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Offshore Expansion

1. Overview

This edition of the JR Corporate Newsletter focuses on taxation and regulatory issues associated with offshore expansion.

For ease of reading we have set out below a commentary on a number of the key issues which require consideration. The list of topics we cover is not intended to be exhaustive.

The choice of a preferred structure for operations in a foreign country generally comes down to the following alternatives:

- A company incorporated in the foreign jurisdiction;
- A branch of an Australian company operating in a foreign jurisdiction;
- The use of an interposed company in a tax friendly foreign jurisdiction to hold the shares in the foreign company;

- The use of an interposed company in a tax friendly jurisdiction to undertake business (a branch) in the foreign country;
- A limited liability company established in a foreign jurisdiction (relevant in particular to the United States); or
- An Australian trust which undertakes operations in a foreign jurisdiction.

The various choices available need to be measured against the commercial, regulatory and taxation issues which arise.

Before moving ahead we should note that the balance of this article proceeds on the basis that the operations inside the foreign jurisdiction will amount to an overseas tax presence (i.e. not just an export arrangement).

2. Commercial Issues

An obvious starting point is to determine the commercial drivers behind the structure which is to be adopted.

For instance, in some countries it may be a commercial requirement to establish a local subsidiary in order to engage with suppliers, financiers or customers.

This article proceeds on that basis that there are no commercial drivers which indicate a preference for one structure over another.

3. Regulatory Requirements

Regulatory requirements which may impact on the structure include the following:

- The requirement for local ownership;
- Restrictions on the ability to operate as a branch;
- Minimum share capital requirements;
- Restrictions on the ability to repatriate share capital; and
- Regulations regarding the balance of debt and equity (thin capitalisation).

This article will proceed on the basis that there are no regulatory requirements which dictate the structure.

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OUR PARTNERS

Chris Ball Peter Camenzuli Jason Evans Warwick Face Nigel Fischer Katrina Haiduk Brett Headrick Teresa Hooper Clark Jarrold Ian Jones
Kylie Lamprecht Bernard Naude Mark Nicholson Ken Ogden Norman Thurecht Ross Walker

OUR CONTACT DETAILS

Level 30, Central Plaza One 345 Queen Street Brisbane Qld 4001 GPO Box 1144 Brisbane Qld 4001 Phone (07) 3222 8444 Fax (07) 3221 7779

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4. Taxation Issues

4.1 Overview of Global Tax Efficiency

It is appropriate to start with an overview of the global requirements for an efficient taxation structure.

Rule Number One It is not appropriate to have taxation profits in one jurisdiction and losses in another.

Rule Number Two Where similar rates of taxation apply it is preferable to pay tax in Australia rather than overseas due to the generation of franking credits.

Rule Number Three Take advantage of low tax jurisdictions where there are no attribution issues under Australia's controlled foreign corporation rules (these rules can subject the overseas income to tax in Australia as it is derived overseas).

Rule Number Four Minimise withholding taxes as they may represent either a permanent loss or a cash flow leakage.

Rule Number Five Take advantage of taxation treaties (note: caution is needed as there are limitations which can apply to what is referred to as "Treaty Shopping").

Rule Number Six Any cross border transactions between related companies must satisfy transfer pricing rules (arms length pricing).

4.2 Profit Repatriation and Exit Considerations

4.2.1 Profit Repatriation

In the first instance it is relevant to consider the after tax return to shareholders from profits derived overseas.

The potential taxation imposts are excessive as there is no credit in the hands of Australian resident shareholders for tax paid in overseas companies (with the exception of foreign hybrids which will be discussed later in this article).

Consider the example of an Australian company holding 100% of the shares in a foreign company. The tax assumptions are as follows:

Corporate tax rate in foreign country	35%
Dividend withholding tax rate in foreign country	10%
Shareholder tax rate in Australia	40%
Profit derived in foreign company	\$1,000
Tax payable (35%)	(\$350)
After tax profit	\$650
Dividend withholding tax (10%)	(\$65)

After tax dividend paid to Australian Company \$585

Tax payable in Australian Company (note: the dividend is exempt from tax in Australia)	Nil
Tax payable by Australian shareholders when a dividend is paid to them (40%)	(\$234)
After tax profit in the hands of Australian shareholders	\$351
Effective Tax Rate	64.9%

As noted above the reason the effective tax rate is so high is that there are no tax credits available in Australia for any tax paid in the foreign jurisdiction.

