Tax on Transactions: Setting up Global Structures for Australian Mining Companies

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SUMMARY

This paper will discuss some of the relevant tax issues associated with investment by Australian companies in mineral exploration and production projects offshore. It will specifically deal with structuring issues, including:

- *the impact of the new controlled foreign company (CFC) legislation;*
- *the type of investment vehicle;*
- *the type of funding which should be used;*
- *planning for disposals; and*
- *planning for dividends.*

INTRODUCTION

For any company wishing to invest offshore, they should seek to achieve the following two objectives:

1. Minimise the amount of tax payable; and
2. Where a tax liability will arise, ensure this is paid in Australia.

The former of these two is probably inherent in all tax structuring undertaken by companies; the latter is, however, important in maximising the Australian company's franking credits, thereby enabling it to pay franked dividends to shareholders.

To achieve these objectives, careful planning must take place at the start of any project. It is imperative to put in place an effective tax structure from the beginning to ensure problems do not arise later in the project or upon disposal of the investment.

The tax issues to bear in mind include:

- CFC considerations;
- whether debt or equity funding should be used;
- capital gains tax (CGT); and
- the type of structure to use.

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CONTROLLED FOREIGN COMPANIES

The CFC legislation was introduced by the government to tax certain income derived by non-resident companies and trusts on an accruals basis rather than on a derived basis, that is when dividends were received. This was intended to ensure there was no erosion in the tax base by taxpayers structuring their investments offshore through the use of companies in low tax rate countries.[1]

On 24 December 1996, the Treasurer announced changes to the CFC legislation with effect for accounting periods commencing on or after 1 July 1997. The major change to the CFC rules, which will be discussed in this paper, will be the creation of two lists rather than one. The change means that investors can be in one of three types of countries for CFC purposes: broad exemption listed country; limited exemption listed country; and unlisted country.[2]

Background

To determine whether an Australian taxpayer is affected by the CFC legislation, it is necessary to consider a number of tests. First the taxpayer must be an "attributable" taxpayer in relation to the non-resident company. Generally, to be considered an attributable taxpayer, the Australian company must have at least a 10 per cent interest in the CFC.[3] From this arises the next test, is the non-resident company a CFC? A company will generally be considered a CFC if:

- five or fewer Australian residents have an entitlement to 50 per cent or more of the direct or indirect interests in the foreign company. This 50 per cent interest also includes interests from associates of the Australian resident company;
- one Australian entity has a 40 per cent or greater interest in the non-resident company and it is not controlled by anybody else; or
- the non-resident company is controlled by a group of five or fewer Australian residents and their associates.[4]

Having determined whether the company is a CFC, it must be considered whether the CFC is resident in a listed country or an unlisted country. These will be discussed in more detail below but broadly a listed country is one which is listed in the regulations of the tax legislation whilst an unlisted country is a country not on the list.[5] This is important for determining what income will be attributed to the Australian taxpayer. Attributed income means that the income of the CFC is recalculated using special formulas provided in the legislation and an amount included in the Australian taxpayer's assessable income.

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1 *Taxation Laws Amendment (Foreign Income) Act* 1990 (Cth).

2 Taxation Laws Amendment (Foreign Income Measures) Bill 1997, Explanatory Memorandum.

3 *Income Tax Assessment Act* 1936 (Cth), s 361.

4 Ibid, s 340.

5 Ibid, s 320.

Pre 1 July 1997 system

Previously, there were only two types of countries for the purposes of the CFC legislation: listed and unlisted. The two types of countries were important in determining what income of the company would be attributed back to Australia. The legislation tried to ensure that income which is concessionally taxed or which is from activities which are not part of the company's trade are attributed to the Australian company. It did not seek to attack legitimate business undertakings by companies but unfortunately this was at times a by-product of the legislation.

For unlisted countries, generally income of a "tainted" nature is attributed to an Australian company. Broadly, tainted income arises from investments or arrangements that are significantly driven by taxation considerations.[6] Tainted income includes dividends, royalties and interest from investments held by the unlisted country company.

