"ATTEMPTED CFC OVERRIDE OF DOUBLE TAXATION TREATIES"

by

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This paper puts forward the proposition at the international tax policy level and at the technical application level that certain parts of the Controlled Foreign Entity (CFE) provisions, are an attempted override of Australia's international taxation treaty obligations. The CFE provisions consist of the "transferor trust" provisions contained in Div 6AAA of the *Income Tax Assessment Act* ("ITAA") and the Controlled Foreign Corporation (CFC) provisions contained in Pt X of the ITAA.

The experiences of other countries with domestic law overrides of their taxation treaties are considered. The paper looks to the question as to how the countries described give the force of law to their double taxation treaties and how the courts of such countries have reacted to legislation which may have the effect of domestic override of the provisions of double taxation treaties. Sections 102AAV and 388 of the ITAA are the most obvious attempts at domestic override in the Australian context.

The paper considers the international tax policy issues of whether CFE legislation (based as it is on "integration" principles) is inconsistent with the "spirit" of taxation treaties (based as they are, on the principle of separate entities). It does this by looking at the Organisation for Economic Co-operation and Development's ("OECD") position on such domestic legislation within the international framework of taxation treaties. The OECD's justification of domestic law overrides in non-business circumstances is discussed and Australia's CFE provisions are considered in that light.

At the technical application level the paper considers whether Australia's CFE provisions are in fact an attempted override of double taxation treaty obligations. It examines various sources of income (and capital gain) derived by CFEs resident in treaty countries and examines whether such income would be capable of attribution under Australia's CFE provisions. It puts forward the proposition that the attribution of "business profits" under the Australian CFE provisions is entirely proscribed by all Australia's double taxation treaties (except where the treaty country resident has a permanent establishment in Australia with which those profits are effectively connected). The paper demonstrates that the CFE provisions attempt an override of Australia's double taxation treaties in relation to rent, interest, royalties and alienation of property under Australia's 24 taxation treaties that contain an "income not expressly mentioned" article. In relation to Australia's other 12 taxation treaties, it demonstrates that the CFE provisions attempt an override in relation to rent, interest, royalties and alienation of property derived by dual resident entities under at least 9 out of 12 of those treaties, being those treaties that have an "income of a dual resident" article.

The paper concludes by submitting that the proper method of dealing with the inconsistency between CFE provisions and taxation treaties is to re-negotiate the existing taxation treaties, and to expressly deal in future taxation treaties with the issues that CFE provisions give rise to. As the current situation stands, a taxpayer assessed to tax by the CFE provisions in purported override of a taxation treaty may wish to rely on s4(2) of the *International Tax Agreements Act* (hereafter the

"Agreements Act"), which provides for treaty supremacy over inconsistent domestic law, and litigate the matter if necessary.

OUTLINE OF AUSTRALIA'S TAXATION OF NON-RESIDENTS UNDER ITS DOMESTIC LAW

Residents of Australia are subject to Australian tax on their world-wide income (s25(1)(a)) and capital gains (s160L(1)). Non-residents are subject to Australian tax on Australian source income (s25(1)(b)) and on gains from the disposal of "taxable Australian assets"[i] (s160L(2)). Foreign source income derived by a non-resident is generally exempt from Australian taxation (s23(r)).

Prior to 1 July 1987, most foreign source income subject to tax in the country of source was exempt from Australian tax pursuant to s23(q). Foreign source dividends were rebateable under s46 and therefore effectively tax free in the hands of a corporate shareholder. The rebate was not dependent upon such foreign source income being subject to tax in the country of source. On 1 July, 1987 Australia fully asserted jurisdiction to tax residents on their foreign source income, subject to a credit for foreign tax paid on such income (Div 18 of Pt III).

Prior to 1 July, 1990 Australian tax was generally deferred where Australian residents had control over a foreign entity in receipt of foreign source income, while dividends were not declared by companies, and income was accumulated by trusts.[ii] Australian tax on foreign source income could be deferred by interposing a non-resident entity between the source of the income and the ultimate Australian resident owner. Further, source rules could be manipulated so what would otherwise be Australian source income could be converted into foreign source income derived by a non-resident, and therefore, was outside Australia's jurisdiction to tax. The ease with which Australian residents could establish and utilise non-resident companies was highlighted by the decision of the High Court in *Esquire Nominees Pty Ltd v FC of T.*[iii]

That the use of non-resident companies and trusts was perceived as a threat to the Revenue becomes more apparent when it is remembered that income derived by a non-resident company or trust could also have its source in Australia, provided that by Australian domestic law or under the provisions of a relevant double taxation treaty, the Australian tax was limited on the flow of income from Australia to the non-resident company or trust. Neither the Information Paper nor the explanatory memorandum to the legislation which introduced the anti-deferral (CFE) measures made explicit note of the potential deferral in relation to Australian source income. However, the international literature clearly recognises this possibility.[iv]

For instance, Australian source interest income is subject, under the domestic law (and not altered by the provisions of any treaty) to 10% withholding tax.[v] Australian source royalty income is now subject , under the domestic law to 30% withholding tax (generally reduced to 10% under the provisions of Australia's double taxation treaties).[6]

By manipulating circumstances, such as the place where a contract is entered into, the source of income could be manipulated such that what otherwise would be Australian source income, could be turned into foreign source income and be derived by a non-resident.

Subject to the laws of the relevant treaty country, it would also be possible for Australian residents to incorporate a

non-resident company in a country with which Australia had a taxation treaty, such that the non-resident company could avail itself of the "business profits" article of the treaty and Australian source "business profits" would thereby be exempt from Australian tax.

The accumulated profits of the non-resident company often allow for a "snowballing" effect since they could in turn be loaned back to the Australian associates of the non-resident company, and commercial interest would be charged on that loan. Again, that interest would only be subject to withholding tax.

ROLE AND DESIGN OF CFC AND TRANSFEROR TRUST RULES

The introduction of the controlled foreign entity provisions effective 1 July 1990 contained in Div 6AAA (in relation to "transferor trusts") and under Pt X (relating to CFCs) seek to prevent that deferral of tax.[7] The Foreign Investment Fund ("FIF") provisions contained in Pt XI were introduced with effect from 1 January 1993 to prevent deferral of tax in certain circumstances where the non-resident entity is not controlled by Australian residents. It goes beyond the scope of this paper to analyse of the FIF provisions.

The design of the CFC provisions is to attribute certain classes of income to Australian residents, derived by a CFC resident in low tax (or "unlisted") countries (s320) and attribute generally more limited classes of income derived by CFCs resident in countries with tax systems comparable to Australia's (ie "listed") countries.[8] All but two of Australia's treaty partners are "listed" countries for the purposes of the CFC provisions. Vietnam and Czech Republic are the exceptions.[9]

The attributable income of a CFC is the CFC's taxable income calculated on the assumption that the CFC is an Australian resident company. The attributable income is the "notional assessable income" (which excludes the "notional exempt income"), less "notional allowable deductions" (s382).

The inclusion of amounts in notional assessable income differs depending on whether the CFC is resident in a listed or unlisted country. The main amount included in the "notional assessable income" of an unlisted country CFC is the "adjusted tainted income"(s386) of the CFC where it fails the "active income test".[10]

For a listed country CFC the amount of its "notional assessable income" is mainly -

- where the eligible CFC does not pass the "active income test"[11], the "adjusted tainted income" that is "eligible designated concession income"[12] in relation to the listed country and any other listed country (s385(2)(a)(i)); and

- income or other amounts (s385(2)(a)(ii)) that;
  * are not eligible designated concession income of the CFC in relation to the listed country or any other listed country; and
  * are not treated as derived from sources in the listed country for the purpose of the tax law of the listed country; and
  * are not "subject to tax" [13]in the listed country or any other listed country.

