiaries wholly owned by Australian holding companies are CFCs, branch foreign source income thus cannot be subject to the new CFC legislation, contained at Part X of the Act. It is instead subject to either specific exemption under s 23AH of the Act, or assessable pursuant to the slightly modified foreign tax credit system (FTCS). Thus the distinction between how Australia taxes branch as against subsidiary income is quite clear cut in terms of the applicable legislation.²¹

The following provides a basic overview of how current Australian legislation assesses or exempts branch and subsidiary income. (Income not exempt is subject to FTCS.)

Listed country:

- (a) genuine business income
 - subsidiary—exempt s 23(r);
 - branch—exempt s 23AH.
- (b) other income
 - subsidiary may be exempt or assessable (active income test or de minimis test);
 - branch—assessable/exempt by virtue of the tests contained in s 23AH.

18 For a comparison of CFC regimes see Arnold (1985) 66 Taxes International 3 - 17.

19 ITAA s 340. For a full definition of a CFC, refer to s 340.

20 By definition the only companies that cannot be CFCs are those resident in Australia.

21 It should be noted, however, that many of the terms and definitions contained in Part X of the ITAA are relevant in determining the assessability of branch profits.

Unlisted country:

- (a) genuine business income
 - subsidiary—exempt s 23(r);
 - branch—assessable subject to FTCS.
- (b) other income
 - subsidiary assessable/exempt by virtue of active income test;
 - branch—assessable/subject to FTCS.

The differences to be analysed are as follows:

- (a) branch
 - unlisted country;
 - listed country.
- (b) subsidiary
 - listed country;
 - unlisted country.

Branch income

Under the FTCS foreign branch income was assessable on a current basis and a credit was given for foreign tax paid.

From 1 July 1990 the FTCS has been amended to make a clear distinction between the tax treatment of foreign branch income derived from listed (tax-comparable countries) and unlisted (low tax countries). Central to this divergent tax treatment is the inclusion of s 23AH which now exempts certain income and capital gains received from comparable tax countries.

Unlisted/low tax countries

Income from branches located in low tax jurisdictions will continue to be taxed to Australian residents on a current basis under the modified FTCS system. Where foreign tax has been paid on this assessable income a credit (subject to certain limitations) will continue to be allowed.²²

Branch income - listed countries

Section 23AH exempts certain branch income earned in a tax comparable country from Australian tax. Exempt income will include profits of a resident company derived in carrying on a business through a permanent establishment located in a listed country, subject to tax in that country, and that are not eligible designated concession income. As s 23AH is the key to determining how branch profits are to be assessed by Australia, it is worthwhile examining the section in greater detail.

²² This is examined in a detailed manner in the comparison to income derived by a foreign subsidiary resident in a non-comparable tax jurisdiction, with regard to Hong Kong investments (below).

First the branch must be deriving income or profit in "carrying on a business".²³ The immediate query that such a definition raises, is what types of receipts are taken to be from the carrying on of a business. The OECD commentary on art 7 of the Model Convention states that it should be understood that "the term (profits) when used in this article has a broad meaning to include all income derived in carrying on an enterprise".²⁴ Such an approach appears to accord with statements in *Inland Revenue Commissioners v Butterley Co Ltd*. Lord Radcliffe said "I think it is an extremely difficult undertaking to identify by a general description the kinds of income which would be at once income received by the company and not income of any trade or business which it was conducting".²⁵ This view is further supported by Lord Diplock's observation in *American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue (Malaysia)* "... in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on a business".²⁶ Thus the requirement that the branches income or profit must be derived in "carrying on a business" in itself would not appear to limit the types of income a branch may earn in a listed country that will enjoy exempt status.

The second key phrase is a "permanent establishment" (PE). Section 23AH(12) defines a PE, in relation to a listed country, to be either:

- where there is a double tax agreement (DTA) in relation to the listed country, the same meaning as in the double tax agreement; or
- in any other case, has the meaning given in s 6(1) of the Act.

Most DTA's define a PE to include a branch²⁷ and s 6(1) defines a PE to be broadly "a place at or through which a person carries on any business".²⁸

"Listed countries" basically comprise those countries that impose a corporate tax rate of greater than 25 percent, and can be found in the regulations.