For listed countries, the income attributed is narrower and includes only concessionally taxed amounts known as eligible designated concession income (EDCI). EDCI is aimed at capturing amounts that would be taxed in Australia but are not taxed in the listed country.[7] For example, EDCI includes capital gains arising from disposals in New Zealand, as the New Zealand legislation does not tax gains on disposal of assets.

Whether companies derived income from a listed or unlisted country was also important in determining how dividends would be taxed when remitted to Australia. If an amount has not been attributed under the CFC measures, then non-portfolio dividends received from listed countries would be exempt. A non-portfolio dividend is where the interest in the company from which the dividend is received is greater than 10 per cent.[8] A dividend from funds previously attributed under the CFC rules will also be exempt.

Dividends from unlisted countries will, if the offshore company passes the "active income test", be taxed but subject to foreign tax credit system, that is the dividend is included in taxable income but a credit given for any foreign tax paid. If the active income test is failed, then income is generally taxed under the accruals system and any dividends received exempt.

The active income test discussed above is undertaken each year and has six criteria that must be met by the CFC.[9] The main criterion relates to the tainted income ratio which is different for both a listed and unlisted country. This tainted income ratio must be less than 5 per cent for the CFC to pass the active income test. Generally, the tests look at those amounts which are tainted, that is they are driven from a tax perspective rather than from a genuine business activity.

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6 Taxation Laws Amendment (Foreign Income Measures) Bill 1997, Explanatory Memorandum.

7 *Income Tax Assessment Act* 1936 (Cth), s 361.

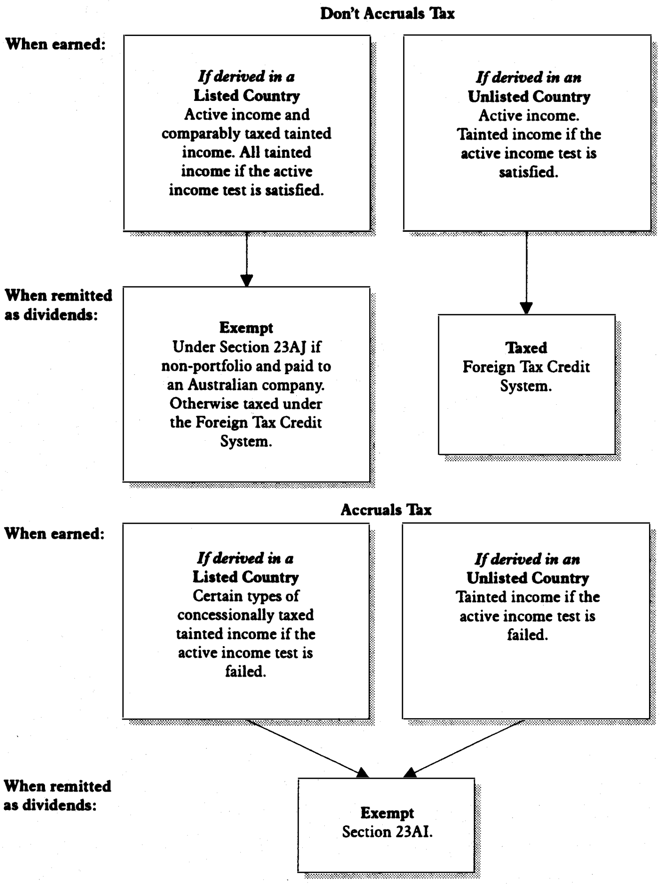
8 Ibid, s 317.

9 Ibid, s 432.

Diagram 1 summarises the position prior to the changes announced on 24 December 1996.

