SHOULD THE INTERNATIONAL INCOME OF AN AUSTRALIAN RESIDENT BE TAXED ON A WORLDWIDE OR TERRITORIAL BASIS?

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Many countries impose income tax on the worldwide income of their residents or citizens. This is the case in Australia where ‘Australian residents for tax purposes’ must pay income tax on their worldwide income including statutory income such as capital gains and dividends. If the government of a country adopts a ‘worldwide’ basis for imposing income tax on its residents then the existence of tax havens and offshore financial centres becomes an important issue because income from passive investments may not be disclosed and subsequently taxed in Australia. The Australian Government has recently funded ‘Operation Wickenby’, in an attempt to detect Australians using tax havens and reinforcing the integrity of a worldwide taxation system. This paper will start with a discussion of the philosophical basis for Australia having adopted a ‘worldwide’ system of taxation as opposed to a ‘territorial system’ and then examine the problems with collecting income tax on foreign sourced income generated by Australian residents. The paper will then draw a conclusion as to the merits of Australia adopting a territorial system for taxing foreign income and whether the worldwide system should be abandoned altogether.

I INTRODUCTION

As capital and labour become more mobile in a globalised world the ability of a government to tax income generated in a foreign country becomes one of the most important challenges of the twenty-first century.1 Similarly, with the growth in technology and electronic commerce as well as the general effects of globalisation, it will be difficult for countries that have a worldwide system of taxation to collect taxes that should be paid by their residents on foreign sourced income.2 This paper will discuss the effectiveness of the Australian government trying to impose income tax on the foreign sourced income of Australian residents under a worldwide system of taxation. The main question to be answered in this paper is whether it would be more equitable, efficient and with fewer complexities to simply impose income tax on income derived within Australia by Australian residents. In other words, should Australia adopt a pure territorial system for taxing foreign income or continue with the current arrangements? It should also be noted that no country uses a pure system of either worldwide or territorial taxation other than Hong Kong.3 Indeed, some commentators in this area of law have advocated the need to describe a worldwide system with deferral...

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for foreign sourced active business income as a ‘hybrid worldwide’ system and a territorial system that taxes some worldwide income as a ‘hybrid exemption system’. On this basis of classification, Australia has a hybrid worldwide system. It is of interest to note that Australia did adopt a pure ‘territorial system’ of taxation between 1915 and 1930 and thereafter retained a modified system with exemptions and credits for foreign income.

The remainder of this paper has been divided into five sections. Section II will look at the philosophical framework for taxing international income and in particular the sharing of tax revenue between nations. Section III of the paper will examine the advantages and disadvantages of a worldwide tax system using the criteria of equity, efficiency and simplicity to assess the current performance of the Australian taxation arrangements. Section IV of the paper will examine the rationale for adopting a territorial system and the advantages and disadvantages will be assessed within the framework of equity, efficiency and simplicity. The taxation system adopted in Hong Kong will be examined in detail and in particular the problem of trying to counter tax avoidance as a result of only imposing income tax on income sourced within the territory. Singapore will also be reviewed from an anti-tax avoidance perspective. Section V will examine measures that have been adopted in Australia and New Zealand to try to attract capital and labour. The introduction of these statutory measures would indicate that the Australian and New Zealand governments are prepared to adopt a territorial basis of not taxing foreign sourced income, as part of that taxpayer’s worldwide income, in those circumstances. Section VI of the paper will provide a conclusion based on the analysis of a worldwide and a territorial system of taxation in order to assess what changes, if any, should be made to the current Australian taxation system.

II PHILOSOPHICAL FRAMEWORK FOR TAXING INTERNATIONAL INCOME

Prior to examining the specific attributes of a worldwide or territorial system for the taxation of international income, it is important to review the theory behind why countries have chosen one method of taxing international income over the other. The three recognised criteria, to be used as a framework for assessing the effects of the tax system on taxpayers, are the need for equity, efficiency and simplicity. These principles are based on the Adam Smith model of taxation, but are now regarded as the ‘recognised cannons’ of taxation. These principles of taxation were also recognised as being fundamental to the review of

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the Australian Tax System by the Asprey Committee and have since been used as a framework for the review of the Australian ‘tax and transfer system’ currently being conducted by the Australian Government. This framework will be used to assess the merits of taxing foreign income on a worldwide basis or a territorial basis. Fundamental to this analysis are the concepts of taxing international income at the ‘source’ of the income in the host country or in the country of the ‘residence’ of the taxpayer, the home country. It should be remembered that all countries tax income that has been derived ‘within the geographic borders of the country levying the tax’, namely the source of the income. In other words, income generated within any country will be subject to income tax even if derived by non-residents. However, in terms of describing an international tax system, the levying of income tax is based on taxation at the source of the income or on the basis of the residence of the taxpayer. Taxation at source is at the foundation of a territorial system of international taxation whereas taxation of international income based on the residence of the taxpayer is at the foundation of a worldwide system of taxation. However, in reality ‘no country uses a pure worldwide or territorial system’. The existence of the exemption of foreign active income from further taxation in Australia or the foreign tax credit for tax paid in the source country are aspects of a ‘territorial’ tax system. These aspects of international taxation are explained in detail later in the paper.

Professor Peggy Musgrave discusses the sovereign right of the nation state to tax its residents on their worldwide income and contends that the right is recognised in international law. Musgrave states that the right to tax the income of residents and non-residents is based on the fact that a resident owes a tax allegiance in return for the rights and privileges which they receive as residents, giving rise to what is commonly referred to as the ‘residence principle’, and this is the reason why the country of residence has sovereignty over the total tax burden on the foreign-source income of its resident taxpayers.

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8 The Commonwealth of Australia, Taxation Review Committee, (1975) University of Sydney Library, Sydney (2001). The Committee was asked to consider the effects of the taxation system upon the economic and efficient use of resources in Australia, the desirability that there should be a fair distribution of the burden of taxation, and that revenue-raising be by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense.’ Chapter 3, 40. The three criteria were also used to evaluate the exemption and credit methods to provide relief against double taxation of international income, Chapter 17, 336.


12 The exemptions for active income, as opposed to passive income are found in sections 23AG, 23AH and 23AJ, Income Tax Assessment Act 1936 (Cth), (ITAA 36) or the foreign tax credit, Division 770, Income Tax Assessment Act 1997 (Cth), (ITAA 97). Division 770 applies from 1 July 2008 and now refers to the foreign tax credit as a ‘foreign income tax offset’.