The term "subject to tax" is defined at s 324(1). It means that income or profit will be taken to be "subject to tax" in a listed country, if foreign tax (other than a withholding type tax), is payable (or deemed to be paid by virtue of the regulations)²⁹ under a tax law on that item because it is included in the tax base of that country.

23 ITAA s 23AH(5) deems income earned in the course of a disposal of branch operations to be also taken to have been derived in carrying on that business.

24 *International Tax Agreements* CCH 592.

25 [1957] AC 32, 61, HL.

26 [1979] AC 676, 684, PC.

27 NZ Treaty art 4(b); US Treaty art 5(b); UK Treaty art 4(b).

28 This statement is general only, and further detail of what will or will not be a PE is outlined in ITAA s 6(1).

29 Tax will be deemed to be paid for example where tax sparing is applicable.

"Eligible designated concession income" (EDCI) is defined in s 317 to include designated concession income which in relation to a particular listed country means income upon which a reduced amount or no tax is payable.

No tax would be payable in a situation where income or profits are specifically exempt from tax, or the said amounts do not fall within the tax base of that listed country.³⁰ A reduced amount of tax is payable in situations where profits are subject to a concessionary rate of tax or some other form of tax credit. Eligible designated concession income however does not include income that is derived in a listed country that has been subject to tax (other than a reduced rate of tax) in another listed country, even if it is designated concession income under the revenue laws of the recipient.

Capital profits of branches in a listed country

Subsections (6)-(10) of s 23AH are also of vital importance to the branch investor in a listed country as they exempt certain foreign branch capital gains from Australian tax. However, the following conditions, as set out in s 23AH(6), must be met before the gain will be exempt:

- the asset must be disposed of in or after the 1990/1991 financial year;
- the asset must be either a unit of depreciable property, building or land and must be used wholly or principally by the taxpayer for carrying on a business at or through a PE in a listed country;
- the asset cannot be a taxable Australian asset;
- a gain on the sale of the asset must accrue to the taxpayer in respect of the disposal;
- the profit is not EDCI; and
- the profit is subject to tax in the host country.

Branches in tax comparable countries that derive active income and capital gains on sale of assets will generally be exempt from Australian tax if this income is subject to tax in the host country.

There is no major practical distinction between the primary Australian taxation of most active foreign source branch or subsidiary profits, in that both will be exempt from Australian tax if the listed host country has imposed tax on such income without concession. Similar to the previous exemption and foreign tax credit systems the host country's taxation system will play a vital role in determining which structure proves to be more tax efficient. A major consideration in this regard will again be the timing and imposition of branch profits tax as compared to withholding tax.

30 N.Z., for example, does not tax most capital gains

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Subsidiary (CFC) income

Listed countries

Most income derived by a subsidiary (CFC) in a listed country will continue not to be subject to Australian tax as it is earned.³¹ Similarly profits in the form of non portfolio dividends paid by subsidiaries in listed countries will now also be exempt from Australian tax (s 23AJ). The amount and type of income of a listed country subsidiary that will not be exempt, but attributed to the Australian parent, will be largely dependent upon whether or not the CFC passes the "active income test".

Active income test

Section 432 of the Act states the tests a CFC needs to pass in order to satisfy the active income test. They are:

- the company was in existence at the end of the period;
- it was at all times either a resident of a particular listed or unlisted country;
- accounts prepared in accordance with commercially acceptable accounting principles, which give a true and fair view of the financial position of the company, have been kept;
- substantiation requirements set out in s 451 have been complied with;
- the company, at all times it was a resident of a particular listed or unlisted country, carried on business in that country through a permanent establishment of that company in that country; and
- the tainted income ratio of the company is less than 5 percent.

The most important of these conditions for our purposes is the last condition relating to the relatively low tainted income ratio. Although the other tests are important in themselves and should not be ignored, it can be assumed that our subsidiary has satisfied those other tests.