Diagram 1

Summary of Old CFC Measures



Post 1 July 1997 system

The major change arising from the new legislation relates to the splitting of the listed country's list into the broad exemption list and the limited exemption list. The break-up of the previous listed countries into two only affects what amounts will be attributed to Australian companies. The government stated that whilst the system was working for the purposes of determining which dividends should be exempt, it was no longer working for determining which income should be attributed.[10]

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10 Taxation Laws Amendment (Foreign Income Measures) Bill 1997, Explanatory Memorandum.

Broad exemption list

Previously, listed countries included several countries which although similar in principle to the Australian system were not considered sufficiently similar to our tax system to warrant the broader exemption afforded. The government determined to establish one list such that a more limited amount of attributable income would be justified due to the tax systems of these countries being almost identical to Australia. Therefore a broad exemption list of countries (often referred to as "white" countries) was established.[11]

The countries on the list are:

- Canada;
- France;
- Germany;
- Japan;
- New Zealand;
- United Kingdom; and
- United States of America.[12]

For companies resident in broad exemption listed countries, EDCI is the only income attributed and only if the active income test is failed. An example would be a capital gain arising on the disposal of an asset in New Zealand.

Limited exemption list

Instead of making all other countries previously on the list unlisted countries, the government created a limited exemption list (often referred to as "grey" countries).[13] It was decided that for companies previously on the list but now on the limited exemption list, only where the company failed the active income test would tainted income be attributed. Tainted income is wider in definition to EDCI and is amounts perceived by the government to be driven by tax considerations and includes interest, royalties and dividends.

Countries on this list include Indonesia, the Netherlands, Brazil, Pakistan and Taiwan.

The treatment of dividends did not change under the revised legislation, as non-portfolio dividends from both broad exemption listed countries and limited exemption listed countries are exempt under the legislation.

Unlisted countries

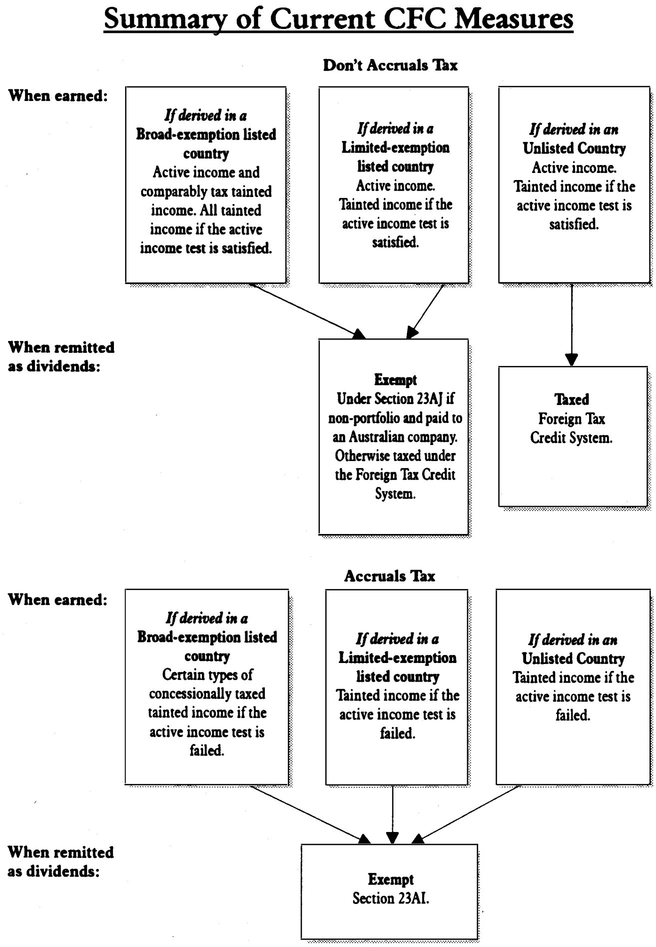
The treatment for an unlisted country (often referred to as "black" countries) has not changed under the new system, that is, only where the active income test is failed will income be attributed under the CFC legislation.