14 Above n 13, 1337.
Professor Kaufman does not agree that a taxpayer’s entire income necessarily needs to be taxed by a single country – the residence country.\textsuperscript{15} According to Kaufman, traditional international tax theory holds that a worldwide tax system based on residency and citizenship is grounded on the ‘ability-to-pay theory’ and source taxation, a territorial system, is based on a ‘benefit theory’.\textsuperscript{16} Therefore, individual taxpayers with equal incomes should pay the same amount of tax no matter where the income is derived.\textsuperscript{17} The benefit theory holds that a non-resident should contribute to the host country’s cost of government by being subject to tax at the source of the income.\textsuperscript{18} However, Kaufman rejects this view and contends that the ‘ability to pay’ and ‘benefit theory’ cannot explain the structure of the present international income tax system.\textsuperscript{19} Horizontal and vertical equity is a national tax matter concerning taxpayers of the home country. The equitable sharing of taxes either based on source or residence is an international matter. As Kaufman states, equity in international taxation is an international matter.\textsuperscript{20} Kaufman rejects the view that ‘fairness in the international tax system necessitates the adoption of a worldwide tax base and that benefit theory underlies source taxation’.\textsuperscript{21}

Inter-nation equity in international taxation is concerned about the sharing of tax revenue. If the host country imposes tax on income generated within its borders then the country of residence, by providing a credit for tax paid or an exemption from further tax on the income is foregoing revenue that it could have collected. Similarly, the host country may impose higher or lower taxes than those imposed in the home country on the resident taxpayer.\textsuperscript{22} It is this sharing of revenue on an equitable basis that is the foundation of international tax law. The justification for the imposition of taxes based on the ability to pay principle grounded in a worldwide system or the benefit theory grounded in a territorial system is what Kaufman argues is not correct, and that economic allegiance theory should be considered as a basis for inter-nation equity. In 1923, when the economic experts appointed by the League of Nations attempted to resolve the problem of sharing international taxation between two or more countries in order to eliminate double taxation, they considered the ‘economic allegiance’ theory for the sharing of taxes.\textsuperscript{23}

According to Kaufman, the League’s economic experts considered economic allegiance to be the foundation of a nation’s competence in taxation.\textsuperscript{24} Kaufman concludes that there are three instances where the current international

\textsuperscript{16} Kaufman, above n 15, 153.
\textsuperscript{17} Above n 15, 153.
\textsuperscript{18} Above n 15.
\textsuperscript{19} Above n 15, 202.
\textsuperscript{20} Above n 15.
\textsuperscript{21} Above n 15, 203.
\textsuperscript{22} In Australia non-resident individuals are subject to higher marginal rates of personal income tax than are residents. This would appear to be at odds with a benefit theory for the imposition of tax at source because even though the non-resident receives little benefit from the host country, the host country imposes higher rates of tax.
\textsuperscript{23} The four economic experts appointed by the League of Nations were Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp. The document produced was the ‘Report on Double Taxation by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp’, League of Nations (1923).
\textsuperscript{24} Kaufman, above n 15, 196.
The tax system provides evidence that the economic allegiance theory is at the foundation of the way in which nations share the tax revenue from international transactions. The first is the present international consensus on residence as the criterion for determining which country is the home country; second is the universality of source taxation despite the condemnation of income taxes based on benefit theory; and third, the foreign tax credit and exemption from tax for foreign source income are consistent with a view that the economic connection between the host country and the income arising there gives the host country its own interest in international income.\(^{25}\) The same reasoning applies when applying a fairness test of ‘ability to pay’, because income derived out of the territory is not taken into account. This is why a territorial system is based on a ‘benefits rule’, in that the non-resident of the source country is levied on their source income on the basis that they have derived benefits from the host country.\(^{26}\) Kaufman contends that source taxation, a territorial system, is out of favour with commentators because the ‘ability-to-pay’ theory has supplanted the ‘benefit’ theory.\(^{27}\)

It would appear that any discussion on inter-nation equity in international taxation is quite distinct from equity considerations at the national level. Commentators are divided over what is the correct philosophical basis for the sharing of tax revenue between the competing states. Philosophically worldwide taxation was grounded on a theory of ability to pay and territorial taxation was grounded on a benefit theory. Kaufman argues that an economic allegiance theory should be considered as the basis for inter-nation equity and the justification for the sharing of revenue based on a worldwide system and a territorial or source based system.

### III WORLDWIDE SYSTEM - RESIDENCE TAXATION

Australia has adopted a worldwide system for the taxation of foreign income, but provides an exemption from income tax in Australia for some active business income that has been subject to tax at source and a credit against income tax to be paid in Australia for tax paid in the source country for passive income. In effect, this is a mixture of a worldwide and territorial system of taxation which prevents the double taxation of the income, first in the source country and then again in the country of residence of the taxpayer. DTAs prevent double taxation occurring in this situation. However, it is not intended to examine the history and details of DTAs in this paper other than to state that they are designed to eliminate double taxation and to allow for the exchange of information to prevent tax avoidance and evasion.\(^{28}\)

Australian residents pay income tax on their foreign ordinary income as well as their statutory income which includes capital gains. The taxing sections of the *Income Tax Assessment Act 1997 (Cth)*, (ITAA 97) are s 6-5 and s 6-10.\(^{29}\) The

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\(^{25}\) Above n 15, 202.

\(^{26}\) Above n 15, 183.

\(^{27}\) Above n 15, 183.

\(^{28}\) For an extensive discussion of the history of double taxation agreements and their future see the paper presented at the Australasian Tax Teachers Association Conference in Christchurch, New Zealand in January 2009 by C John Taylor, "Twilight of the Neanderthals or are Bi-lateral Double Tax Treaty Networks Sustainable?".

\(^{29}\) Sub-section 6-5(2) - If you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia,
provisions relating to statutory income derived by residents and non-residents are very similar to the sections relating to ordinary income.30

**A Equity - Vertical, Horizontal and Inter-nation**

Put simply, the concept of equity holds that the rich pay more in tax than the poor; vertical equity, and those on the same income pay the same amount in tax; horizontal equity. Over the past centuries different forms of taxation has been imposed on different sources of income and wealth, at different rates, and in some cases at higher rates for the wealthy than for the poor. One of the main aims of a tax system is to redistribute wealth from the rich to the poor, hence the concept of vertical equity. If tax is imposed at the same rate on the rich and poor alike, then it is considered to be contrary to vertical equity because it impacts on the poor to a greater extent than the rich. Therefore it can be seen that a progressive rate system is crucial in achieving vertical equity, namely that different rates of tax are imposed on different amounts of income. The Australian tax system adopts a progressive rate system for income tax and views vertical equity as being important for redistributive purposes.31

In terms of a worldwide tax system, vertical equity requires all taxpayers in Australia to pay income tax at different rates based on their total income and their ‘ability to pay’ in a progressive rate system. Unless foreign sourced income is included in assessable income then at least two inequitable consequences would follow; first the burden of tax would fall on those taxpayers unable to move capital offshore, and second; there would be an even greater incentive to earn foreign sourced income. This is one of the main reasons why a worldwide system is seen as being better than a territorial system, because with a territorial system foreign sourced income is not subject to income tax in the home state. What then is the situation with horizontal equity under a worldwide system? Horizontal equity requires all taxpayers earning the same level of income to pay the same amount of income tax. Proponents of a worldwide tax system contend that horizontal equity is safeguarded under that system because all taxpayers must include foreign income in their taxable income based on their residency, and pay the same rate of tax on that income.32 As well, horizontal equity is further enhanced because a system of foreign tax credits or exemptions ensures that the taxpayer does not pay more tax in their country of residence just because they include foreign sourced income.

during the income year. Sub-section 6-5(3) - If you are not an Australian resident, your assessable income includes: the ordinary income you derived directly or indirectly from all Australian sources during the income year.