The tainted income ratios can be found in s 433 of the Act. This section sets out different ratios for corporate residents of unlisted countries (s 433(1)) and listed countries (s 433(2)). For listed countries the tainted income ratio is:

$$\frac{\text{Tainted eligible designated concession income}}{\text{Eligible designated concession income}}$$

Attributable income when the tainted income ratio exceeds 5 percent, includes the following:

³¹ ITAA s 23(r).

- 1 income that is both eligible designated concessional income and tainted income³² (adjusted slightly by s 386);³³
- 2 amounts derived from a source outside the listed host country that are not comparably taxed in that listed country, another listed country, or Australia;
- 3 trust income not taxed comparably in a listed country or Australia; or
- 4 trust amounts that would be attributed to the CFC as transferor to a non-resident trust.

Where the CFC passes the active income test an exemption from attribution is given to EDCI, 1 and 2 above, only. Certain trust income, 3 and 4 above, will be attributable regardless of the active income test.

De minimis exemption

Regardless of whether the active income test and the calculation of the tainted income ratio is met, otherwise attributable non-trust amounts (see 1 and 2 above) will not be attributed if s 385(4) applies. This section provides a de minimis exemption for a listed country CFCs only. If otherwise attributable non-trust amounts do not exceed the lesser of five percent or \$50,000 of the gross income of the listed country CFC, they will be exempt from Australian tax.

Summary

Thus the "active income test" and the "de minimis exemption" offer the subsidiary structure protection from certain receipts being taxed in Australia, whereas s 23AH (the listed country branch profits tax exemption) does not, in that EDCI derived by a branch will always be assessable in Australia.

Subsidiary income in non listed countries

Accruals taxation does not apply to income derived by a CFC in an unlisted country except to the extent that it is found to be attributable income. "Attributable income" largely represents either passive income, income earned in conjunction with associates, and certain trust income.

Attributed income will continue to be subject to the foreign tax credit system and the Australian holding company will be able to obtain a credit for foreign tax paid in respect of income attributed.³⁴

At the second level of taxation, dividends paid by the unlisted CFC subsidiary out of income not subject to accruals taxation will be assessable

32 Definition of what comprises tainted income under the ITAA s 446 (above).

33 ITAA s 386 slightly adjusts the definitions used in s 446(1)(k) (l) and (m). Section 446 is used for the purposes of calculating gross tainted turnover relevant for unlisted CFCs, whereas s 386, in conjunction with s 385, determines tainted income.

34 ITAA s 160AF.

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in the recipient's hands, and subject to the FTCS. However, specific exemptions apply to exempt dividends out of income which has previously been attributed to the Australian parent³⁵ and amounts which have been paid out of profits, to the extent that they have borne tax in Australia or another listed country.³⁶

Attributable income CFC - unlisted country

The attributable income of a subsidiary in an unlisted country is dependent on whether or not the CFC passes the active income test. If the subsidiary does not pass the active income test its attributable income is its tainted income and certain trust income. If the CFC passes the active income test, it is only trust income derived by the CFC as a beneficiary of a trust estate and income attributed to the CFC as a transferor to a non-resident trust estate, that is attributable.

The tainted income ratio

The tainted income ratio to determine the active income test for an unlisted subsidiary is different to that for a listed subsidiary and it is potentially easier to trigger the five percent threshold test, as "gross tainted turnover" is defined to mean many significant types of subsidiary income.

The tainted income ratio for unlisted subsidiaries is defined by s 433(1) to be:

$$\frac{\text{Gross tainted turnover}}{\text{Gross turnover}}$$

Section 435 includes in gross tainted turnover the following types of income:

- passive income—s 446;
- tainted sales income—s 447;
- tainted services income—s 448.

"Passive income" is in turn defined to include:

- dividends;
- unit trust dividends;
- an assessable amount received on liquidation pursuant to s 47;
- tainted interest income;
- annuities received;
- tainted rental income;
- tainted royalty income;
- amounts derived as consideration for assignment of or part thereof, of copyrights, patent, designs, trademarks or other like property or rights;

³⁵ ITAA s 23AJ.

³⁶ Refer to ITAA s 23AJ in conjunction with the operation of the ITAA ss 377, 378 and 379 for unlisted countries.