11 Ibid.
12 *Income Tax Regulations*, reg 152J, Sch 10, Pt 1.
13 *Income Tax Regulations*, reg 152J, Sch 10, Pt 2.

Countries which are unlisted include Peru, Uruguay, Chile, Argentina and Bermuda.

Diagram 2 below summarises the new tax position:

Diagram 2



Source: Taxation Laws Amendment (Foreign Income Measures) Bill 1997, Explanatory Memorandum.

STRUCTURING

There are four broad considerations which should be considered when structuring an offshore investment:

- type of investment vehicle;
- level of debt:equity funding;
- exit strategies; and
- repatriation of profits.

Type of vehicle

When an Australian company expands its operations offshore, one of the first decisions it is faced with is whether to set up as a permanent establishment (branch) or company (subsidiary). There are two broad issues which may impact any decision on which is the preferred alternative, being:

- commercial considerations; and
- transfer pricing.

Commercial considerations

Often commercial considerations will be the major driving force in any decision on whether a branch or subsidiary should be established. Obviously, from a legal perspective, a subsidiary provides limited liability, although in some cases the parent company may be required to give guarantees and so become liable itself. This limited liability aspect is often important especially when the mining activities are undertaken in undeveloped countries.

Further, sometimes local incentives such as tax holidays or other grants may only be available to locally incorporated companies and not to permanent establishments. Subsidiaries are also useful in clearly identifying the participants in unincorporated joint ventures, which are common in the mining industry.

Conversely, a branch is often simpler to operate than a subsidiary. Also, stamp duty or capital duties may not be imposed on capital contributed to establish the branch. There are also often less onerous rules on foreign shareholdings and/or foreign directors as there can sometimes be for subsidiaries.

Ultimately, the subsidiary company is the typical vehicle of choice. The tax structuring issues discussed in this paper reflect, and are largely dependent upon, the use of subsidiary companies.

Transfer pricing

In recent years there has been an increased focus by the Australian Taxation Office (ATO) on the issue of transfer pricing. This has also become a major focus for a number of ther tax authorities around the world. There are however only two broad differences from a transfer pricing viewpoint, when considering the use of a subsidiary or branch as the preferred option.

(a) Cost allocation

There is an advantage for a subsidiary in cost allocation from a transfer pricing perspective. This advantage lies in the fact that the parent company can include a mark-up on charges it makes to its subsidiary. If the subsidiary were to get the same services from a third party then there would be a profit component in the cost and therefore the parent is also entitled to this mark-up. This is only advantageous where there is a differential on the tax rates in the two regimes in favour of the Australian tax system. Therefore the deduction can be claimed at a higher rate whilst the income is taxed at a lower rate.

A branch on the other hand can only be charged its share of costs by head office with no mark-up for profit. The reason for this is the branch and head office are seen as one entity and therefore the company cannot make a profit from itself.[14]

Thus, if the Australian company will be able to recharge a number of costs to the offshore operation and the tax rate differential is favourable, then there may be benefits in utilising a subsidiary rather than a branch.

(b) Income allocation

Obviously, where a subsidiary is established, any transfers occurring between the parent and its subsidiary will need to be at an arm's length third party rate. There is a different treatment for branch transfers to a head office.

The ATO has produced guidelines which indicate that the head office and branch are to be treated as a single entity. To allocate any income arising from the transfer of goods, a third party transaction must occur *before* the allocation can be made.[15] The ATO suggests the following allocation:

- any transactions between the branch and head office and a subsequent sale to a third party are to be grouped together;
- the income arising from the third party transaction is then to be allocated between the head office and branch according to their respective participation in the sale where the sale has occurred;
- where a transaction has occurred between head office and the branch but there is no subsequent sale to a third party, the transaction is to be ignored.

As can be seen, this may cause difficulties for mining companies who extract minerals which are transferred to Australia for processing where there is a long lead time before sale to a third party.

Funding

Whether to use debt or equity funding is one of the most important considerations to be made from a tax perspective. Further, given the changes to the CFC legislation, this issue needs renewed consideration to determine which type of funding will be best from an Australian tax perspective.