30 Sub-section 6-10(1) - Your assessable income also includes some amounts that are not ordinary income. Sub-section 6-10(2) - Amounts that are not ordinary income, but are included in your assessable income by provisions about assessable income, are called statutory income.

Sub-section 6-10(4) - If you are an Australian resident, your assessable income includes your statutory income from all sources, whether in or out of Australia. Sub-section 6-10(5) - If you are not an Australian resident, your assessable income includes your statutory income from all Australian sources.


The issue of the source country imposing taxes on income generated by non-residents raises the concept of inter-nation equity. The country of source and the country of residence must agree on the share of taxes each country will claim. The source country is entitled to tax the income of the non-resident ‘in line with the benefits provided by government services in generating that income’. On this basis, the source country imposes a withholding tax on interest, dividends or royalties paid to a non-resident on their income from passive activities. An interesting example of differences with withholding tax rates is found in the exemption provided by the USA, UK and Australia with interest withholding tax for payments from Australia to banks in the UK and the USA. Income from business activity is taxed at source on the basis of the non-resident having a ‘permanent establishment’ in that country and the income is subject to the higher rates of tax than the withholding tax rates. The standard of inter-nation equity is a responsibility of the source country whereas taxpayer equity is a responsibility of the residence country.

B Efficiency

The concept of capital neutrality is fundamental to having an international tax system that is efficient. The concept of ‘neutrality’ holds that the tax law should have no effect on behaviour and in this situation in relation to the choice of location where capital is to be invested. In order to achieve efficiency in international taxation, two types of neutrality are regarded as being crucial to that goal, capital export neutrality (CEN) and capital import neutrality (CIN). Under an efficient international tax system CEN requires the taxpayer to be neutral about domestic or foreign investment because both should provide the same pre-tax rate of return. As Professor Michael Graetz states, ‘economists regard CEN as essential for worldwide economic efficiency, because the location of investments will be unaffected by capital income taxes.’ For CEN to work, the country of source should not impose any source-based taxes, only the country of residence. The CEN concept has been adjusted in practice to allow for source based taxes but with a credit for those taxes being given in the country of residence.

This is similar to the current situation in Australia and many other OECD member countries that allow a credit for tax paid by their residents in the source country. It is usually passive income that is subject to a form of withholding tax at source, and a credit given for those taxes that have been paid.

The other type of neutrality is CIN, which ‘requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor’. According to Graetz, ‘if CIN holds, all savers,

34 As a result of the Australia-USA free trade agreement, Australia exempted interest withholding tax of 10% when interest is to be paid to banks in the USA and UK.
35 Musgrave, n 33, 281.
37 Above n 36, 270.
38 Above n 36, 271.
39 Division 770, ITAA 97.
40 Above n 36, 270
regardless of their residence, receive the same after-tax returns’. CIN is said to support taxation only by the source country, with the country of residence exempting foreign source income from further taxation. This is the situation with active or business income being generated by an Australian resident in a foreign country with a full exemption being given for the income that has been subject to income tax at a comparable rate in the foreign country. However, it should be remembered that the USA does not provide an exemption for active income generated by its own business residents in a foreign country that has been subject to income tax at source.

Graetz states that it is ‘impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations’. This means that governments must either choose a worldwide or territorial system for the taxation of foreign income in order to achieve efficiency in the tax system. Graetz uses the following three principles to illustrate the ‘irreconcilable conflict between residence and sourced based taxation of income:

Principle 1: People should pay equal taxes on their income regardless of the country that is the source of that income. In particular U.S. taxpayers should be treated equally regardless of the source of their income.

Principle 2: All investments in the United States should face the same burden regardless of whether a U.S. person or foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.

Principle 3: Sovereign countries should be free to set the ir own tax rates and to vary them as their domestic economic situations demand. The essential difficulty is that the first two principles can hold simultaneously only when capital income is taxed at the same rate in all countries. This requires identical tax systems, including identical tax rates, tax bases, and choices between source-and residence-based taxation. That has never happened, and it never will. Moreover, there would be no way to keep such a system in place without violating Principle 3.

These principles outline the problem facing any government in trying to achieve equity in an international taxation system and at the same time trying to achieve efficiency. Both a residence and sourced based system have difficulty in achieving efficiency when most countries have different rates of income tax. The simple answer in deciding on the most efficient system to use is to adopt the system used in Australia, a hybrid system with a mixture of a worldwide and territorial system that allows for a credit for foreign taxes paid and an exemption from further income tax on the resident taxpayer for active income. In recent

41 Above n 36, 271.
42 Above n 36, 271.
43 Sections 23AH and 23 AJ, ITAA 36.
45 Above n 36, 272.
46 Above n 36, 272, footnote 36.
years many countries have adopted a hybrid exemption system and more than half of the OECD member countries have adopted such a system.\textsuperscript{47}

1. **Permanent Establishment – Active v. Passive Income**

Professor Reuven Avi-Yonah contends that in 1923 when the League of Nations was trying to resolve the problem of double taxation that it came to the conclusion that the ultimate goal underlying the international tax regime is that active business income is taxed in the source country in which it originates and that passive income should be taxed in the country in which the recipient resides.\textsuperscript{48}

This can be extended to reflect that income from investments should be subject to some limited form of taxation in the source country but greater tax in the home country, namely the country of residence. The distinction between passive and active business income is reflected in the double tax treaties by use of the permanent establishment concept. The basis on which income tax is imposed on non-resident business taxpayers is the concept of having a ‘permanent establishment’ (PE) in that country. The distinction between passive and active income by the use of a PE is a compromise, according to Avi-Yonah, because the threshold of what constitutes a PE is quite low: a single office, or even a single agent with authority to conclude sales, is generally sufficient.\textsuperscript{49} Taxation of passive income in the country of source still exists but at very low rates of tax. The OECD Model Income Tax Treaty recommends that dividends be subject to withholding rates of tax of between 5 percent and 15 percent, interest at 10 percent and royalties 0 percent.\textsuperscript{50} Avi-Yonah holds that the low tax rates imposed by the source country are a compromise between the source countries levying some tax but at the same time acknowledging that the country of residence should be the primary taxing authority.\textsuperscript{51}

However, according to Graetz, the PE concept is ‘facing new pressure from electronic commerce, new financial techniques, and new forms of business arrangements and combinations’.\textsuperscript{52} He strongly advocates a modernisation of the permanent concept possibly based on a threshold amount of sales, assets, labour or research and development within a nation.\textsuperscript{53} The threat of reduced tax revenue from e-commerce was discussed by Professor Daniel Cheung when examining the challenges facing Hong Kong with its territorial tax system.\textsuperscript{54} Because Hong Kong only taxes income based on its geography, e-commerce threatens future tax

\begin{itemize}
  \item Fleming et al, n 4, 37.
  \item Above n 48, 1307.
  \item Above n 48, 1308. In Australia the withholding rates are different depending on whether or not the dividends are carrying imputation credits, and if so, then the non-resident shareholder is subject to withholding tax to the extent the dividend is unfranked up to a maximum rate of tax of 15%. Interest is subject to 10% withholding tax unless paid to a ‘bank’ in the UK or USA and then 0% applies. Royalties are subject to 5% in the case of a US resident owner of the IP or 15% for any other non-resident.
  \item Above n 48, 1308.
  \item Above n 52, 319.
\end{itemize}
revenue to a far greater extent that a tax system based on the residence of the taxpayer.\textsuperscript{55}