It should be noted that s385(2)(a)(ii) in effect focuses on income or other amounts sourced in third countries.

Section 386 defines the "adjusted tainted income" as the sum of the "passive income, tainted sales income and tainted services income".[14]

Section 388 specifies that in calculating the attributable income of a CFC, the Agreements Act is to be disregarded, except for the purposes of references in the ITAA to that Act.

The "transferor trust" provisions in Div 6AAA attribute to Australian resident transferors the net income of the non-resident trust (to which the Australian residents have transferred property or services) where the trust is resident in an unlisted country, and attribute to the Australian resident transferor the "eligible designated concession income" derived by transferor trusts resident in listed countries. Of course, where an amount of income is already assessable income, for example, to a beneficiary under s97, that amount is excluded from the attributable income. Section 102AAV specifies that in calculating the attributable income of a transferor trust, the Agreements Act is to be disregarded, except for the purposes of references in the ITAA to that Act.

For the purpose of this paper, as Vietnam and Czech Republic are the only unlisted countries with which Australia has taxation treaties, and they are not common law countries likely to recognise trusts, the analysis will be confined to listed country discretionary trusts which accumulated their income during the periods under consideration and are within the definition of transferor trusts. Hereafter, such a trust shall be referred to as a "listed country accumulation transferor trust" (LCATT). As noted above, only the "eligible designated concession income" of a LCATT is attributable income.

As will be demonstrated later, the failure by Australia to provide an active income exemption in relation to transferor trusts, gives rises to more potential conflict with Australia's treaty obligations than with CFCs. In short, this is because more classes of income will necessarily be attributable.

DOUBLE TAXATION TREATIES

Taxation treaties seek to achieve their purpose of avoiding double taxation by allocating the right to tax various types of income (and in some cases capital gain) to the country of residence only, or partly to the country of source with residual taxation to the country of residence. Australia has by its taxation treaties, limited its right to tax certain sources of income in the hands of the resident of a country with which Australia has a taxation treaty. Taxation treaties are generally given priority over the domestic law by virtue of s4(2) of the Agreements Act. Australia currently has 36 comprehensive taxation treaties. Generally treaties entered into by Australia have been more influenced by the OECD model conventions (1963 and 1977) than the UN model, the US model or the Andean model.[15]

Double taxation does not arise in respect of income flowing between the two countries where the terms of the taxation treaty provide for the income to be taxed only in one country, or where the domestic taxation law of the source country exempts the income from its tax; or the domestic law of the country of residence provides a unilateral tax credit or

exemption. Where both countries domestic law subjects the income to tax it is necessary, however, to prescribe a method for relieving double taxation in the taxation treaty. Australia's taxation treaties provide a credit basis for the relief of double taxation to be applied by Australia and, in the other country, relief variously by credit and sometimes by deduction.[16]

There is a "source of income" article appearing in most of Australia's taxation treaties.[17] More than half of those articles provide that income derived by a resident of one country which is permitted to be taxed in the other country in accordance with the taxation treaty, is deemed for all purposes of the treaty to be income arising from sources in the other country. This empowers each country to exercise taxing rights allocated to it by the treaty. Almost all treaties specify this to be the case for the purposes of providing tax credits, which ensures double taxation relief as intended.

Taxation treaties which do not contain a "source of income" article, other than one which is only for the purposes of the "relief from double taxation" article, invariably have limited source rules for particular types of income.[18]

Business Profits

The "business profits" article of Australia's treaties always provides that the business profits of a resident of one treaty country are taxable only in that country unless it carries on business in the other country through a permanent establishment. Under these circumstances, the profits of the enterprise which are "attributable" or "effectively connected" to the permanent establishment may be subject to tax in the treaty country in which the permanent establishment is located.[19]

Where a treaty country in which the permanent establishment exists subjects the permanent establishment's profits[20] to tax, the country of residence of the enterprise is required to avoid double taxation by providing a credit against its tax payable or an exemption from tax on the permanent establishment's profits.[21]

The OECD commentary on model article 7(7), the equivalent provision of which is found in more modern Australian treaties, for example, article 7(6) of the Thai treaty, specifies that although it was not found necessary in the OECD model to define the term "profits", it should nevertheless be understood that the term when used in model article 7 and elsewhere in the model convention has a broad meaning including all income derived in carrying on a enterprise. It should be noted that s3(2) of the Agreements Act specifies that for the purposes of that Act and the ITAA, a reference in a taxation treaty to profits of an activity or business shall, in relation to Australian tax be read, where the context so permits, as a reference to taxable income derived from that activity or business.[22]

The "business profits" article is not a "catch all" provision but rather only deals with whatever is found to constitute "business profits" in the particular treaty under consideration. Most treaties specify that income dealt with under another article are not, in the absence of a permanent establishment, to be regarded as "business profits." Income not dealt with in the "business profits" article or elsewhere in a treaty may be dealt with by an "income not expressly mentioned" article, if there is one. To fall within the "business profits" article it is necessary that the profit in question be derived by an "enterprise of one of the Contracting States" carried on in the other country through a permanent establishment situated therein. An "enterprise of a Contracting State" means, in effect, an enterprise carried on by a resident of one Contracting

State.

In the decision of the full High Court in *Thiel v FC of T*[23] it was held that although the Swiss resident individual was involved in a "entirely isolated venture" that it could be said that his activities in Australia represented an "enterprise" of a Swiss resident.

Permanent Establishment

The term "permanent establishment" is defined in the "permanent establishment" article as a fixed place of business through which the business of an enterprise is wholly or partly carried on. The concept of "permanent establishment" is of crucial importance for determining the taxation liability of an enterprise of one contracting state in the other contracting state.[24]

Sometimes the provisions of the "permanent establishment" article are applied for the purposes of determining the existence of a permanent establishment outside both countries, and whether an enterprise, not being an enterprise of one of the countries, has a permanent establishment in the other country.[25]

Income not expressly mentioned

The existence of an "income not expressly mentioned" article is of fundamental importance to the proposition put forward in this paper. Where there is one, the "income not expressly mentioned" article of Australia's treaties provides rules for the allocation between treaty countries of taxing rights in relation to items of income not expressly "mentioned" or "dealt with" in the proceeding articles of the treaty, e.g. business profits, rents, interest, dividends, royalties, and alienation of property and sometimes also covers income arising in third countries.

The common form of the "income not expressly mentioned" article in Australia's modern taxation treaties (with the exception of Italy) does not adopt the form of OECD model article 21(1). The OECD model article 21(1) preserves the right to tax items of income sourced in third countries to the country of residence of the recipient. It does this by specifying that items of income of a resident of one country not "dealt with" in the other articles of the treaty, "wherever arising" shall be taxable in the country of residence of the recipient.[26] Australia reserved its position on the model article 21 and wished to retain the right to tax income arising from sources in Australia. This right is effectively retained in all Australian taxation treaties that have such an article.