In order to obtain a deduction for interest, there must be a nexus with earning assessable income.[16] If the interest is incurred in producing exempt income, it will not be deductible.[17] Given the above

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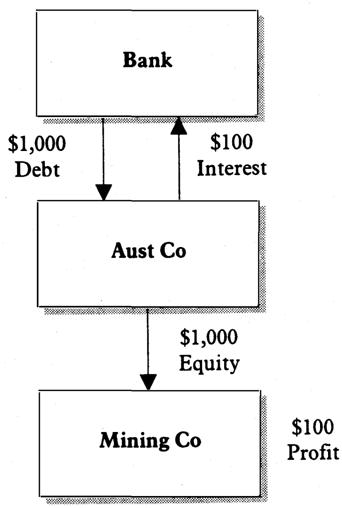
14 Draft Income Tax Ruling TR95/D11.
15 Ibid.
16 *Income Tax Assessment Act* 1997, subs 8-1(1).
17 *Income Tax Assessment Act* 1997, subs 8-1 (2).

comments on the CFC treatment of dividends under the CFC regime, this issue is critical. It should also be noted that the following comments assume that the dividend is a non-portfolio dividend, that is the Australian company has a 10 per cent or greater interest in the foreign company.

The way to fund any proposed investment into each of the different types of countries is best illustrated by way of example:

Facts



Aust Co borrows $1,000 from the bank and uses this to acquire 100 per cent of the shares in a non-resident, Mining Co. Mining Co makes $100 profit from which it pays an after-tax dividend to Aust Co.

(a) Broad exemption listed country

Any dividend received by Mining Co will be exempt from tax and therefore Aust Co will not be entitled to a deduction for its interest expense because it is incurred in producing exempt income. Therefore Aust Co has an interest expense of $100 for which it is not entitled to a deduction.

As seen the best method of funding for an investment into a broad exemption listed country is by using equity rather than debt.

(b) Limited exemption listed country

Again, any dividend paid by Mining Co to Aust Co will be exempt from tax. Aust Co will not be entitled to a deduction for its $100 interest expense and should therefore use equity for its investment.

It should be highlighted that where it is stated that equity should be used, it is possible to create an equity pool using borrowed funds. This can occur where the Australian company has an Australian subsidiary which has retained profits but no cash. In this situation the Australian subsidiary borrows cash from an external party to fund a dividend payment from its retained profits to the parent company. The parent company can then use this equity to invest in the offshore operation.

The ATO accepts that interest on funds borrowed to pay a dividend is deductible, therefore avoiding the problem of a non-deductible interest expense.[18]

(c) Unlisted country

As explained in Diagram 2, if Mining Co passes the active income test and no amount is taxed under the accruals systems, any dividend received is subject to tax with a credit available for any foreign tax attached to the dividend. As a result of the dividend being taxable, Aust Co is entitled to a deduction for its interest expense of $100. The interest deduction can sometimes reduce the Australian tax on the dividend such that the full amount of the attached foreign tax credit cannot be utilised. This requires careful management of the timing and quantum of interest and dividend flows.

If Mining Co does not pass the active income test and an amount is taxed under the accruals system, then any dividend received is exempt from tax. Again the interest expense would not be an allowable deduction. A company should therefore consider carefully if it believes the subsidiary will pass the active income test.

In summary the following table outlines when debt or equity should be used to fund an investment from a tax perspective:

Table 1

Type of Country	Equity	Debt
Broad-exemption listed	✓	
Limited exemption listed	✓	
Unlisted: – pass active income test		✓
Unlisted:– not pass active income test	✓	

Future disposals

One of the main objectives which a company should try to achieve is to pay any tax liability in Australia rather than offshore. The rationale being if a company must pay tax anywhere, it should be paid in Australia because only Australian tax payments generate franking credits. When considering divestment strategies it is of fundamental importance to ensure any tax on disposal arises in Australia.