2. \textit{Active v. Passive Income – Exemption or Credit}

Australia already provides relief from double taxation in the form of exemptions of certain active income, s 23AG\textsuperscript{56} for limited situations where personal services income is derived in a foreign country; s 23AH for branch income derived in certain foreign countries; and s 23AJ exempts non-portfolio dividend income paid by a foreign company. It is important to note that the USA dose not provide an exemption for active business income for its resident companies, and this issue has become an important consideration for the US government, especially as US corporations are claiming that they are not as competitive as other MNEs.\textsuperscript{57} If these exemptions already apply, why try to impose income tax on worldwide income and be concerned with Tax Havens? Australia also provides a credit for foreign tax paid on passive foreign sourced income so again in many instances no more income tax is paid in Australia.

A credit given by the home country for income tax paid in a foreign country is not as effective as the exemption method. Division 770 of the ITAA 97 applies from 1 July 2008 and now refers to the foreign tax credit as a ‘foreign income tax offset’. Philip Bender has highlighted one of the potential defects of the new foreign tax credit arrangements: when active business income is repatriated to Australia that is exempt it carries no imputation credits from the foreign tax that has been paid. So, while the income is not subject to double taxation, it is subsequently taxed in the hands of the Australian resident shareholders when they receive a dividend.\textsuperscript{58} The solution may be to only impose income tax on a territorial basis and not be concerned with income derived in foreign countries. Or the Australian government could adopt a derived and remitted system where only income remitted back to Australia is subject to income tax but this may act as a disincentive to repatriate profits to the home country.

3. \textit{Anti-Deferral Measures - The Accruals System – the CFC, FIF and Transferor – Trust Provisions}

In 1991 Australia introduced anti-tax deferral legislation to impose income tax on Controlled Foreign Corporations (CFC’s) and Foreign Investment Funds (FIF’s) by ‘attributing’ to Australian taxpayers income perceived to have been generated in a tax haven or low taxing country. At the same time the Government introduced measures to prevent foreign trusts and foreign beneficiaries being used to avoid income tax in Australia. Those anti-avoidance and anti-deferral rules of taxation law have not worked well. As Professor Lee Burns states, the ‘legislation enacting these regimes is among the most detailed and complex tax legislation in Australia. … It is argued that the design does not

\textsuperscript{55} Above n 54.
\textsuperscript{56} Section 23AG was amended effective from 1 July 2009, Tax Laws Amendment (2009 Budget Measures No 1) Bill 2009, and only provides an exemption for relief workers and defence force personnel.
\textsuperscript{57} USA, Joint Committee, Graetz and other commentators and organisations.
\textsuperscript{58} Bender, Philip, ‘Foreign tax credits and overseas investment: More reform necessary?’ (2008) \textit{Australian Tax Review} 38, 61.
adequately take account of the nature of the global economy today.\textsuperscript{59} If Australia adopted a territorial basis of taxation then these anti-avoidance provisions would not be required resulting in a reduction of complexity in the existing taxation law. The issue of the severe complexity of the Australian taxation law,\textsuperscript{60} and the urgent need for reform has been discussed above and the fact that one way in which complexity can be resolved is to adopt a territorial basis of taxation. Under a territorial system there is no need to have CFC, FIF and transferor-trust provisions as foreign sourced income would not be subject to income tax in the home country. The third criterion for determining an appropriate tax system is whether or not the laws and rules are simple to apply and administer and to be understood by taxpayers, both resident and non-resident taxpayers.

\textbf{C Simplicity}

According to Fleming et al, territorial systems are not simple, but are simpler than a worldwide system.\textsuperscript{61} Other commentators have also expressed the view that a territorial system is less complex that a worldwide system due largely to the anti-avoidance and anti-deferral measures contained in such a system.\textsuperscript{62} One simple way in which the existing taxation system in Australia could be made less complex would be to introduce a territorial basis of taxation.

A complex system is perceived to lead to tax evasion and tax avoidance because of the wealthy being able to obtain advice on how to take advantage of the complexities in the law.\textsuperscript{63} The current review of the Australian tax system has noted that the income tax law contained in the various statutes is now 5,743 pages, up from 526 pages in 1975 when the ‘Asprey’\textsuperscript{64} report on the review of the tax system was produced.\textsuperscript{65} The Business Council of Australia and the Corporate Tax Association released a report in 2007 on measures to reduce compliance costs on business and found that those businesses had to deal with 21 Australian Government taxes, 33 State taxes and 2 Local Government taxes. It was noted that this was more than twice the number of taxes effecting businesses in the United Kingdom.\textsuperscript{66}

\textbf{D The Practical problems of detecting income in a tax haven}

The Australian Government has recently funded ‘Operation Wickenby’, a multi-agency task force investigating tax avoidance and tax evasion involving the use of offshore entities. The task force comprises the Australian Taxation Office (ATO), the Australian Crime Commission (ACC) and the Australian Federal

\textsuperscript{61} Fleming et al, n 4, 39.
\textsuperscript{62} Joint Committee on Taxation, n 17, 5.
\textsuperscript{63} Fuest, Clemens, Peichl, Andreas and Schaefer, Thilo, Does a Simpler Income Tax Yield More Equity and Efficiency?, (2008) 54 CESifo Economic Studies 73, 73 and 74.
\textsuperscript{64} The Report on ‘Commonwealth Taxation Review Committee (Asprey Committee) (1975) looked at the Australian tax system in terms of equity, efficiency and simplicity as well as the need to broaden the tax base that existed in Australia at that time.
\textsuperscript{65} Commonwealth of Australia, n 31, 305.
\textsuperscript{66} Above n 65, 307.
Police (AFP). The budget for a five year period is around $300 million and the Commissioner of Taxation estimates that the revenue recovered will be over $300 million.\textsuperscript{67} The 2009 Budget provided a further $122 million over the next three years for ‘Project Wickenby’.\textsuperscript{68} According to the ATO, Project ‘Wickenby’ investigations have so far also resulted in:

- 23 criminal investigations
- 42 people charged on indictable offences
- 544 completed tax audits (and a further 716 underway)
- $299.61 million in tax liabilities raised
- $255.94 million in tax collected, assets restrained and compliance dividend.\textsuperscript{69}

If the ATO has not recovered in excess of $420 million within the eight year period then the question will be asked, why go to this trouble and expense when the cost of recovery of income tax exceeds the amount of income tax actually recovered? The simple solution is to only impose income tax on income derived from sources in Australia by Australian residents and impose income tax on foreign income remitted to Australia by Australian residents. In addition, many countries including Australia are facing the problem of ‘international tax arbitrage’. International tax arbitrage has been described by Professor Adam Rosenzweig as arising when a taxpayer can technically comply with the laws of two or more jurisdictions while at the same time reducing their total worldwide tax liability.\textsuperscript{70} This is similar to situations that arise with countries that impose income tax on a territorial basis where a structure is used to derive income in another jurisdiction by artificial means so that it is not construed to have been derived in the home country. As a result of the fact that it is very difficult for the ATO to ascertain the existence of income being generated by Australian taxpayers in a tax haven or OFC, should the Australian Government therefore consider the merits of adopting the ‘territorial approach’ to the imposition of income tax on the foreign sourced income of Australian residents?\textsuperscript{71}