Ward et al[27] have described Australia as adopting the "UN approach." This is a reference to the third paragraph added in the UN model to the 1977 OECD model article 21. It is noted, however, that the third paragraph uses the term "not dealt with" rather than "not expressly mentioned." It also uses the term "arising" rather than "sourced in." Of Australia's 36 currently operative taxation treaties, 24 contain articles properly described as "income not expressly mentioned" articles. Of these only three[28] use the words "not dealt with" and like the 1977 OECD model, the others refer to income, "wherever arising." The only other exception to the general pattern in the 22 treaties with "income not expressly mentioned" articles is the taxation treaty with Sweden (1981), which although using the term "expressly mentioned", unlike all those others using

that term, explicitly refers to income from "sources outside both contracting states", only being taxable in the state of residence, unless there exists a permanent establishment in the other contracting state with which that income is effectively connected.

Of the 12 treaties which do not have an “income not expressly mentioned” article, all but three have an article generally called the "income of a dual resident" article,[29] which limits the scope of the other income article to cases where the taxpayer , in the absence of the treaty, would be a dual resident but, by virtue of the treaty, is deemed to be a resident of only one state. In these treaties, the "income of a dual resident" article provides that such a taxpayer is taxable only in the state of his treaty residence in respect of other income from sources in that state, or in third states, and grants the source state, a concurrent right to tax.

The only treaty which does not have either an "income not expressly mentioned" or an "income of a dual resident" article is the taxation treaty with Japan (1969). Ward et al note[30] that there are some examples of taxation treaties world-wide that depart from the OECD and the UN models and give each of the contracting states an unlimited right to tax all other income, regardless of wherever it arises, and note that Australia has one such treaty, with Singapore (1969).

As will be seen to be a matter of considerable significance later in this paper, under "income not expressly mentioned" articles of which all but three are "income not expressly mentioned" articles of the type for example, in the Thai treaty,[31] income sourced in third countries is precluded from being subject to Australian tax.

This is so as the words "items of income" not dealt with in other articles of the taxation treaty do not refer only to classes of income not dealt with, as the expression "items of income" means income on a case by case basis, e.g. as from a particular source. If the words "not expressly mentioned" or "not dealt with" (being the 1963 and 1977 wordings respectively, of the OECD model article) are not so interpreted the “income not expressly mentioned” article would fail to achieve is obvious purpose of providing for the jurisdiction to tax items of income where jurisdiction is not fixed by other articles of the treaties.[32]

Although Ward et al acknowledge[33] the wording of the OECD model convention of 1977 was changed from the 1963 model in relation to this article, and that some commentators such as Vogel[34] have suggested that the wording of the other income article in the 1963 draft model could have been interpreted as referring only to classes of income not dealt with, Ward et al suggested that this would not be the better interpretation. They note that the Swiss authors, Locher, Meier and von Siebenthal[35] are also of the view that the old wording encompasses both classes and sources of income not mentioned. The wording change therefore, merely clarified that the other income article applied also to categories of income mentioned, that arise in a state not mentioned, that is, in the state of residence of the taxpayer or in a third state in cases where the model treaty referred in the preceding articles only to such income sourced in the non-resident state.

Even if the interpretation favoured by Vogel was correct, it is the fact that the Hungary, China, Sweden and Czech Republic taxation treaties of the 24 treaties entered into by Australia which have "income not expressly mentioned" articles, specifically preclude income from sources in third countries from being subject to tax in Australia, unless it is effectively connected to a permanent establishment of the treaty country partner in Australia. Accordingly, there can be no doubt in

those cases, that such income is precluded from being subject to Australian tax. Furthermore, in relation to 9 out of 12 treaties which do not have a "income not expressly mentioned" article but do have an "income of a dual resident" article, income from sources in a third country are expressly precluded from Australian tax.

Necessarily a CFC which is a resident of one of Australia's treaty partners will be subject to the treaty, however, trusts resident in treaty countries may not always be a "person" subject to the treaty, which would have the effect that the treaty would not be relevant to the trust. However, it is certainly the case that the treaties with the US, Canada and Philippines are applicable to trusts resident in those countries. It is noted that the treaties with the US and Canada (but not the Philippines) contain "income not expressly mentioned" articles, such that income sourced in the third country derived by a trust in the US or Canada, is by virtue of the "income not expressly mentioned" article of those treaties, precluded from being subject to tax in Australia. Of course this may also be the case under other treaties, dependent on the type of trust involved and the domestic law of Australia's treaty partners.[36]

INTERNATIONAL COMPARISON OF DOMESTIC LAW OVERRIDES OF DOUBLE TAXATION TREATIES GENERALLY

United Kingdom

In the UK, taxation treaties are transformed into the domestic law, currently under the authority of s788 of the *Income and Corporation Taxes Act* 1988, which provides that where an Order in Council declares that a taxation treaty shall have effect, it has effect in relation to income tax and corporation tax "notwithstanding anything in any enactment."

However, in *Salomon v Commissioner of Customs and Excise*[37] Diplock LJ stated, "the sovereign power of the Queen in Parliament extends to breaking treaties."[38]

In *Collco Dealings Ltd v IRC*[39] there was inconsistent legislation subsequent in time to the taxation treaty under consideration. There was an amendment to UK income tax legislation which was intended to put an end to practise of "dividend stripping", and the plain words of the enactment intended to override the exemption for Irish residents under the UK/Ireland treaty.[40]

In the *Collco Dealings'* case although the subsequent amendment to the enactment of the treaty was not contained in the Act which gave the treaty force of law, because the subsequent legislation was so clearly directed to amend the position under the earlier enactment which adopted the treaty, the House of Lords held that the treaty was overridden.[41] There was no provision such as s4(2) of the Agreements Act to stand in the way of the House of Lords in *Collco Dealings*.

Reference may also be made in *Ostime (Inspector of Taxes) v Australian Mutual Provident Society,*[42] where it was held by the House of Lords that the provisions of the former UK treaty prevailed over those of the UK *Income Tax Act* 1952 in regard to the ascertainment of profits attributable to the UK branch of a life assurance company resident in Australia. In the *AMP* case, although there are references to a treaty overriding UK legislation with which it may conflict,[43] it should be noted that the treaty in that case came into force **after** the UK legislation under consideration.

Bartlett[44] notes that the UK approach to taxation treaty override particularly in the CFC area, is cautious, and is to be contrasted to the approach taken by the US.

Canada

As with the United Kingdom, taxation treaties are not self-executing and each is adopted into the Canadian domestic law by a particular act of parliament. Each implementing act provides that in the event of any inconsistency between the taxation treaty and the domestic law, the treaty shall prevail.

Although in Canada there is no express authority giving treaty provisions precedence over subsequent domestic legislation, the Supreme Court of Canada has held in *The Queen v Melford Developments Inc.*[45] that subsequent domestic legislation will not override a treaty unless it is clear that parliament intended the subsequent legislation to override the treaty.

In the *Melford Development* case, the Supreme Court of Canada was concerned with the application of the Canada/Federal Republic of Germany treaty. Under that taxation treaty, "interest" was an undefined term and, therefore, the meaning of interest was to be determined according to the domestic law. Subsequent to entering into the taxation treaty, the definition of "interest" under the Canadian domestic law was amended such that guarantee fees were deemed to be to interest. Revenue Canada sought to impose withholding tax on a guarantee fee paid by Melford Developments to a German bank.