- income from carrying on a business of trading in tainted assets;³⁷
- gains on disposal of tainted assets;
- net tainted commodity gains; or
- net tainted currency exchange gain.

"Tainted sales income" means gross income from the sales of goods where the goods were either purchased from or sold to an Australian resident associate³⁸ or by a non resident associate who sold the goods in the course of carrying out a business at or through a permanent establishment in Australia.

Section 447(4) provides an exception to this very wide definition of what sort of sales income will lead a company to failing the active income test and having its tainted income subject to Australian tax under the FTCS. This exception excludes tainted sales income derived from the sale of goods that have been processed as manufactured from other goods by the company in carrying on a business. The explanatory memorandum gives the example of the foreign subsidiary turning cocoa supplied by the Australian associate into chocolate bars or the assembly of car parts into a car.

"Tainted services income" broadly includes the provision of services to either an associate of the company, to a resident of Australia or in connection with a permanent establishment in Australia. It should also be noted that in addition to the very wide definitions of what is tainted income, the de minimis rules do not apply to unlisted countries.

Thus, although the active income test is more rigid in respect of low-tax countries than listed countries, it is significant to note that the present legislation allows subsidiaries earning active income to compete on an equal basis with the low taxed host countries domestic companies. As the foreign branch in contrast suffers the imposition of the 39 percent Australian corporate tax rate, there is a clear bias to utilize subsidiaries in cases where active income is to be earned in low tax jurisdictions.

Foreign tax implications

It can be seen then, that under the current taxation of foreign source income regime, the answer to the question whether a branch or subsidiary should be utilised will be different depending on whether or not we are looking at a listed or unlisted host country. Another major consideration is the domestic tax legislation of the investee host country, without which an informed decision can not be made.

37 ITAA s 317. A definition of "tainted assets" is given in s 317.

38 ITAA s 318. An "associate" for the purposes of the CFC rules is defined in s 318.

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In this regard an overview of the domestic tax legislation as it affects foreign branch and subsidiary income is discussed in terms of the following listed countries:³⁹

- New Zealand;
- the United Kingdom;
- the United States of America; and
- Hong Kong (an example of an unlisted country).

New Zealand

New Zealand ("NZ"), like Australia, is a capital importer, and, like Australia, its taxation and associated legislation appears at first glance to be drafted in such a manner to encourage foreign investment.⁴⁰

The NZ corporate income tax rate is 33 percent for resident companies and 38 percent for foreign branch operations. To gain a real appreciation of the effective NZ tax rate it should be noted that a goods and services tax of 12.5 percent applies to the supply of almost all goods and services within NZ. NZ can be distinguished from its OECD trading partners in that it does not yet tax capital gains, other than those made in circumstances similar to where either s 25 or s 25A of the Australian legislation would apply. NZ company tax (for both branch and subsidiary) is paid in advance whereas Australian company tax is paid in arrears. Although the calculation of taxable income (other than the exclusion of capital gains) is similar to that used in Australia, a number of significant timing and permanent differences are apparent. From a timing point of view, rent and interest is returned on an accruals basis for taxation purposes in NZ. NZ also grants deductions for entertainment expenditure reasonably related to the production of assessable income and more recently fringe benefits tax.⁴¹

Withholding tax

A NZ branch may remit profits to its Australian head office without incurring withholding tax, with the exception of interest paid to a non-resident lender. From a tax planning point of view there would seem to be little incentive⁴² for the NZ branch to pay interest on borrowed funds from its head office, as the Australian corporate tax rate is slightly higher than the

39 Most of the following information pertaining to foreign company taxation has been obtained from the *International Tax Planning Manual* CCH.

40 A summary of the tax incentives New Zealand gives to foreign investors would include:

- no thin capitalisation rules;
- low stamp duty rates and only on commercial real estate;
- no GST if businesses are purchased as a going concern;
- incentives for R&D, regional development; and
- most grants allowable to both branch and subsidiary.