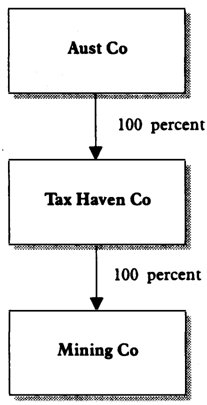
The issue of divestment strategy is particularly relevant when the country of investment has capital gains tax provision such that the Australian company is taxed on the disposal of its investment. Where the company is taxed in the foreign jurisdiction, the company is

[18] Income Tax Ruling, TR95/25.

unlikely to be taxed in Australia. This would arise because of the operation of double tax treaties or the Australian Tax Office ensuring the company is not taxed twice for the same disposal. This causes concerns for the Australian company because they have paid tax but have not generated any franking credits.

One way to overcome this problem is to interpose an intermediate holding company resident in a tax haven which does not have a capital gains tax regime.

Diagram 3



Therefore any subsequent disposal of Mining Co can be effected by disposing of the shares in Tax Haven Co.

In addition, or alternatively, a special purpose Australian subsidiary (Aust SPV) may be incorporated to hold the offshore investment.

The benefits obtained by implementing such a structure are:

- flexibility is maintained as to how the divestment will occur – either through a disposal of the shares in Aust SPV or a disposal of the shares in Tax Haven Co. The shares to be sold can be dictated by the structure which the potential purchaser wishes to adopt;
- sale of the shares in either company gives rise to Australian CGT which:
  - generates franking credits; and
  - uses any available tax losses; and
- no foreign CGT is paid.

Repatriation of profits

Another aspect which needs to be considered is how dividends will be repatriated to Australia and in particular determining a structure to ensure any foreign tax credits attached to a dividend are not wasted. This "wasting" may arise due to the Australian tax legislation limiting the use of foreign tax credits by considering their use on a year-by-year basis and also by ensuring they are attached to the specific dividend received and not grouped over all dividends.

One issue that is often unique to the mining industry, be it for Australian tax or offshore, is the accelerated write-off of exploration expenditure for tax as compared to accounting profit.[19] This difference often means careful tax planning is required when paying dividends to ensure there is no wasting of foreign tax credits.

Take the following example:

	Year 1	Year 2	Year 3	Year 4
Income	500	500	500	500
Accounting Write-off	150	150	150	150
Accounting Profit	350	350	350	350
Tax Write-Off	500	500	0	0
Taxable Income	0	0	500	500

In years 1 and 2, the company generates no taxable income, therefore the company will pay no foreign tax and consequently no foreign tax credit will be attached to any dividend paid from the accounting profit. However in years 3 and 4, taxable income is greater than the accounting profit and therefore as tax is paid on taxable income, there will be excess foreign tax credits attached to the dividend. The following table highlights this:

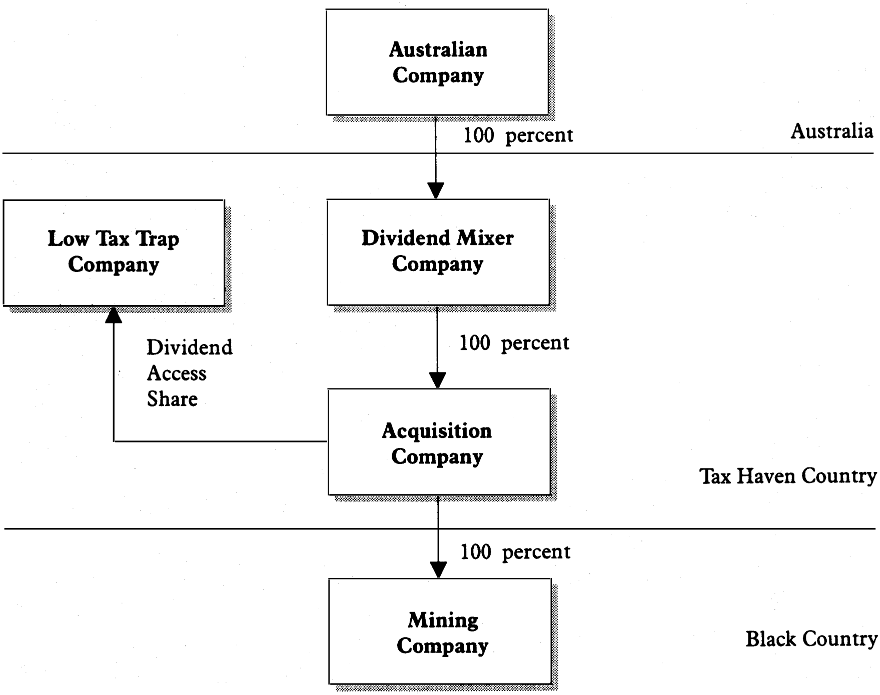
	Year 1	Year 2	Year 3	Year 4
Accounting Profit	350	350	350	350
Taxable Income	0	0	500	500
Foreign tax (assume 30% rate)	0	0	150	150
Dividend	350	350	350	350
Foreign tax credit (limit to 36%)	0	0	126	126

19 For example, in an Australian context, the outright deduction for exploration expenditure allowed by s 330-15 of the *Income Tax Assessment Act* 1997.

As can be seen in years 3 and 4, there is an excess foreign tax credit of $24 which most likely cannot be used by the company.

Careful tax planning by an investor can avoid wasting of foreign tax credits by putting in place an appropriate structure. One such way of ensuring the most efficient use of foreign tax credits is by implementing a "dividend mixer" company into the structure. Consider the following:

Diagram 4



The structure works in the following manner:

- in the early years, Mining Company pays its dividends, with low foreign tax credits, to the Acquisition Company, who in turn pays the dividend to the Low Tax Trap Company by virtue of a dividend access share. The share capital of Mining Company would be split such that Mining Company can choose to pay either a dividend to The Low Tax Trap Company or the Tax Haven Company. This is achieved by having a special share category giving the Low Tax Trap Company a right to dividends but probably no other rights such as voting;

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- in the later years, Mining Company pays its dividends with high foreign tax credits to the Acquisition Company. This dividend is not passed to the Low Tax Trap Company;
- dividends are paid by both the Acquisition Company (with the high foreign tax credits still attached) and by the Low Tax Trap Company (with the low foreign tax credits attached) to the Dividend Mixer Company in later years;
- the dividends received by the Dividend Mixer Company are "mixed" such that the dividends and the foreign tax credits are combined, thereby averaging the foreign tax credits with a dividend then paid to the Australian company.

As can be seen, this will alleviate the problem for mining companies where expenditure can be written off more quickly for tax purposes than for accounting purposes. Of course this structure may be of benefit where there is any accelerated write-off for tax as compared to accounting, for example a higher tax depreciation write-off, research and development or any special foreign tax holidays.

This structure will also be of benefit should the group expand to more than one geographical area. This is because the dividend mixer could be used to mix dividends from both high rate tax regimes and low rate tax regimes before paying a dividend to the Australian company.

The benefits of using a structure which incorporates tax haven companies include:

- ensuring any capital gains tax arising on the sale of the business will be paid in Australia;
- it can be used by the group to ensure there is no wasting of foreign tax credits through the use of a dividend mixer company;
- it is a good basis for any further acquisitions by the company for the mixing of dividends from high tax rate countries and low tax rate companies.

CONCLUSION

To summarise, the main objectives from a tax perspective when undertaking offshore operations are:

- to minimise the amount of tax payable;
- where tax must be paid ensure that it is paid in Australia.

These two objectives can be achieved by implementing a tax structure which is efficient for CFC purposes, dividend repatriation, utilisation of foreign tax credits, future acquisitions and any subsequent disposal. These tax structures usually include the establishment of a tax haven resident company, which can be of benefit in all aspects of the tax planning.