IV TERRITORIAL SYSTEM - SOURCE TAXATION

Under a ‘territorial system’ of taxation, income tax is only imposed on income derived within the territory and this system is known as a pure ‘territorial system’ of taxation. Hong Kong is one of the few remaining countries with a territorial system and is the best example and it will be used throughout this section of the paper to illustrate the advantages and disadvantages of a territorial system of taxation. Up until 1 January 2001, South Africa also used a source

\textsuperscript{67} Thomson ATP Weekly Tax bulletin, 23 February 2007, [285].  
\textsuperscript{68} D’Ascenzo, Michael, ‘From the Commissioner’s desk – we live in interesting times’, (speech delivered at the National Institute of Accountants Public Practice Symposium, Sydney, 21 May 2009)  
\textsuperscript{69} Above n 68.  
\textsuperscript{70} Rosenzweig, Adam, ‘Harnessing the costs of international arbitrage’, (2007) 26 Virginia Tax Review 555, 557.  
\textsuperscript{71} The territorial basis of imposing income tax is to only tax income sourced within the country or territory. This means that income generated by a resident taxpayer out of the territory is not subject to income tax in the home country. This is the situation in Hong Kong, Malaysia, Philippines and Singapore, Australia’s nearest neighbours.
based system of income tax but changed to a worldwide system. The Minister of Finance, Trevor Manuel stated that a sourced based system was out of line with international practices and permitted tax avoidance by allowing income to be structured as ‘foreign sourced’ and that this was one of the main reasons for changing to a worldwide system. Other countries including Singapore and Malaysia have a hybrid territorial system which only imposes income tax on income that is sourced in their country and some categories of remitted foreign source income. This is commonly referred to as a ‘derived and remittance’ basis of a territorial system. Moreover, Australia, New Zealand and Canada had a territorial system of taxation up until the first few decades of the twentieth century due to the fact that the tax law was based on statutory law developed in the UK and applied in the colonies.

One of the major criticisms of those advocating a territorial system is that if a country that was currently using a worldwide system changed to a territorial system, then businesses and investment would move to a low or no tax country. There would be a flight of capital and business activity and with it employment and technology. A worldwide system is seen as protecting the residence country’s tax base more effectively than a territorial system. On the other hand a territorial system would make MNEs, currently a resident of say Australia, more competitive in a global environment because they would not need to worry about paying income tax on their foreign sourced income in situations where there is no exemption, either because it is passive income or the source country is not a listed country with comparable tax rates or no tax is paid to generate a tax credit. This is more important for companies resident in the U.S. where there is no exemption system, only a tax credit for foreign paid taxes. Professor Robert Green claims that ‘sourced based taxation is difficult to justify on theoretical grounds’. Green makes this statement on the basis that it is hard to reconcile with an ‘ability to pay theory’ and the cost to government. Presumably he means that ability to pay and the benefits theory cannot be reconciled. There is no argument with that finding, but the Kaufman approach, as discussed above, based on the economic allegiance theory may provide a solution. Green then suggests that in order to prevent income shifting by MNEs and tax competition, an international acceptance of a worldwide system would be the best solution.

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73 Above n 72, 19.
76 Joint Committee on Taxation, n 11, 4.
77 Fleming et al, n 4, 39.
79 Above n 78, 70 and 86.
the adoption of a territorial system in the U.S. but suggest ways to remedy the defects in the U.S. worldwide system.\textsuperscript{80}

\textbf{A Equity – Vertical and Horizontal}

The major impact on equity within a territorial system is that taxpayers only pay income tax on their income generated within their own country of residence and their foreign income is not subject to income tax, other than taxes imposed by the source country such as withholding tax on passive income or normal taxes on active business income on the basis of having a PE. This means that the concept of horizontal equity has no meaning because not all taxpayers deriving the same income pay the same amount of income tax. Similarly, the imposition of progressive rates of tax, in order to achieve vertical equity, does not achieve a distributional effect because some taxpayers are only paying tax on a portion of their total income, namely income derived in their home country.

From an equity perspective, a territorial system fails to achieve either horizontal or vertical equity. This statement is reinforced by Dr Michael Littlewood when commenting on the Hong Kong taxation system. He contends that the tax system is inherently inequitable due to the rampant tax avoidance and evasion\textsuperscript{81} but with the poorest two-thirds of the workforce exempt from tax altogether, it is not necessary to try to ‘achieve equity among this part of the workforce’.\textsuperscript{82} In terms of the remaining third of taxpayers, Littlewood is of the view that the inequality is considerable, given the fact that under the Hong Kong tax system no income tax is paid on interest, offshore income and employee perquisites such as employer provided housing and motor vehicles.\textsuperscript{83} However, according to Littlewood, people do not complain about the inequality due to the very low rates of tax, namely 16 percent.\textsuperscript{84} However, given the extent of the poverty and deplorable living conditions for a substantial part of the population in Hong Kong,\textsuperscript{85} the tax system is arguably failing to achieve vertical and horizontal equity by not collecting sufficient revenue from those with the ability to pay and providing the requisite level of welfare. In conclusion, a territorial system, as illustrated by the example of Hong Kong, clearly proves that a worldwide system satisfies vertical and horizontal equity better than a territorial system.

\textbf{B Efficiency}

It is in the area of efficiency that a territorial system, arguably, has substantial advantages over a worldwide system. A territorial system ‘treats all investment within a particular country, the source country, the same, regardless of the residence of the investor’.\textsuperscript{86} This efficiency norm is referred to capital import neutrality, CIN, which is seen as favouring competitiveness between MNEs. In

\textsuperscript{80}Fleming et al, n 4, 40.
\textsuperscript{82}Littlewood, above n 75, 287.
\textsuperscript{83}Above n 75.
\textsuperscript{84}Above n 75, 288.
\textsuperscript{86}Joint Committee on Taxation, n 11, 5.
other words, source countries with a territorial system are indifferent as to the tax rates that apply in the capital importing country because that income will not be taxed in the source country. The investment decision is neutral from the perspective of the taxpayer in a territorial system and the government of that state. If the tax rates in the capital importing nation are lower than the home country, then the taxpayer obtains the benefit. However, if the capital is imported to a low-taxing country and the taxpayer is a resident of a country with a worldwide system, then the taxpayer obtains no advantage in taxation with their own home country. In the case of U.S. MNEs, they claim that they are at a competitive disadvantage because they are not able to claim an exemption from tax from their home country on tax paid at source, but merely a credit for tax paid at source. However, Australian MNEs do obtain the benefit of an exemption for active business income and non-portfolio dividends in some cases so they are not disadvantaged. In the situation with Australian MNEs exporting capital, they would hold that CIN is a measure of efficiency when investing in foreign countries because the home country provides an exemption or credit for tax paid. The Australian MNE is able to obtain the efficiency advantages because of the exemption from tax on active income that has the result of placing the MNE in the same position as that of an MNE in a territorial system.