41 Since 1 April 1989 NZ has allowed a deduction for fringe benefits tax.

42 Other than cases where the respective countries transfer pricing rules are at issue.

NZ corporate branch rate. Withholding tax, however, is payable at the following rates in the case of a subsidiary remitting income to the Australian parent:

- dividends—15 percent;
- interest—10 percent;
- royalties—15 percent.

It is of interest to note that even though NZ has a imputation system withholding tax is still imposed at 15 percent on dividends flowing to Australian resident companies who cannot obtain any tax benefit in respect of the New Zealand imputation credits.⁴³

In comparing the taxation of active business income in NZ between subsidiary and branch, it would appear at first glance that investment by way of branch, rather than subsidiary due to withholding tax imposed on dividends, is *prima facie* a more tax efficient form of investment.

	Subsidiary \$	Branch \$
Income derived	100	100
less corporate tax	<u>(33)</u>	<u>(38)</u>
Amount to be remitted to Australia	67	62
less 15 percent NZ withholding tax	<u>(10)</u>	<u>-</u>
Net amount received	<u>57</u>	<u>62</u>
<i>Assessability to Australian shareholder</i>	Exempt s 23AJ	Exempt s 23AH

However, this view is simplistic as it should be remembered that withholding tax only needs to be paid when dividends are remitted to Australia, which may be some years hence or never. This being the case, a subsidiary becomes more attractive.

Permanent differences-capital gains

As previously stated, NZ does not tax most capital gains. If the NZ branch were to sell a non taxable Australian asset and make a capital gain on disposal, s 23AH(6)-(10) would not operate to exempt this gain from Australian tax as the gain would be EDCI and not be subject to tax in NZ.⁴⁴ Any gain calculated in accordance with the Australian capital gains tax legislation would be assessed at 39 percent in Australia, with no

43 In the converse situation a fully franked Australian subsidiary's dividend would not be subject to Australian withholding tax.

44 In this case it is assumed for the purposes of simplicity there is no recouped depreciation or NZ interest clawback applicable.

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corresponding foreign tax credit available as foreign tax was not paid upon the gain.

This result, however, may be very different if the gain was made by a NZ subsidiary. If say, NZ factory land⁴⁵ is disposed and this asset falls outside the definition of "tainted asset"⁴⁶ such a gain cannot be said to constitute tainted eligible designated concession income. This is because tainted eligible concession income means income that is both EDCI and tainted income. As tainted income includes the disposal of tainted assets which may not include factory land such a gain may not form part of tainted income or "tainted eligible designated concession income" and thus the subsidiary's active income test would be passed. If the active income test is satisfied (and it could be satisfied even where disposals of "tainted assets" do not trigger the tainted income ratio as defined for listed countries at s 433(2)), designated concession income derived in a listed country will be exempt from Australian tax. Even if the subsidiary does not pass the active income test by breaching its tainted income ratio such profit may still not be assessable should the de minimis exemption apply. Furthermore, s 23AJ in this situation would exempt dividends subsequently paid out of these capital profits.

Thus, in a number of situations a subsidiary structure's income may not be subject to accrual taxation whereas "designated concession income" in respect of a branch operation will be.

Investment in the United States

Direct investment in the United States ("US") has historically been made by corporate structures (branches or subsidiaries), for the following reasons:⁴⁷

- anonymity and disclosure reasons;
- avoidance of US estate and gift tax on non resident aliens; and
- individual tax rates were higher than corporate rates (this situation however since the Tax Reform Act 1986 has reversed).

Corporate investment through foreign branches has become less attractive since the Tax Reform Act 1988 (US) introduced a "branch profit tax". This tax was introduced to provide a more equitable tax treatment between branches and subsidiaries located in the United States.⁴⁸ An example of how the US now taxes both active branch and subsidiary income is shown as follows.

⁴⁵ Towers (1990) 25 Taxation in Australia 103.

⁴⁶ ITAA s 317. See s 317 for a definition of a "tainted asset". Such land must not be used for deriving rental income or be used solely in carrying on a business.

⁴⁷ Hudson "Post-1988 Tax Planning for Foreign Direct Investment in the United States" (1989) Tax Management International Journal 4.

⁴⁸ Genz, above n 11.