The effective tax rate may be reduced by moving profits from the foreign company to the Australian parent. In the above example there are three reasons for this:

- 1) The corporate tax rate in Australia is lower than in the foreign country;
- 2) There is no dividend withholding tax; and
- 3) The tax payable in Australia creates franking credits which are able to reduce the tax payable on dividends in the hands of shareholders.

The common mechanisms for moving profit back to Australia are as follows:

- Changing functions undertaken in the foreign jurisdiction
- Pricing of product
- Management fees
- Royalties
- Interest (note potential thin capitalisation restrictions)

As noted above, however, the pricing of cross border transactions between related parties is the subject of transfer pricing rules. In this circumstance it will be the foreign country's rules which may be of concern as profit is essentially being moved from overseas to Australia.

These rules are likely to be contained in the foreign country's domestic tax legislation and in any tax treaty between Australia and the foreign country.

4.2.2 Exit Considerations

It will need to be determined if there are taxation implications associated with the disposal of shares in a foreign company in that foreign jurisdiction.

Where the sale of shares in a foreign jurisdiction is subject to tax it may be useful to consider if the sale of shares in an interposed holding company (located in another country) would be caught in the same way. If they were not it may be possible to consider an exit by way of sale of shares in the interposed company.

There are a number of issues to consider if this level of complexity is being contemplated as follows:

- The commercial possibility of being able to sell shares in the interposed company;
- The location of the interposed company;
- The tax residence of the interposed company;
- The cost of establishing and maintaining the interposed company;
- The taxation implications of flowing dividends through the interposed company.

Singapore and Hong Kong are countries which are generally considered for this purpose because they don't tax capital profits.

4.3 Transfer Pricing

4.3.1 Overview

As discussed above, transfer pricing rules require cross border transactions between related parties to be undertaken utilising arms length pricing.

In this article we will focus on one aspect of the manner in which this pricing is determined, being the nature of the functions in the foreign jurisdiction.

In simple terms the transfer price is determined after taking into account the actual functions undertaken in the foreign jurisdiction and the relevant risk and investment associated with these functions.

If the object of planning was to reduce the profitability of a company in a foreign jurisdiction it then follows that one possible strategy is to reduce the risk profile.

Mechanisms which could be considered include the following:

- Moving inventory risk back to Australia;
- Moving foreign exchange risk back to Australia;
- Moving certain functions outside the foreign jurisdiction;
- Changing the terms of trade with, or the financing structure of the foreign company.

4.3.2 Software Illustration

Overview

Consider the circumstances of an Australian software developer who wants to expand into the North American market place.

Further, we will assume that rather than sell through an independent distributor (which would not create a tax presence overseas) a decision has been made to open an office in the United States (US).

It is likely that this office will give rise to a tax presence in the US by creating what is referred to as a permanent establishment.

After considering the relevant options we will further assume that a decision was made to incorporate a US subsidiary.

The three common relationships between the Australian parent company and the US subsidiary are as follows:

1. The US subsidiary acts as a sales and marketing agent for the Australian parent;
2. The US subsidiary acts as a distributor for the Australian parent; or
3. The Australian parent licences the US subsidiary with the right to exploit the software.

The three arrangements have particular taxation issues which require consideration. Importantly, as the functions of the US subsidiary will not be the same in the different scenarios the level of profit or loss in the US will also vary.

Sales and Marketing Function

Under this scenario all sales revenue continues to be booked in the Australian parent.

The US subsidiary will be paid a fee by the Australian parent for carrying out sales and marketing activities.

The amount of this fee will determine the profitability of the US subsidiary and accordingly it is governed by transfer pricing rules. It would generally be expected that this fee would be in the vicinity of cost plus 7.5 – 10%.

That is the US subsidiary will make a profit equal to 7.5 – 10% of its cost structure.

This arrangement carries the potential of limiting the tax payable in the United States (refer the above rules of international tax planning).

However, there is a material limitation attached to a sales and marketing style arrangement.

Where the sales people have the ability to enter into contracts on behalf of the Australian parent and habitually do so, a tax presence of the Australian parent in the US is created (refer paragraph 4(a) of Article 5 in the Australia/US Double Tax Agreement).

This would mean that profits of the Australian parent would become taxable in the United States.

If it is not practical for sales contracts to be executed in Australian, the sales and marketing model will not be appropriate. For this reason a sales and marketing model is generally only utilised in the early years of the expansion into the US.

Distribution Agreement

Under this scenario the Australian parent sells the software to the US subsidiary who then on sells it to the customer.