Professor Paul McDaniel disagrees with the contention that from an efficiency perspective tax planning by lawyers and accountants is wasteful and that under a worldwide system the tax planning is more complex and hence more wasteful. His view is that sophisticated and complex tax planning to reduce the burden of tax would not change if the MNEs operated in a territorial system. He contends that the U.S. tax culture is such that just as much effort would be exerted in reducing the tax burden in the U.S.A.

C Simplicity

A territorial system is seen as being less complex than a worldwide system because it does not need the anti-deferral regimes or the tax credit provisions which are ‘two of the most complex features of a worldwide system’. This contention has been totally rejected by Professor Paul McDaniel and he argues that the complexity in a worldwide system should also be present in a territorial system. He contends that source of income rules; transfer pricing rules and the use of tax havens all impact on the complexity of taxation laws in a territorial tax system to the same extent as they do in a worldwide system. It could be claimed that from an administrative perspective, a territorial system would not require vast amounts or money to be spent on trying to detect foreign income being derived by its residents and trying to obtain the cooperation of many nations in exchanging information about foreign investors. The perfect example of the resources required in tracking foreign investments by high-net-worth individuals or the activities of MNEs engaging in transfer pricing or profit shifting through interposed entities can be found in Australia with ‘Operation Wickenby’.

88 Joint Committee on Taxation, n 11, 5.
89 McDaniel, Paul, n 87, 291.
90 Above n 89, 292-296.
However, tax avoidance and tax evasion is a problem for tax administrators in a
territorial system in the same way it is in a worldwide system.

1. **Tax avoidance and tax evasion**

   Using Hong Kong as the example of a pure territorial system, it is evident
that tax avoidance and tax evasion occurs because income can be structured as
being derived from a ‘foreign source’ and not from within the territory. In Hong
Kong the Inland Revenue Ordinance contains an anti-avoidance rule which is
based on the Australian and New Zealand rules.\(^{91}\) However, according to
Littlewood the Hong Kong approach is unique as the law has also adopted the
‘Ramsay Principle’ as enunciated by the House of Lords in that case.\(^ {92}\) The
Ramsay principle is an approach to statutory interpretation based on the concept
of ‘fiscal nullity’.\(^ {93}\) In other words, transactions are entered into between parties
where there is no commercial business effect other than to achieve an avoidance
of tax. However, Hong Kong appears to have rarely used its few anti-avoidance
rules in the same way as Australia and New Zealand have done, and as Littlewood
states, the lack of the number of specific and general anti-avoidance rules has
reduced the complexity of the tax law in that country.\(^ {94}\) The tax authorities in
Singapore are facing the prospect of greater tax avoidance and tax evasion as a
result of increasing their Goods and Services Tax to a rate of 7 percent, up from 3
percent. Halkyard and Phua contend that this increase will see a greater rise in the
use of cash within the black economy.\(^ {95}\)

2. **Examples of territorial systems - Singapore, Hong Kong and Malaysia**

   The Singapore, the basis of levying income tax on the residents of
Singapore is only on income derived in Singapore or income remitted to
Singapore. The *Income Tax Act (Cap 134)* section 10(1) states that ‘[i] income tax
shall … be payable at the rate or rates specified … for each year of assessment
upon the income of any person accruing in or derived from Singapore or received
in Singapore from outside Singapore in respect of - (a) gains or profits from
business … (b) gains or profits from employment; (c) dividends, interest or
discounts …’.

   In Malaysia, the imposition of income tax on residents of Malaysia is
similar to Singapore. The *Income Tax Act 1967 (Act 53)*, section 3 states that ‘… a
tax to be known as income tax shall be charged each year of assessment upon
the income of any person accruing in or derived from Malaysia or received in
Malaysia from outside Malaysia’. The Malaysian statute, Schedule 6, Part 1
contains a list of income which is exempt from income tax. The list specifically
exempts the ‘income of any person … derived from sources outside Malaysia and
received in Malaysia’.

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\(^{91}\) Littlewood, Michael, ‘The Legacy of UK Tax Law in Hong Kong’, (2008) 3 *British Tax Review*
253, 267.

\(^{92}\) Above n 91, *WT Ramsay v IRC* [1982] AC 300.

\(^{93}\) For a detailed discussion on this case and the concept of fiscal nullity see, Burgess, Philip,
Cooper, Graeme, Krever, Richard, et al, *Cooper, Krever & Vann’s Income Taxation Commentary

\(^{94}\) Littlewood, n 91, 268.

\(^{95}\) Halkyard and Phua, n 74, 22.
In Hong Kong the Inland Revenue Ordinance (Chapter 112) imposes tax, under a scheduler system, on rental income from property, section 5; on salaries from employment, section 8; and on business profits, section 14. In all of the three separate taxes, the key wording in the sections is that tax shall only be charged on property, salaries and profits ‘situated in; arising in or derived from Hong Kong’. This means that there is no general tax on income, but rather a tax on three different kinds of income from specific activities. The definition of ‘profits arising in or derived from Hong Kong’ is defined pursuant to section 2, as ‘for the purposes of Part IV shall, … include all profits from business transacted in Hong Kong, whether directly or through an agent’. The issue of determining the extent to which a profit ‘has arisen or is derived from Hong Kong’ has created a unique situation under the Hong Kong territorial tax system. Littlewood discusses this issue in detail and the fact that the current judicial interpretation of the statutory law is that a Hong Kong business must show that they have a branch, similar to a PE in another jurisdiction or they fall within a ‘rare case’ principle before the income can be said to have originated outside Hong Kong.

These three states do not need to have elaborate bureaucracies in place to try to ascertain the income of their residents that are derived in other countries such as tax havens. Moreover, the statutory law is contained in legislation that is a fraction of the size of the Australian Income Tax Assessment Acts, 1936 and 1997. However, these countries do have anti-avoidance rules but they do not have complex anti-deferral provisions similar to the CFC and FIF provisions used by Australia and other OECD member countries that tax on a worldwide basis.

V DEVELOPMENTS IN ATTRACTING CAPITAL AND LABOUR IN AUSTRALIA AND NEW ZEALAND

This section of the paper discusses two examples of relatively new changes to the taxation law in both Australia and New Zealand which adopt a ‘territorial basis’ of taxation for certain taxpayers living in either country. These two examples are included in this paper because they do support the overall contention that Australia could adopt a territorial system of taxation, as is the case with temporary residents in Australia or new migrants or returning New Zealand citizens to New Zealand.