Mark Northeast	Outward Investment: Branch v Subsidiary	
	Branch	Subsidiary
Profit	100	100
less US tax	(34)	(34)
	<u>66</u>	<u>66</u>
If remitted		
— US withholding tax	-	(10)
— US branch profits tax	(10)	-
	<u>56</u>	<u>56</u>
Profit after US tax is paid		
	<u>56</u>	<u>56</u>
Assessability of active income derived in Australia	NIL per s 23AH	Nil per s 23AJ

It is interesting to note that the US branch profits tax is unlike the former Australian or NZ tax on branch profits in that it:

- only applies to after tax income, not taxable income; and
- only applies to branch profits not retained in America or a dividend equivalent amount.

It operates more in the nature of a withholding tax in that prior year profits (after the 1987 income year) can be retained in a branch for a number of years and only suffer branch profits tax if distributed at a future date. Unlike the previous NZ example, branch profits tax is not levied on a current basis, and thus any advantage obtained by subsidiary over a branch in being able to defer withholding tax as opposed to branch profits tax is eliminated in the US example. As most Federal US tax incentives are applicable to both the US branch and subsidiary,⁴⁹ the decision of whether a US branch or subsidiary is to be utilised is more likely to largely rest upon an analysis of US state and local taxes and whether the new Australian system for branch/subsidiary purposes is consistent in how various types of income are treated.

United Kingdom investment

Like Australia and the United States, the United Kingdom ("UK") tax base includes both income and capital gains.

UK corporations are taxed in the 1990/1991 financial year at a rate of 25 percent to 200,000 pounds which increases to 35 percent by a shading in process at one million pounds.⁵⁰ An Australian branch located in the UK is however not entitled to this lower tax rate. However, once over one million pounds worldwide is earned either by the subsidiary or branch and the related corporate group, the calculation of taxable income and tax payable is

⁴⁹ Incentives may differ from state to state.

⁵⁰ The threshold is spread between related companies worldwide and includes the combined income of an Australian parent and UK subsidiary.

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the same for either a branch or a subsidiary, as the UK does not impose a branch profits tax.

Withholding tax is payable at 10 percent on interest and royalty income remitted by a subsidiary to its foreign parent. Interest on loans to a foreign associated company must be charged at arm's length rates. Like payments (interest and royalty) by a branch to Australia are not deductible in calculating UK branch income.

Withholding tax is not payable on the payment of dividends to the Australian holding company but advance corporation tax (ACT) (which is calculated and paid in advance in much the same manner as franking deficit tax) is payable at a rate of 25 percent of the gross dividend. However, once the UK subsidiary's profit is calculated and tax is levied at, for example, 35 percent, a credit is given for ACT paid. Thus full credit is received for such tax paid and total company tax is the same whether profits are retained or distributed. A branch may therefore be able to obtain a slight timing advantage in not paying tax on profits at the time of distribution but later at assessment. Most incentives and grants are available to branches as well as subsidiaries.

The other main differences between a branch and subsidiary appear to lie in the current Australian tax treatment of concessionally taxed UK income. This is because the applicable Australian legislation differs as to how foreign source branch and subsidiary income is to be assessed or exempted. An example of this can be found in looking at the more generous CGT rollover relief the United Kingdom has for business assets than Australia. Basically where UK assets used in trade are sold to an arm's length party and the proceeds used to acquire other business assets any capital gain can be deferred. Under Australian income tax legislation⁵¹ amounts representing recouped depreciation can be offset against the cost of the replacement asset. If the sale price exceeds original cost of the assets purchased after 19 September 1985 a capital gain and present liability for the excess accrues. Such capital gains would be taxed in Australia at 39 percent if a branch structure was used as s 23AH(6)(g) would not exempt these capital gains, as they would not be subject to tax in any listed country in a tax accounting period:

- ending before the disposal year of income; or
- commencing during the disposal year of income.

If the branch elected to defer UK tax the Australian branch could again be subject to tax on the same profit in the UK, (less any allowance for UK inflation adjustments) upon subsequent disposal of the replacement asset.