Revenue Canada made two arguments to support the imposition of withholding tax. First, the amendment to the domestic law definition of interest overrode the treaty. The Court held that to do so the parliament would have had to expressly set out to amend the Act that brought the treaty into force, which it did not do. Secondly, the Revenue argued the undefined terms provision referred to the law of Canada as it may exist from time to time (ie. that an ambulatory interpretation applied). On the second argument the Supreme Court of Canada held that a "static" rather than "ambulatory" interpretation applied to the treaty there being considered.[46]

Thus where a provision exists such as s4(2) of the Agreements Act, on the authority of *Melford Developments*, if the legislature intends to override a treaty, in order to make it abundantly clear, it should do so in the equivalent of the Agreements Act, rather than in another Act such as the ITAA.

In relation to the Canadian CFC legislation, Canada has added provisions to its taxation treaties explicitly allowing Canada to impose tax pursuant to its CFC legislation.[47]

United States

Taxation treaties entered into by the United States executive government obtain force of law without House of Representatives, but with Senate ratification. The US Constitution provides:

> This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all Treaties

made, or which shall be made, under the authority of the United States, shall be the supreme Law of the land..." (art VI cl.2).

However, the US Courts in effect, have adopted a "later in time" rule, laid down in *Whitney v Robinson*[48] as follows:

"By the Constitution a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other. When the two relate to the same subject, the Courts will always endeavour to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in date will control the other..."

The "later in time" rule is subject to the proviso that a treaty provision is not overridden by later domestic legislation unless Congress specifically indicated an intention to override the treaty.[49] Such an indication was given when CFC legislation was enacted in the US by s.31 of the *Revenue Act* 1962 which provided:

"Section 7852(d) of the Internal Revenue Code of 1954....shall not apply in respect of any amendment made this Act."

At that time s7852(d) provided:

"No provision of this title shall apply in any case where its application would be contrary to any treaty obligations of the United States in effect on the date of enactment of this title."

With respect to the CFC legislation, s31 therefore removed the rule contained in s7852(d) that gave precedence to tax treaties in effect before the Internal Revenue Code 1954 was enacted.[50] Rigby [51] concludes that it would be unlikely that a US court would resolve any conflict between US taxation treaties and its CFC legislation in favour of taxation treaties.

There have been a number of occasions in recent times where Congress has expressed an intention to override taxation treaties entered into by the US e.g. the Foreign Investment in Real Property Act[52] ("FIRPTA"), 1980; the Tax Reform Act, [53]1986; the Technical and Miscellaneous Revenue Act,[54] 1988; the Revenue Reconciliation Act,[55] 1989; and the Foreign Tax Equity Bill,[56] 1990.

The *Tax Reform Act* of 1986 prompted much discussion amongst US treaty partners and commentators generally on taxation treaty override. In letters dated 15 July 1986 to the Chairman of the House Ways and Means Committee and the Chairman of the Senate Finance Committee representatives of the United Kingdom, Belgium, Denmark, Germany, France, Japan, Luxembourg, The Netherlands, Switzerland and the Commission of European Communities said:

"...several proposals contained in the House And Senate Tax Reform Bills would discriminate against foreign countries, and some cases would seek to override double taxation agreements....Secretary Baker [has] said that, if the US made a practise of unilateral renouncing its obligations under existing treaties, the value of future treaty

> commitments from the US would obviously be diminished....If there is abuse of treaties, this should be dealt with - not by unilateral action but - through bilateral renegotiation."

Similar sentiments were echoed by professional advisers.[57] Notwithstanding these protests, the legislation went ahead.[58]

Australia

A taxation treaty, like any other treaty to which Australia is a party, only has force of law if is enacted as part of the domestic law of Australia.[59] In other words, taxation treaties are not self-executing. Taxation treaties obtain force of law by being enacted as part of the Agreements Act.[60]

Section 4(1) of the Agreements Act provides that the ITAA is incorporated into, and is to be read as one with the Agreements Act. Under s4(2), the provisions of the Agreements Act have effect notwithstanding any inconsistency with the ITAA. Section 4(2) states that this overriding of the ITAA is not applicable in relation to s160AO and Pt IVA of the ITAA.

The priority given to the Agreements Act means that a taxation treaty may extinguish taxing power otherwise applicable under the ITAA. For example, under domestic law, Australia has jurisdiction to tax a non-resident on "business profits" sourced in Australia according to domestic source rules. However, under a taxation treaty, it is contended that Australia only has jurisdiction to tax those profits if they are attributable or effectively connected to a permanent establishment in Australia through which the non-resident operates.

Where the Australian domestic law expressly purports to have the effect of overriding Australia's treaty obligations, if the terms of that legislation are unambiguous, although there is no Australian authority on the point in the revenue law context, it is most likely they must be given effect to. This is whether or not that domestic law carries out the treaty obligations, for the sovereign power of parliament extends to "breaking" treaties,[61] and therefore presumably, to overriding particular parts of treaties.

For taxation treaties entered into by Australia prior to the Austria treaty (1986), as those treaties did not expressly provide for any ambulatory interpretation to undefined terms, amendments to the ITAA in 1968 and 1976 relating to Australian tax on royalties, have arguably had the effect that the provisions of s4(2) of the Agreements Act have been overridden.[62] Another example of this kind of unilateral action by Australia is in the extension of withholding tax to interest paid to non-residents on or after 1 January 1968 in certain circumstances.

Australia's recent treaties have made it clear that an ambulatory interpretation[63] is to apply to the undefined terms provision. This approach started with article 3(3) of the Austria treaty.[64]

As it has been noted above, by virtue of s4(2) of the Agreements Act, Australia has overridden its treaty obligations expressly by giving paramountcy to Part IVA and s160AO. In the latter case however, s160AO operates merely to limit the amount of a credit which would otherwise be available under the Agreements Act, and the credit provisions of Australia's treaties typically commence with the words: "Subject to any provisions of Australian law".

If the Australian legislature wished to give the CFE provisions express override, they could simply have added a reference to the CFC provisions to the two current exceptions to s4(2).

INTERNATIONAL TAX POLICY RESPONSE TO CRITICISM OF DOMESTIC LAW OVERRIDES IN CONTROLLED FOREIGN COMPANY AND TRANSFEROR TRUST PROVISIONS

The OECD[65] has identified a number of situations which actually involve or are similar to taxation treaty override and may have the same effect. The resolution of 2 October, 1988 referred to below addresses the type of treaty override involving the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations. In contrast to that situation, the OECD noted three "lesser" situations upon which it does not focus.

OECD Position

That domestic law overrides of double taxation treaties is not an isolated problem can be seen from the 2 October 1988 resolution[66] of the council of the OECD:

"I. RECOMMENDS Member countries:

1. To undertake promptly bilateral or multilateral consultations to address problems connected with tax treaty provisions, whether arising in their own country or arising by countries with which they have tax treaties:

2. To avoid enacting legislation which is intended to have effects in clear contradiction to international tax obligations.

II. INSTRUCTS the Committee on Fiscal Affairs to follow developments in this area and to bring to the attention of the Council any action which would constitute a material breach of member countries international treaty obligations".

The position of the OECD in relation to CFC legislation is not as straight forward as the resolution of 2 October 1988 would appear. Reference needs to be made to one of four related studies published by the OECD.[67] At para 47 of the OECD study it is said:

> "Whilst the majority of OECD Member countries thus accepts counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, it firmly adds that such measures should be used only for this purpose. <u>It would be contrary to the general principles underlying the OECD Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected.</u> Counteracting measures should not be applied to

countries in which taxation is comparable to that of the country of residence of the taxpayer. It is also of relevance that a country's willingness to co-operate effectively with other tax administrations will normally be a strong deterrent to use base companies in that country". (Emphasis added).