The US subsidiary will generally have a higher level of risk in this arrangement and accordingly be expected to make a higher level of profit.

The US subsidiary will generally provide the installation services and ongoing support. It is not uncommon for the parent to provide a Help Desk.

The payments for software under the distribution agreements have the benefit of not being subject to withholding taxes.

As the software is produced on a needs basis the US subsidiary does not carry inventory risk.

The price at which the software is sold to the US subsidiary will have to satisfy transfer pricing rules. The following will be relevant in setting this price:

- The taxation position of the Australian parent and its recovery of research and development costs to date;
- The level of investment in the US subsidiary;
- The level of risk inherent in the distribution activities;
- Comparable sales with both unrelated and related parties;

- The profitability of the US subsidiary after payment to the Australian parent for the software;
- The recovery of the US subsidiary from other services (including installation fees).

Licensing Agreement

Under this financial scenario the Australian parent licences the US subsidiary with the right to exploit the software by way of sale.

The licence fee is generally expressed as a percentage of sales revenue.

Unlike the distribution agreement the licensing fees are subject to royalty withholding tax. This will represent either a cash flow leakage or in circumstances where the withholding tax is not able to be utilised in Australia a permanent loss.

We note here for completeness that withholding tax credits are no longer able to be carried forward in Australia.

The risks and rewards are very similar to the distribution style agreements and the pricing considerations are accordingly also similar.

4.4 Pros and Cons of the Alternative Options

4.4.1 A Company Incorporated in a Foreign Jurisdiction

The use of a wholly owned foreign company is a common structure due to its simplicity.

However, as discussed above the effective tax rate in the hands of the ultimate Australian resident shareholders is very high and in some circumstances a more complex structure may be appropriate.

The foreign capital gains tax (or equivalent) implications on disposing of the shares in the foreign subsidiary require careful consideration. In some countries a branch is a preferred structure for this reason.

In some jurisdictions a local company is not a preferred vehicle as a result of a onerous regulatory environment which may impact flexibility in moving funds out of the country.

4.4.2 A branch of an Australian Company Operating in a Foreign Jurisdiction

As a starting point it should be noted that in some jurisdictions branch structures are not permitted.

The company utilised would generally not have any other operations to ensure the effective quarantining of risk.

The taxation implications are generally similar to a local company structure as there are no tax credits in Australia for any taxes paid in the foreign jurisdiction.

This structure provides a cleaner exit from the foreign jurisdiction and may have some savings in withholding taxes on dividends (not all countries have withholding taxes on remittances from branches).

The consideration of whether to use a branch structure is generally driven by commercial and regulatory issues, however taxation considerations may arise.

Branch structures are favoured in the mining industry for many of the above reasons. Business structures involving

day to day interface with customers often favour the local company structure for commercial reasons.

4.4.3 The use of an Interposed Company in a tax friendly Foreign Jurisdiction to hold Shares in a Foreign Company

The taxation benefits of using this structure must obviously be weighed against the costs of establishing and maintaining the interposed company.

Where it is managed and controlled in Australia it may be an Australian resident for taxation purposes (which may or may not be problematic).

The interposed company structure is generally driven by the following material taxation issues:

1. A lower net dividend withholding tax rate on moving profits back to Australia; and
2. The possibility of avoiding foreign capital gains tax on exit by selling shares in the interposed company.

It should be noted that anti avoidance provisions can apply where interposed companies are utilised for the sole purposes of reducing withholding taxes.

4.4.4 The use of an Interposed Company in a tax friendly Jurisdiction to undertake Business (a branch) in the foreign country

The use of this structure is generally driven by commercial and regulatory considerations.

However, taxation advantages may exist through lower withholding taxes and in some circumstances a capital gains tax free exit through selling the shares in the interposed company which undertakes the branch.

4.4.5 Foreign Hybrid Structures

The foreign hybrid legislation is contained in Division 830 of the 1997 Tax Act. There are certain qualification tests, a discussion on which is beyond the scope of this article.

Where these qualification tests are satisfied foreign hybrids which would otherwise be treated as companies for Australian tax purposes will instead be treated as partnerships.

The most common form of foreign hybrid is a Limited Liability Company (LLC) in the United States.

The concessional tax treatment of foreign hybrids provides two material taxation advantages, as follows:

1. Taxation credits are potentially available in Australia for taxation paid overseas; and
2. A share of taxation losses incurred overseas will be available for use in Australia (note that the size of the tax loss is limited to the amount of the investment in the foreign hybrid).