In a subsidiary situation, an Australian taxation liability would not arise as such a gain would generally not be deemed to be EDCI⁵² as the sale of

51 ITAA ss 59(2A)-(2E).

52 Refer to the Draft Regulations to Taxation Laws Amendment (Foreign Income) Bill 1990 released by the Treasurer 29 June 1990 in *Federal Tax Reporter* 892,651 CCH.

such an asset would not be deemed to be the sale of a tainted asset. Even if a tainted asset was sold, no Australian tax liability would arise if the active income test was satisfied or the de minimis exemption was available.

Thus, with careful planning, the opportunity exists in utilising a subsidiary structure to defer Australian and UK tax indefinitely whereas such a gain would under a branch operation either be:

- subject to Australian tax of 39 percent if UK rollover relief was sought, with the possibility that UK tax of 35 percent might apply at a later date; or
- subject to UK tax of 35 percent if UK rollover relief was not utilized.

Investment in Hong Kong

Hong Kong, which constitutes a low tax country for the purposes of the CFC legislation, attracts foreign investment largely through its low corporate tax rate of 16.5 percent, the fact that capital gains are not taxed combined with the establishment of one of the most sophisticated commercial centres in the world.⁵³ The concept of where an entity is "resident" for taxation purposes (other than in cases where shipping or air transport profit are concerned) is not relevant because Hong Kong applies a territorial system of taxation and thus only Hong Kong source profits are subject to tax.

Tax incentives are available in the form of significant capital expenditure allowances and high depreciation rates, as well certain exemptions for interest income. Hong Kong does not impose a branch profit tax, nor does it impose withholding taxes on dividends remitted overseas.

All these factors favour investments in Hong Kong via an entity that will not suffer Australian tax which is significantly higher at 39 percent. Thus a subsidiary investment in a unlisted country will prove to be superior to a branch investment in that:

- all branch income is taxed in Australia at 39 percent under the revised foreign tax credit tax system whereas;
- active income earned by a CFC subsidiary will continue to be exempt if it passes the active income test, and only attributable income in the case that both active and passive income is earned will be assessed by Australia (however, dividends, when remitted from the subsidiary, will be subject to the FTCS);
- equity funding which is only available via a subsidiary structure will maximize Hong Kong profits which may be exempt from Australian tax and can be retained in Hong Kong. Internal loan funding on the other hand reduces lowly taxed Hong Kong profits and increases Australian profits.

53 Bush, *Guidebook to Taxation and Investment Law in Hong Kong* (2nd ed) CCH.

Where income is attributed to Australia by virtue of the fact that the investor fails the active income test, there will be little difference as to whether or not a branch or subsidiary structure is used as generally income earned by either will be assessable in Australia at 39 percent. However Part X, Division 7C of the (Australian) Act which modifies Part IIIA (the capital gains tax provisions) so that they relate to CFC's, provides for different taxation implications in respect of foreign capital gains that fall to be taxable in Australia.

As Hong Kong does not assess capital gains most gains, made by subsidiaries will fall subject to Australian tax. Similarly, as branch profits are assessable under the FTCS, capital gains made by branches are subject to Australian tax. However, whereas branch capital gains are subject to the normal Part IIIA provisions (due to the fact that the branch is but a division of a larger resident Australian company) the subsidiary (CFC) is subject to Part IIIA as modified by Division 7, subdivision C of Part X. Section 411 of this subdivision deems all non-taxable Australian assets⁵⁴ to have been acquired by the eligible CFC on 30 June 1990. Section 412 deems the cost base of the asset to be the cost of the asset or the market value of the asset at 30 June 1990 whichever results in the smaller gain or loss. Thus the Hong Kong branch only will not be subject to capital gains tax on the sale of assets purchased prior to 19 September 1985. Any decision to transfer a branch asset to a subsidiary structure to obtain, for example, an exemption for active Hong Kong income, should be made mindful, first, of any available rollover relief provisions and, secondly, the fact that the subsidiary can not "grandfather" non-taxable Australian assets. In addition, the rapid escalation and subsequent revaluation of worldwide property prices over the last three years may also provide anomalous results as to whether a branch or subsidiary structure has been utilised.