Rigby notes[68] that the OECD comments underlined at para 47 do not appear to have any legal basis. Indeed, Rigby says of the OECD distinction between "real industrial or commercial activity" and other activity is an example of what Vann described as the "creative" reasoning that characterised arguments made in the OECD publication on thin capitalisation.[69] Rigby says that the OECD argument at para 47:

"Appears designed to justify a conclusion already reached: namely, that there is no conflict between CFC measures and tax treaties."

After having referred to the Vienna Convention on the Law of Treaties, that treaties are to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty and their context and in the light of their object and purpose, Rigby says:[70]

"... the scheme for taxing companies income contained in tax treaties indicates that CFC measures are clearly not contemplated where a tax treaty is an existence. Also, CFC measures can give rise to double taxation and this is contrary to one of the main objects of tax treaties. Therefore, the 'underlying principles' of tax treaties tend to support the argument that CFC legislation is inconsistent with tax treaty rules, particularly the rules governing the taxation of business profits. Further, if the scheme for taxing company income does not contemplate the application of CFC measures it is difficult to imagine how such measures can be consistent with the spirit of tax treaties.

"The argument ... that CFC legislation is inconsistent with the business profits article of tax treaties in all cases where business profits are subject to the legislation, is to be preferred to the OECD argument which turns on the characterisation of the income earned by the CFC. There is nothing in the underlying scheme or purpose of tax treaties that supports the OECD approach. Moreover, the OECD argument has no legal basis as it ignores the actual language used in tax treaties."

It is noted that the recently issued 1992 OECD Model convention has made various technical amendments to the 1977 Model convention referred to in this thesis but has not dealt with the issue of CFC legislation.

Prof. Arnold has said:[71]

"Although it would be preferable for a country to renegotiate its tax treaties in order to take the domestic tax change into account, this may not always be practical. However, the recent US legislation goes much further. In effect, it rejects the general principle that tax treaties override domestic legislation. Tax treaties are contracts between nations which should not be disregarded lightly. ... If the United States take the position that what it cannot achieve through treaty negotiations it will achieve through overriding domestic legislation, the process of negotiating tax

treaties will be rendered meaningless."

Arnold's sentiments appear to be shared by Vann[72] who also contrasts what might be described as an "integration" principle inherent in CFC legislation with the "separate entity" principle inherent in taxation treaties:

"CFC legislation ... contradicts once again the fundamental building blocks of the typical tax treaty. Under CFC legislation a parent company is effectively taxed on the profits of a subsidiary resident and deriving profits in another country. Tax treaties recognise the separate existence of subsidiaries and in its associated enterprises article treats them as distinct from the parent.

"... The increasing use of more and more extensive legislation in the CFC area will also inevitably lead to economic double taxation of the same income. This problem is already recognised in the law of some countries and an attempt is made to deal with it. Australia along with most other countries adopting CFC legislation, however, will make no such attempt and as a result economic double taxation may occur. Thus one of the primary objects of tax treaties is being subverted."[73]

However, Vann[74] later examined the possible use of multilateral treaties in an attempt to overcome the problem. The lack of enthusiasm which has since greeted the OECD Multi-lateral Convention for Mutual Administrative Assistance in Tax Matters does not bode well for the short to medium term prospects of multi-lateral treaties in overcoming CFC override problems.

Australian Taxation Office Position

The Australian Taxation Office (ATO) apparently was of the view that the CFE provisions are generally not in conflict with treaties, because it is not a tax upon the income of a non-resident.[75] The tax is levied on the Australian resident attributable taxpayer, and there is no prohibition on Australia subjecting its residents to taxation. That is, the tax under the CFE provisions is not upon a non-resident entity, but upon an Australian resident in respect of his or her deemed interest in the income of that entity. Australia is taxing its residents on their deemed income. It is not taxing residents as "surrogates" for a tax liability of a non-resident.[76]

It is of note however, that the ATO was aware of conflict between the CFC provisions and Australia's taxation treaties, in relation to dual residents, as the definition of "Part X Australian resident" in s316 of Pt X resolves domestic law dual residence under the Pt X in favour of an overriding taxation treaty.[77] It can also be seen from the fact that "tax spared" income under Australia's taxation treaties is treated under s324(1) and reg. 152H as being "subject to tax".

Arnold[78] notes that a similar analysis is taken by the Revenues of the various countries that have CFC legislation however, he also says:

"It is well established, however, that treaties, including tax treaties, are to be interpreted broadly and liberally in accordance with their spirit. Consequently, an argument can be made that taxing shareholders of a foreign

> corporation on their share of the corporation's income under CFC legislation is broadly equivalent to taxing the foreign corporation... The country in which the parent corporation is resident is not entitled to impose tax on the foreign-source income of the foreign subsidiary. Accordingly, the imposition of tax on the parent corporation in respect of the income of the foreign subsidiary is a violation of the spirit of the treaty.
>
> "One possible reason why the foregoing argument has not been considered seriously is that the CFC legislation is prophylactic. Most taxpayers will plan their affairs to avoid the application of the legislation rather than risk relying on a treaty to invalidate the legislation. Nevertheless, whether out of excessive caution or serious concern about a possible treaty violation, some countries, such as Canada, have added provisions to their tax treaties explicitly allowing them to impose tax pursuant to CFC legislation. (See, for example, Article 27 (3) of the Canada-UK Tax Convention)."

Rigby[79] has said in relation to the "business profits" article, in response to the argument that as the article does not expressly limit residence country taxation on the foreign source income of treaty partner residents:

> "If it was contemplated that a state could tax non-residents on foreign source income, the concentration on limiting source country taxation of domestic income would be futile because it would mean that although such countries might be restricted in their taxation of domestic source income of non-residents they could still tax foreign source income of non-residents in full."

Rigby notes[80] the argument that CFC legislation does not deal with the same subject matter as the "business profits" article because it does not tax the profits of the CFC but rather only uses them as a measure for calculating income of shareholders along the lines of an accruals capital gains tax. However he notes that although in legal terms the profits of a CFC are not taxed to the shareholder, that the economic effect is in fact to tax the CFC's profits.

TO WHAT EXTENT DOES THE AUSTRALIAN DOMESTIC LAW HAVE THE EFFECT OF OVERRIDING AUSTRALIA'S INTERNATIONAL TAXATION TREATY OBLIGATIONS UNDER THE CONTROLLED FOREIGN COMPANY AND TRANSFEROR TRUST PROVISIONS?

Constitutionality

As to the constitutionality of the CFC provisions, the High Court decision in *MacCormick v F C of T*[81] is relevant. That decision dealt with the constitutional validity of the *Taxation (Unpaid Company Tax) Assessment Act* 1982 (Commonwealth - "TUCT" legislation). The CFE legislation, like the TUCT legislation, creates a new tax liability for a person other than the person who derived the income. In the TUCT legislation and presumably also in CFE legislation, the liability of the vendor shareholder or attributable taxpayer respectively, is a new liability rather than the requirement of payment by a party of another party's tax. Under the CFE provisions the CFE is not assessed to Australian tax. A new liability to tax is to be directly enforced against the Australian resident attributable taxpayer. The CFE legislation can be distinguished, therefore, from the transfer of the land tax liability held to be unconstitutional in *Waterhouse v Deputy Federal Commissioner of Land Tax, SA*[82]. In *Waterhouse*, the High Court's interpretation of the legislation was that the tax liability of Party B was by the relevant land tax legislation to be met by Party A. Therefore, the CFE legislation is most

likely to be constitutionally valid.