The type of structure which holds the interest in the foreign hybrid will be critical to enjoying the taxation benefits the structure may provide.

For example, holding the interest in a company structure will not provide any material savings at the ultimate shareholder level in Australia. This is because whilst the foreign tax credit will reduce the tax payable in Australia it does not create franking credits. This means that the Australian shareholders in the company which holds the interest in the foreign hybrid will still receive unfranked dividends.

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Tax Consolidation Changes Open a Window of Opportunity

1. Overview

The Tax Laws Amendment (2010 Measures No 1) Bill 2010 contains some important changes to the tax consolidation rules. Importantly these changes will have a retrospective application, creating the opportunity for reviewing prior year assessments (aka grave digging).

The changes have the potential to further skew the difference between the tax outcomes generated by a share acquisition as opposed to an asset acquisition.

In many circumstances the share acquisition will be more beneficial as it will allow, via tax consolidation, the push down of cost to assets which carry favourable tax attributes.

2. Clarification of the Existing Law

Section 701-55 of the 1997 Tax Act will be amended to clarify that an amount allocated to a reset cost base asset is incurred for tax purposes. This then provides the necessary link between the allocation to a reset cost asset and the claiming of a deduction.

The Explanatory memorandum to the new legislation provided a number of more obvious examples as follows:

- An allocation of Allocable Cost Amount (ACA) to consumable stores is able to be written off either immediately or on a usage basis contingent upon the usual shelf life of the consumables;
- An allocation of ACA to a share trading portfolio is able to be treated as a cost of that stock;
- An allocation of ACA to traditional securities such as bonds and debentures will be treated as a cost in calculating any profit or loss on disposal.

Most readers would have expected that the above illustrations were the status quo under the existing law. However, the following assets may also qualify for a beneficial allocation of ACA under the proposed changes:

- Core technology for the purpose of the Research and Development concessions;
- Supply and trade tie agreements where the relevant agreements are a frequent and incidental part of a business; and

- Other non contractual relationships with customers which may amount to an intangible asset.

We note here that significant caution should be exercised before pursuing these allocations as the operation of the law is uncertain at this time.

3. The New Deduction

The proposed Section 716-405 of the 1997 Tax Act recognises a new asset being a right (including a contingent right) to receive an amount for the doing of a thing.

This right will be treated as a reset cost asset meaning that its allocation of cost will be on a proportionate basis to the other reset cost assets held by the relevant company.

The deduction for the allocation to this new asset will be capped each year to the level of assessable income received in respect of the asset, however, any balance is deductible if no further revenue is expected.

Tax advisers are currently putting their mind to two critical issues:

1. How broad is "the doing of a thing"; and
2. If there is a right to income in respect of the doing of a thing how is that right valued?

In particular if the relevant "thing" is not yet done then presumably the costs involved in doing the thing will reduce the value of the relevant right.

The explanatory memorandum provides the following list of rights which may give rise to deductions under the proposed changes:

- Long term construction projects;
- Trailing commissions;

- Land development rights;
- Deferred management fees from retirement villages; and
- Rights to unbilled income from the supply of gas.

However, taking a more expansive view as to what might constitute the doing of a thing the following types of arrangements will require consideration:

- funds management agreements;
- software licences;
- contract mining arrangements;
- power supply contracts;
- commodity supply contracts;
- leasing arrangements; and
- security monitoring agreements.

As noted above the valuation issues arising are complex in themselves and it will be necessary to distinguish the difference between the net present value of revenue streams and the value of the relationships created by the contracts.



Taxation	Team member	Position	Phone	Email
	Chris Ball	Managing Partner	07 3222 8405	CBall@jr.com.au
	Bernard Naude	Partner	07 3222 8444	BNaude@jr.com.au
	Ian Jones	Partner	07 3222 8444	IJones@jr.com.au
GST	Ken Ogden	Partner	07 3222 8444	KOgden@jr.com.au
	Peter Camenzuli	Partner	07 3222 8444	PCamenzuli@jr.com.au
Audit / Corporate	Ross Walker	Partner	07 3222 8444	RWalker@jr.com.au
	Jason Evans	Partner	07 3222 8444	JEvans@jr.com.au
	Warwick Face	Partner	07 3222 8444	WFace@jr.com.au
	Katrina Haiduk	Partner	07 3222 8444	KHaiduk@jr.com.au
	Clark Jarrold	Partner	07 3222 8444	CJarrold@jr.com.au

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