A Taxation of Temporary Residents in Australia

Two very important changes to the existing income tax law have been introduced by the government that have very favourable implications for non-residents working in Australia or investing in Australia. Some commentators have gone so far as to suggest that Australia is now a confirmed ‘tax haven’ as a result of these changes. The first change relates to ‘temporary residents’ that have

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96 A scheduler system of taxation imposes a different rate of tax, in some cases at progressive rates, on salaries, property and profits. In Australia the scheduler system was abolished in 1953 and was reintroduced for one year only in 1974.
97 Littlewood, n 91, 258. If an individual elects to be assessed on their total income from all three schedules then in effect a general income tax operates.
98 Above n 91, 266.
temporary visas for work purposes and how that impacts on their non-Australian sourced income. Under the law a temporary resident will only be liable to income tax on their Australian sourced employment or services income and not their worldwide income even though they live and work in Australia and may not be a resident of any other country for income tax purposes. This means that income generated from non-Australian sources, including capital gains, may not be subject to income tax anywhere, especially if they take advantage of a tax haven to hold their foreign capital and investments. There are no tax implications in Australia if the temporary resident remits all of the foreign source income to Australia for their use while living in Australia.

The second change in the tax law relates to non-residents and the narrowing of the range of assets that will be subject to income tax under the capital gains tax regime. The new law only imposes income tax on capital gains made from real property, or other assets being used in a business being conducted through a permanent establishment in Australia. The term ‘permanent establishment’ takes its meaning from s 23AH, ITAA 36, where a Double Tax Agreement applies, or if no DTA, then the definition under s 6(1), ITAA 36. The definition of a permanent establishment referred to in s 23AH is the definition contained in the DTA which is based on the OECD Model. The definition in s 6(1), ITAA 36 is broader and more descriptive than the definition contained in the DTA.

B Temporary Residents – No Income Tax on Foreign Source Income

The law took effect from 1 July 2006 and is contained in Division 768, ITAA 97. Section 768-900 provides that ‘this Subdivision modifies the general tax rules for people in Australia who are temporary residents, whether Australian residents or foreign residents. Generally foreign income derived by temporary residents is non-assessable non-exempt income and capital gains and losses they make are also disregarded for CGT purposes. There are some exceptions for employment-related income and capital gains on shares and rights acquired under employee share schemes. Temporary residents are also partly relieved of record-keeping obligations in relation to the controlled foreign company and foreign investment fund rules. Interest paid by temporary residents is not subject to withholding tax and may be non-assessable non-exempt income for a foreign resident.

Section 768-910 prescribes the way in which income derived by a non-resident is treated for income tax purposes. The following income is non-assessable non-exempt income (NANE):

(a) the ordinary income you derive directly or indirectly from a source other than an Australian source if you are a temporary resident when you derive it;

(b) your statutory income (other than a net capital gain) from a source other than an Australian source if you are a temporary resident when you derive it.

100 ‘Permanent establishment’ is defined in the OECD Model Convention on Double Tax Agreements as ‘a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, quarry or any other place of extraction of natural resources’.

This subsection has effect subject to subsections (3) and (5).

Section 768-915 provides that certain capital gains and capital losses of temporary resident are to be disregarded. Section 768-915 states that ‘a capital gain or capital loss you make from a CGT event is disregarded if:

(a) you are a temporary resident when, or immediately before, the CGT event happens; and

(b) you would not make a capital gain or loss from the CGT event if you were a foreign resident when, or immediately before, the CGT event happens.’

C Who is a temporary resident?

The major question is who is a ‘temporary resident’ for the purposes of obtaining this tax concession? Section 995-1, ITAA 97 provides the definition of a ‘temporary resident’. ‘A person is a temporary resident if:

(a) They hold a temporary visa granted under the Migration Act 1958; and

(b) They are not an Australian resident within the meaning of the Social Security Act 1991; and

(c) Their spouse is not an Australian resident within the meaning of the Social Security Act 1991.

However, they are not a temporary resident if they have been an Australian resident (within the meaning of this Act), and any of paragraphs (a), (b) and (c) are not satisfied, at any time after the commencement of this definition. The tests in paragraphs (b) and (c) are applied to ensure that holders of temporary visas who nonetheless have a significant connection with Australia are not treated as temporary residents for the purposes of this Act.’

This definition would therefore exclude any Australian citizen returning to Australia after having worked in a foreign country for a considerable length of time. This tax concession differs from the New Zealand tax concession in that New Zealand provides an incentive for New Zealand citizens to return to New Zealand if they have been away for more than 15 years. It is a missed opportunity for the government of Australia to provide an incentive for Australian citizens to return to Australia and to be able to bring their wealth and experience without paying income tax on their foreign earnings. If the former Australian resident had considerable wealth from foreign investments then they would not be able to take advantage of these provisions to avoid income tax on those investments, namely their worldwide income. However, for ‘temporary residents’ they are treated more like non-residents and the new tax concessions impose no income tax on foreign sourced income. This applies even if they have a controlled foreign corporation, CFC, or a foreign investment fund, FIF. The country that misses out on tax revenue is the home country of the temporary resident because all of their investments can be located in a tax haven where no income tax is paid.

D Non-Resident Investors - No Income Tax on Capital Gains

The Taxation Laws Amendment (2006 Measures No.4) Act 2006 introduced new measures to overcome disincentives for foreign investors to invest in a range of non-real-property investments. The new provisions provide a definition of assets having the ‘necessary connection with Australia’ and instead
of nine categories the law simply uses the concept of ‘taxable Australian property’. The Explanatory Memorandum states that the new law will narrow the range of assets that a foreign resident will be subject to income tax on their capital gain.\textsuperscript{102} Basically, only an interest in Australian real property, namely land and fixtures such as buildings and mining and quarrying interests that are not considered to be real property, and business assets of a ‘permanent establishment’ will be considered to have the necessary connection with Australia, s 885-15, ITAA 97. The law also provides elaborate tests to be used to prevent a non-resident investor using an interposed entity to hold real property and avoid income tax on any capital gain.

**E Australia as a ‘Tax Haven’**

A temporary resident living in Australia and being regarded as a non-resident in their home country, can generate income from their foreign investments in any country including a tax haven, and pay no income tax on that income. Similarly, any capital gain generated through investment in Australian shares will not be included in the temporary resident’s assessable income in Australia and effectively not taxed anywhere in the world. This situation fits within the classic definition of a ‘tax haven’ in that there are no or low effective tax rates being imposed on the temporary resident and in the case of capital gains on non-real property investments, the non-resident.

The OECD\textsuperscript{103} has expressed concerns with its member countries having harmful preferential tax practices in order to attract investment and other ‘financial and geographically mobile activities’.\textsuperscript{104} One specific area that the OECD is concerned about is when a country ‘ring fences’ its own residents from taking advantage of taxation benefits that are only offered to foreign investors that are non-residents. The law in Australia which provides tax concessions for temporary residents and non-residents is not available to ordinary residents of Australia. They are being excluded from these benefits by a ‘ring fence’ and by definition; Australia is a tax haven according to the OECD guidelines.\textsuperscript{105}

The OECD contends that regimes that engage in ‘ring fencing’\textsuperscript{106} have a harmful effect on foreign tax bases. If the temporary resident of Australia is a non-resident of say the United Kingdom, then any capital gain generated from an investment in a third country, such as Vanuatu, will not be subject to income tax anywhere in the world. It is expressly excluded in Australia, not subject to income tax in the United Kingdom and not subject to income tax in the source country. For example, a temporary resident can generate income on investments in say Vanuatu, and pay no income tax on their world-wide income in Vanuatu, the United Kingdom or Australia.