Income not expressly mentioned

As was noted previously, under the "income not expressly mentioned" articles of Australian taxation treaties, income sourced in third countries is generally precluded from being subject to Australian tax.

In analysing the "income not expressly mentioned" article, the international literature says that it is the "item of income" rather than the taxpayer upon which tax is charged which must be considered.[83] This is not inconsistent with the Australian cases dealing with the now repealed s23(q). That section, in essence provided that foreign source income not exempt from tax in the country of source and derived by an Australian resident, was exempt from Australian tax.

In those cases it was held that an item of income was not exempt from tax where, although that item itself is not formally taxed, it entered indirectly into the calculation of taxable income, including someone else's income. For example in *Mutual Life Citizens Assurance Co Ltd v F C of T*,[84] Fullager J stated that income is not exempt "if it is required to enter into the calculation directly as itself a part of the assessable income, or even if, though it is excluded from the actual calculation of assessable income, the rate of tax is increased by reference to its existence". See also *F C of T v Angus*,[85] where Fullager J also stated "it is the income, and not the person who receives the income, that is required to be 'not exempt' by s23 (q). Whoever has to pay the tax in Singapore, tax is charged on the income, and the income is clearly 'not exempt' in Singapore."

Role of s388 (and s102AAV)

Another aspect of the CFC provisions, to which Dwyer[86] has referred, is s388 of the ITAA which reads, "in calculating the attributable income of the eligible CFC, the *International Tax Agreements Act* 1953 is to be disregarded, except for the purpose of references in this Act to that Act".

Dwyer's view is that s388 represents an attempted unilateral override of Australia's taxation treaty obligations. Section 388 was necessary to enable the attributable income of a CFC to be determined since the starting assumption is that the CFC is a tax resident of Australia. The question of override only arises if the calculation results in "attributable income" and the attribution to an Australian "attributable taxpayer" is not avoided by s4(2) of the Agreements Act. In any event as Dwyer points out, the government's response to this argument was dealt with in the Senate;[87]

> "Senator Watson has suggested that proposed s388 effectively nullifies part of Australia's international agreements. This is neither the government's intention, nor is it the effect of s388, to override any provision of any international agreement. Section 388 is only relevant for the purposes of calculating the attributable income of a CFC for the purposes of the proposed Div 7 of Pt X of the ITAA. This is not a matter to which the double tax treaties apply."

The writer agrees with Dwyer that after the decision of the full High Court in *Thiel v FC of T*, the ATO's view as noted previously, that the CFC legislation does not attempt to override treaties will not sit well with the High Court's decision, and in particular that there must be a question as to whether the High Court will not see the "process of indirectly taxing an item

of foreign income as squaring with an exemption given by a tax treaty which the Parliament has not been willing to override unambiguously by legislation".[88]

Double Taxation

There is "double taxation" in the ordinary sense of that expression when the same person pays tax twice on the same income *Canadian Eagle Oil Co. Ltd v The King*.[89] It is a well established principle that a court will not adopt a construction of a taxation act that will result in the imposition of double taxation unless the intention to do so is clear beyond doubt. It is also a general principle that the concept of double taxation encompasses the situation where different taxpayers are assessed on the same income: see *Richardson v F C of T*.[90]

It has been contended that the CFE provisions will not result in double taxation as credit will be given against tax on attributable income for foreign tax paid.[91] To the extent that the Australian tax rate applicable to the income is less than the foreign tax for which credit is to be given, there will necessarily be some element of double taxation of that income as Australia will not give a credit for foreign tax in excess the relevant Australian tax applicable.[92]

Further, credit is not always given for foreign tax in relation to attributable income. Only Australian resident companies with a 10% or more interest in a foreign company are entitled to a credit for a relevant part of the underlying tax of the foreign company. Individual Australian residents are only entitled to a credit for foreign withholding taxes. The amendments to the foreign tax credit system as result of the CFC provisions are as a matter of policy, only to give credits to Australian attributable corporate taxpayers that are attributable on the income of a CFC, but not to Australian resident individuals who are so attributable.

At "first blush" that treatment of foreign taxes on attributable income appears consistent however it overlooks the fact that the attributable income of the resident individual has not been received, whereas foreign source income actually received provides a source of funds from which the relevant tax can be paid. The corporate taxpayer attributed with income of a CFC at least has the benefit of the foreign tax credit to compensate for the fact that the income of the CFC is not being distributed by way of dividend to the Australian resident (corporate) shareholders. There is thus the question of whether the consistent application of policy distinguishing between individuals and corporate shareholders in CFCs is appropriate in relation to attributable income, even if it is appropriate in relation to foreign income actually received.[93]

Business Profits

All of the tainted sales income and tainted services income that is eligible designated concession income of a listed country CFC, and all of the tainted sales income and tainted services income of an unlisted country CFC, is attributable but will be precluded from Australian taxation by the "business profits" articles of Australia's taxation treaties where the treaty partner CFC has no permanent establishment in Australia or if the income is not attributable to such a permanent establishment. Therefore the CFC provisions are directly in conflict with Australia's treaty obligations in relation to that income derived by the treaty partner CFC without a permanent establishment in Australia or where that income is not attributable to such a permanent establishment.

Even if this interpretation was not upheld, attributable "business profits" with a source in the treaty partner country or a third country would be precluded from Australian taxation if there was an “income not expressly mentioned” article in the relevant taxation treaty, as such income would in that event, not be "dealt with" by the "business profits" article.

The same conclusion applies in relation to LCATTs (listed country accumulation transferor trusts). However, as there is no active income test in relation to trusts, it is not just the "tainted sales income" and "tainted services income" which are also "eligible designated concession income" which will be attributed, but rather all of the "eligible designated concession income". Thus, there is greater potential for conflict with Australia's taxation treaties under the transferor trust provisions than with the CFC provisions.

Rent, Interest, Royalties, and Alienation of Property

Where a listed country CFC in a treaty country derives “tainted rental income”[94], “tainted interest income” [95], or “tainted royalty income” [96], in its country of residence, the CFC provisions will only attribute that income to Australian resident attributable taxpayers if the "active income test" is not met and that income is "eligible designated concession income."
Where there is a limited alienation of property article (of the type generally appearing in the agreements signed before the China agreement (1988)), dealing with gains on the disposal of real property, that article will preclude Australia from attributing a gain on disposal of real property in the treaty country by a treaty country CFC.

Where a listed country CFC derives passive income by realising a gain on the disposal of a tainted asset (e.g. a real property that gave rise to tainted rental income) the gain that is “eligible designated concession income” will be attributable unless the CFC meets the active income test.

Where the listed country CFC in a treaty country derives “tainted rental income” “tainted interest income”, “tainted royalty income”, or real property gains on alienation of property, from a third country source, if that income is not "eligible designated concession income", assuming that it is not "subject to tax" in any listed country, it is attributable under s385(2)(a)(ii).

Thus the conclusion is that the attribution of such treaty country source income or third country source tainted income to an Australian resident attributable taxpayer is in conflict with the "income not expressly mentioned" article appearing in 24 of Australia's taxation treaties.