Example: Property worldwide has over the past eighteen months suffered a decline in prices.

Hong Kong property	\$A
Purchase price January 1989	200,000
Indexed cost base 30 June 1990 (s 160ZJ)	224,000
Deemed cost base (s 412):	
— market value: 30 June 1990	180,000
— cost: 30 June 1990	200,000

Thus, in this example, the branch would be advantaged in that it would be able to claim a capital loss for consideration received to the extent it was

54 ITAA s 160T details assets which constitute taxable Australian assets. Assets that do not fall within s 160T are non-taxable Australian assets.

less than \$200,000 (subsidiary \$180,000) and would suffer Australian capital gains tax to the extent that consideration received exceeded \$224,000 (subsidiary \$200,000).

This difference will, however, gradually diminish to be of less significance in the future, in that:

- less pre September 1985 assets and pre 30 June 1990 assets will be held by the same taxpayer as time passes; and
- Capital gains in respect of assets purchased after 30 June 1990 will be calculated in the same manner.

Conclusions

Listed countries

It can be seen that there is practically little difference in terms of Australian tax legislation as to how listed country branch and subsidiary income are now assessed. From an Australian viewpoint most income derived from listed countries will be exempt whether it is derived by way of branch or subsidiary. Similarly, most subsidiary income that is attributable under the CFC rules would not be exempt branch income pursuant to s 23AH if it was instead derived by a branch.

The major taxation divergences will be found to lie in respect of foreign tax imposed on branch/subsidiary income. A significant consideration will often be the comparison of branch profits tax as opposed to dividend withholding tax. This however varies from country to country, in that this is a major consideration in respect of NZ investment but is not a relevant consideration in terms of the US branch/subsidiary determination.

In other cases differences emerge because of the way in which the Australian legislation is drafted. The basis for these differences appears to be inherent in the residency of the entity utilized. As the branch is a resident it falls assessable to income tax pursuant to s 25(1)(a), on whether the income is derived directly from sources whether in or out of Australia. Section 23AH the major branch provision operates to *exempt income normally assessable*. Conversely s 25(1)(b) only assesses the non-resident on income derived from Australian sources. Although s 23(r) also exempts income derived by a non-resident from sources outside Australia, the CFC rules in attributing income to the Australian resident are aimed at *assessing income normally exempt*. Therefore the Australian legislation, which can be seen to some extent to revolve around s 25(1) in determining what branch/subsidiary income should be assessable/exempt, could be said to be coming from different directions in trying to achieve consistency in the treatment of foreign branch/subsidiary profits.

If in fact the aim of the legislation in respect of listed countries is to obtain consistent tax treatment between branch and subsidiary then problems can be seen to arise in cases where the host country concessionally taxes

certain items of income. In certain cases the CFC rules do not attribute the same income s 23AH does not exempt. The CFC rules also further bias the utilisation of a subsidiary structure in granting specific concessions such as the active income exemption and the de minimus rule.

If these divergences are undesirable (and the writer contends that there is no worthwhile purpose achieved in having corporate foreign investment assessed in different ways), then the simple answer would appear to deem a foreign branch a non-resident CFC.

Unlisted countries

It was originally proposed that all income earned in low tax countries would be attributable.⁵⁵ It was however argued by various interested groups that Australian owned businesses carrying on genuine business activities in low tax countries would be disadvantaged when compared to foreign owned businesses operating in those countries. In response amendments were made⁵⁶ which have resulted in legislation that now exempts genuine business activities in low tax countries.

However, as such amendments only extend to subsidiaries (CFCs) and not branches the taxation treatment of active branch/subsidiary income in unlisted countries is quite distinct. Again should the definition of a non resident CFC be widened to include foreign branches this difference would disappear and like the subsidiary the branch would only be subject to Australian tax on sheltered passive and tainted income.

55 May 1988 Economic Statement *Consultative Document* AGPS(c) Commonwealth of Australia (1988).

56 April 1989 Mini Budget, *Taxation of Foreign Source Income* AGPS(c) Commonwealth of Australia (1989).