Australia is now an attractive place to live as a temporary resident. According to Szekely, ‘the tax law changes will not only attract the super rich but

\textsuperscript{102} Explanatory Memorandum, Taxation Laws Amendment (2006 Measures No.4) Bill 2006, 34.
\textsuperscript{104} Above n 103, 7.
\textsuperscript{105} Above n 103, 26.
\textsuperscript{106} The term ‘ring fencing’ is used by the OECD to describe situations where the resident taxpayers are prevented from accessing tax benefits that are being provided to non-resident taxpayers. In effect the resident taxpayers are ‘fenced in’ and not allowed to enjoy the tax benefits being offered to foreign investors or businesses.
should assist in attracting the super talented’.\textsuperscript{107} Large investment funds can be left in a tax haven and the income or capital gains generated will not be taxed in Australia and not in the temporary resident’s home country. The temporary resident can even invest in say shares or units in a unit trust in Australia and not pay income tax on the capital gain generated from those assets in Australia as the new CGT rules for non-residents would apply as well. It would appear that the Australian Government is keen to attract very wealthy individuals from around the world to live in Australia as ‘temporary residents’ and bring their wealth with them. It will be interesting to see if the OECD has any comment to make about these very attractive tax concessions and whether or not it generates a tax war between other countries all trying to compete for wealthy individuals.

\textbf{F New Zealand and the Exemption for Transitional Residents}\textsuperscript{108}

The government of New Zealand was concerned about alleviating the extra tax costs for skilled labour working for the first time in New Zealand or New Zealanders who were returning after being away for more than 10 years.\textsuperscript{109} As an incentive for new migrants to settle in New Zealand, or for New Zealanders to return to New Zealand, certain foreign income is exempt from taxation in New Zealand. Returning New Zealanders must have not been a tax resident at any time during the past 10 years prior to their arrival in New Zealand. The exemption from New Zealand tax on foreign income is for a period of four years or up to 49 months. The type of income that is exempt includes CFC and FIF income that would have been attributed under the New Zealand rules; income from foreign trusts; foreign dividends, foreign interest or royalties derived offshore; foreign rental income; income from employment performed overseas before coming to New Zealand such as bonus payments; gains on the sale of real property derived offshore; and offshore business income that is not related to the performance of services.

\textbf{VI THREATS TO THE TAX BASE}

It may not matter whether a country has a worldwide or territorial system for taxing the income of its residents as MNEs are able to take advantage of lower taxes in other countries by locating operations in different jurisdictions. Portfolio or passive capital and foreign direct investment by MNEs are increasing in their mobility. MNEs will continue to become larger and more powerful and their revenue sources and operations will lack any ‘true residence’.\textsuperscript{110} Avi-Yonah discusses the U.S. trend towards a territorial system as the result of MNEs moving their head offices to low tax jurisdictions and the way in which those jurisdictions are lessening the impact of their CFC rules.\textsuperscript{111} Avi-Yonah illustrates this point by

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{107} Les Szekely, n 99, 3.
\item \textsuperscript{108} The statutory law provisions providing the exemption from income tax for ‘transitional residents’ are contained in sections FC 22, FC 23 and FC 24, \textit{Income Tax Act 2004 (NZ)}.
\item \textsuperscript{109} Inland Revenue Department, ‘Reduction tax barriers to international recruitment to New Zealand – a government discussion document’, (2003), 3.
\end{itemize}
\end{footnotesize}
showing that a third of the foreign profits of US-based multinationals are in countries with an effective tax rate of less than 10 percent. In 2003 when the data was gathered those countries were the Netherlands, Ireland and Bermuda. Avi-Yonah contends that the CFC rules and similar anti-deferral regimes need to be adopted and enforced by all OECD member states. However, he accepts that if MNEs are prepared to reincorporate in non-OECD countries then the OECD will need to do more to protect the corporate tax base. This may be harder to do in practice as the current project to eliminate harmful tax competition has demonstrated.

The current situation with the flows of capital from one country to another is illustrated by the following example given by Graetz:

Luxemburg, for example, supplies almost as much direct investment to the United States as France and Canada, and the size of direct investment from the United States to Bermuda and Panama surely is not justified by economic considerations alone.

Many commentators in this area of international taxation have pointed out the fact that the traditional tax base will be continue to be eroded as capital in the form of portfolio investment or direct investment is moved to low taxing countries. The global economic crisis may add to this problem as investor chase better after-tax returns on their investments.

VII CONCLUSION

In answer to the main question raised in this paper, whether Australia should adopt a territorial basis for taxing international income and abandon the worldwide system, it is contended that based on the available research in this area of taxation law that the current system that exists in Australia is perfectly adequate from the perspective of the three main criteria for assessing a tax system: namely equity, efficiency and simplicity. From the various views examined above, a territorial system of taxation is inherently inequitable from both a vertical and horizontal perspective. Based on the example of Hong Kong, Littlewood provides more an excellent overview of the existence of inequity in the current system. However, Hong Kong is unique and the fact that the taxpayers do not complain may just be indicative of the beneficial effects of having very low tax rates.

There is no evidence from the above analysis that a territorial system is more efficient than a worldwide system. Many of the commentators in this area are examining efficiency from the perspective of the U.S. system where the only benefit for U.S. MNEs is with a credit for foreign taxes that have been paid. This encourages the deferral of profit from being repatriated to the U.S. whereas a credit and exemption system, similar to that used in Australia and elsewhere, would arguably be better for U.S. companies competing internationally.

In terms of simplicity, the argument that a territorial system is simpler than a worldwide system is not conclusive. A territorial system still needs to have robust anti-avoidance rules, transfer pricing rules and laws that clearly distinguish between income sourced within the state and sourced in a foreign jurisdiction. The

112 Above n 111, 13.
example of Hong Kong used in this paper also illustrates the government’s need to relay on anti-avoidance rules to safeguard revenue.

Australia does adopt both a worldwide and territorial system for the taxation of international income. Active business income, non-portfolio dividends and certain foreign employment income is exempt from taxation in Australia under the exemption mechanism. In other words, this type of income is not taxed on a worldwide basis. Passive income from investments is not subject to double taxation due to the existence of the credit mechanism that operates in Australia. Given this current situation, the only reason why the Australian Government would consider changing from a worldwide system to a pure territorial system is that in the global environment it is becoming very difficult to tax the income from mobile capital unless all nations co-operate on the disclosure of information on investments by non-residents in the host country. This raises questions about the effectiveness of the OECD measures in relation to ‘harmful tax competition’ and exchange of information agreements. It also raises questions about the effectiveness of ‘Operation Wickenby’ in Australia and the estimated income tax to be recovered. However, on balance there are strong arguments to leave the current hybrid worldwide system in place because it already incorporates many aspects of a territorial system, as discussed above.

The fact that the Australian and New Zealand governments introduced measures to put temporary residents and new migrants in a position where their foreign sourced income was not taxed in their home country can be explained as the two countries merely trying to compete globally for mobile capital and labour. It is contended that these measures should not be seen as a sign that a territorial system should replace the existing worldwide systems in at least Australia.