In the case of the 12 treaties that do not have such an article, there is generally not a conflict between the CFC provisions and the treaties in relation to such income, unless the CFC is a dual resident in 9 of those treaties.

In relation to the taxation treaties with Vietnam and Czech Republic, which are unlisted countries, the CFC provisions will attribute rental income from Vietnam, Czech Republic, or a third country source, if it is tainted income and the CFC does not meet the active income test. As the Vietnam and Czech Republic treaties have "income not otherwise mentioned" articles, such attribution is in conflict with the Vietnam and Czech Republic taxation treaties.

Where a LCATT in a treaty country derives rental income in its country of residence or from a third country, the transferor trust provisions attribute that income to an Australian resident attributable taxpayer if the income is "eligible designated concession income" (s102AAU(1)). As it is noted there is no "active income test" in relation to trusts and as it is not only income within the definition of tainted income that will be attributed, there is a greater possibility of a LCATT's income being attributed in conflict with the "income not expressly mentioned" article appearing in 22 of Australia's taxation treaties. This also assumes that the relevant treaty deals with the trusts.

For those treaties which do not deal expressly with trusts (i.e. all except the US, Canada and the Philippines), and for those that do which do not have a "income not expressly mentioned" article, there is generally not a conflict between the transferor trust provisions and the treaties in relation to such income.

CONCLUSION

If Australia wanted to put the matter beyond doubt in the way that Canada did, it would have amended s4(2) of the Agreements Act to include the CFE provisions with the other exclusions to the supremacy of Australia's international double taxation treaties (s160AO and Pt IVA) at the time the CFE provisions were introduced. If it sought to do so now that would make the purported override (ss102AAV and 388 of the ITAA), into an express override.

This is so in relation to the attribution of "business profits" that can take place in relation to such items which have their source outside Australia, since under all of Australia's taxation treaties, it is submitted Australia's ability to tax those items is entirely prescribed (except where the treaty county partner has a permanent establishment in Australia with which those profits are effectively connected).

Where the treaty under consideration has an "income not expressly mentioned" article, which is the case in 24 of Australia's taxation treaties, the problem is also apparent in relation to rent, interest, royalties, dividends and real property gains sourced outside Australia which is attributable income. Of the remaining 12 treaties, the problem is also apparent for dual residents in relation to that income, under 9 of those treaties

Even if Australia amends s4(2) of the Agreements Act to refer to the CFE provisions, the difficulty remains that the more exceptions that are made to the supremacy of taxation treaties, the less valuable the treaties. It is submitted that the proper method of dealing with the problem is to renegotiate existing treaties and to expressly deal in future treaties with the issues that the CFE provisions give rise to. It is noted that none of the treaties into by Australia since the introduction of the CFE provisions have referred to those provisions.

Suggestions for overcoming the difficulty by multi-lateral treaties as proposed by Vann are not likely to be available solutions in the short to medium term, as evidenced by the collapse of the negotiation for the multi-lateral exchange of taxation information treaty for OECD members.

As the current situation stands, a taxpayer assessed to tax by the CFE provisions in purported override of a taxation treaty

may wish to rely on s4(2) of the Agreements Act, and litigate the matter if necessary.

29 September, 1996

REFERENCE NOTES

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i. "Taxable Australian Asset" is defined in s160T

ii. As was acknowledged in the *"Taxation of Foreign Source Income - An Information Paper, April 1989,"* AGPS at para 1.2.

iii. 72 ATC 4076 (*Gibbs* J); 73 ATC 4114 (Full Court). Contrast the approach taken by the House of Lords in *Unit Construction Co Ltd v Bullock* [1960] AC 351; see also *Malayan Shipping Co Ltd v FC of T* (1946) 71 CLR 156

iv. See for example, Brian J. Arnold *"The Taxation of Controlled Foreign Corporations: An International Comparison"* Canadian Tax Paper No.78 at v, and 7-8.

v. Such interest withholding tax "schemes" may have had no more substance than an Australian taxpayer incorporating a tax haven entity and subscribing substantial redeemable capital in that entity with the Australian shareholder borrowing back those same funds at commercial rates of interest. The question of legal professional privilege dealt within *FC of T & Ors v Citibank Limited* 89 ATC 4268 arose as a result of the Commissioner seeking access to Citibank documents relating to such "schemes" apparently promoted by Citibank to its clients.

6. Prior to the 1993-94 year of income, royalties paid to a non-resident were subject to tax by assessment such that, if for instance, a tax haven entity sub-licensed its ultimate Australian shareholder company to use intellectual property where the tax haven entity itself had a head licence from another related entity, licence fees under the head licence paid by the tax haven entity to a related tax haven entity would theoretically be deductible from the Australian source royalty income of the first tax haven resident in determining its Australian tax liability. Alternatively, the licensor might be a resident of the Netherlands, with which Australia has a taxation treaty, which would limit the Australian tax to 10% of the gross royalty paid. By virtue of the tax arrangements in the Netherlands, provided that the Netherlands company itself on-paid the bulk of the royalties received, an insignificant amount of Dutch tax would be payable. The head licensor would invariably be a Netherlands Antilles company to which the intellectual property had been sold (especially before the introduction of Australian capital gains tax).

7. Introduced by the *Taxation Laws Amendment (Foreign Income) Act* 1990 amendments to the ITAA. For discussion of what has been described as the "better response", of treating a CFC's residence as that of its owners, see R J Vann, *"Trans-Tasman Taxation of Equity Investment"* op cit at 47-8. For a discussion of the background to the introduction of the CFC provisions and as to their application generally, see Lee Burns, *"Controlled Foreign Companies: Taxation of Foreign Source Income",* Longman, 1992.

8. The CFC amendments acknowledge that the efficiency of the foreign tax credit system in relation to income sourced in countries with a comparable tax system to that of Australia was doubtful, because it created a heavier compliance burden for taxpayers with entities in those countries without any significant increase in Australian tax payable due to the tax credit for tax paid in those countries: Explanatory Memorandum to the *Taxation Laws Amendment (Foreign Income) Bill* at 12. Exemptions from tax were introduced for dividends from (s23AJ), and branch profits (s23AH) which are fully taxed, in a listed country.

9. Czechoslovakia is still listed but has split into two countries: Czech Republic and Slovakia. Australia is also likely to enter into taxation treaties with other countries which will be unlisted e.g. Mexico and Chile are unlisted and Australia is in the process of negotiating taxation treaties with those countries. See minutes of 19 April 1996 meeting of NTLG's Sub-Committee on Foreign Source Income, as reported in Taxation in Australia" red. ed. August 1996 at 55. R L Deutsch, "*An Overview of the International Tax Legislation: Offshore Investment*", New South Wales Division of the Taxation Institute of Australia, 1992 Intensive Seminar, at 7 notes the "more profound operation" of the CFC legislation in relation to unlisted countries.

10. For a CFC that is a resident of a particular unlisted country, it is necessary to pass the active income test that the tainted income ratio be not more than 0.05. For a particular unlisted country the ratio is determined by: tainted turnover / gross turnover.

11. For a CFC that is a resident of a particular listed country it is necessary to pass the active income test, that the "tainted income ratio" be not more than 0.05. For a particular listed country the ratio is determined by: tainted eligible designated concession income / eligible designated concession income.

12. Under the CFE provisions the "eligible designated concession income" essentially arises for a CFE resident of a listed country where - (i)capital gains derived from the CFE are not "subject to tax" in the listed country; (ii) income such as interest or royalties in a listed country are subject to a reduction in tax; or (iii) an item of income or profits is subject to a reduction of tax in a listed country pursuant to the items referred to in Schedule 9 of the Regulations. Countries such as New Zealand, Malaysia and Singapore do not have a capital gains tax. In some listed countries interest and royalties are subject to reductions in the rate of tax, and Schedule 9 to the regulations currently lists 52 concessions in relation to 25 countries.

13. A particular item of income or profit derived by a CFC is taken to be "subject to tax" in a listed country only if - (i) Foreign tax (other than a withholding-type tax) is payable under the tax law of the listed country because the income or profits have been included in the tax base of that country; or (ii) Foreign tax (other than a withholding-type tax) which is treated as deemed paid under tax-sparing relief (either under regulations under s160AFF or under a taxation treaty) provided the tax spared would have otherwise have been payable because the item would have been included in the tax base of the listed country (s324(1)). The concept of "subject to tax" is relevant to determining the "notional assessable income" of a listed country CFC, as it is relevant: (i) to determine whether a capital gain is "eligible designated concession income"; and (ii) to determine whether income not being "eligible designated concession income" is otherwise attributable pursuant to s385(2)(a)(ii).

14. "Passive income" is defined in s446 to include dividends, tainted interest, and tainted royalties. "Tainted sales income" is defined in s447 to include income from the sale of goods that are either purchased from or sold to an associate who is an Australian resident, excluding goods substantially altered by the CFC. "Tainted services income" is defined in s448 to include income from the provision of services to an associate or an Australian resident.

15. For a comparison of the 1963 and 1977 OECD model conventions see *"Model Income Tax Treaties"*, ed K van Raad, Kluwer 1990. For a discussion of the UN and Andean models, see, K Ongaranuhann "*The Taxation of Income from Foreign Investments*", Kluwer 1991 at para 1.4.2.

16. Denmark, Sweden (and in some cases, exemption from tax for companies), Switzerland (and in some cases exemption).

17. Other taxation treaties, although having a "source of income" article, are supplemented by a specific provision of the Agreements Act, for instance, in relation to Canada (s6A(4)), China (s11S(2)) and France (s9A(3)).

18. See generally in relation to source rules under taxation treaties - Hamilton & Deutsch "Understanding Australian International Taxation" 2nd ed., Sydney, CCH 1988 at para 256.

19. The superseded New Zealand treaty was the major exception. It applied the "force of attraction" principle such that all "business profits" in the country where its permanent establishment existed were subject to tax there.

20. For the purpose of determining the amount of profits, the "associated enterprises" article may have application and should be referred to. In addition, para (2) of the "business profits" article usually provides that the profits of a permanent establishment which may be subject to tax in the country in which the permanent establishment is located shall be that profit which might reasonably be expected to have been derived if the permanent establishment was conducted as a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions.

21. The OECD commentary on its model "business profits" article (7(1)), makes it clear that the article does not work on the principle of the "force of attraction of a permanent establishment".

22. Income Tax Ruling IT355 issued on 11 January 1975 fails to deal with s3(2) of the Agreements Act and in the light of the decision in *Thiel v FC of T* 90 ATC 4717 it should be withdrawn

23. 90 ATC 4717

24. For further discussion see Hamilton & Deutsch op cit at paras 614-617 and the cases noted therein, and I Langord-Brown, *"Permanent Establishments"*, Intensive Seminar on International Transactions, Taxation Institute of Australia, 4-6 November, 1982. In addition there are a number of useful Canadian decisions relating to

permanent establishments: including *MNR v. Panther Oil & Grease Ltd* [1961] CTC 363; *Sunbeam Corp Ltd v MNR* [1962] CTC 661; *Fowler v MNR* [1990] 90 DTC 1384; *American Wheelabrator v MNR* (1951) 4 Tax ABC 345; *Ronson Art Metal (Can) Ltd v MNR* (1956) 15 Tax ABC 439. Also see the US case if *IRC v Consolidated Premium Iron Ores Ltd et al* 59-1 USTC 71, 947.

25. There is no such provision in the OECD model but such a provision is found in several treaties Australia has signed (e.g. Thailand, Austria, Finland and Italy).

26. The OECD commentary makes it clear that the rule in model article 21(1) applies irrespective of whether the right to tax in the country of residence is in fact exercised and thus when the income arises in the other country, that country cannot impose tax even if the income is not taxed in the first mentioned country.

27. David A Ward et al, *"The Other Income Article of Income Tax Treaties"*, British Tax Review, 1990, p352 at 376.

28. China (1988), Hungary (1990) and Czech Republic (1995).

29. Australia's taxation treaties with: United Kingdom (1976), Germany (1972), The Netherlands (1976), France (1976), Belgium (1977), The Philippines (1979), Switzerland (1980), Malaysia (1980) and Italy (1982).

30. Op cit 377.

31. Article 22 of the Thai treaty provides: (1) Items of income of a resident of one of the Contracting Sates which are not expressly mentioned in the foregoing Articles of this Agreement shall be taxable only in that Contracting State. (2) However, if such income is derived by a resident of one of the Contracting States from sources in the other contracting State, such income may also be taxed in the Contracting State in which it arises. (3) The provisions of paragraph 1 shall not apply to income derived by a resident of one of the Contracting States where that income is effectively connected with a permanent establishment or fixed vase situated in the other Contracting State. In such a case, the provisions of Article 7 or Article 14, as the case may be shall apply.

32. Ward et al op cit at 354, 356 and 364, R L Deutsch, *"An Overview of the International Tax Legislation: Offshore Investment"* op cit at 6-7 is attracted to this view but does not examine it.

33. Op cit 356.

34. Klaus Vogel, *"Doppelbesteurungsabkommen"* (Munich: Beck, 1983) annotation 12 to article 21, as reported by Ward et al op cit at 354.

35. Kurt Locher, Walter Meier and Rudolf von Siebenthal, *"Doppelbesteurungsabkommen Schweiz - Deutschland, 1971 und 1978"*, Vol 3. (Basel: Verlang fur Recht und Gesellschaft AG, 1985) as reported by Ward et al op cit at 356.

36. Also see s3(11) of the *Agreements Act*..

37. [1967] 2 QB 116 at 144 (see also *Ellerman Lines v Murray; White Starline and US Mail Steamers Oceanic Steam Navigation Co Ltd v Comerford* 14 [1931] AC 126; subnon. The Croxteth Hall; The Celtic, 47 at TLR 147, HL(E).

38. His Lordship made other observations relevant to the interaction of the UK domestic law and treaties at 143-5: " ... if the terms of the legislation are not clear but are reasonably capable of more than one meaning, the treaty itself becomes relevant, for there is a prima facie presumption that Parliament does not intend to act in breach of international law, including therein specific treaty obligations; and if one of the meanings which can reasonably be ascribed to the legislation is consonant with the treaty obligations and another or others are not, the meaning which is consonant is to be preferred....One must not presume that Parliament intends to break an international convention merely because it does not say expressly that it is intending to observe it. Of course the court will not merely guess that the statute was intended to give effect to a particular international convention. The extrinsic evidence of the connection must be cogent."

39. [1962] AC 1 at 18-24.

40. In *Collco Dealings*, s349 of the *Income Tax Act*, 1952, gave force of law to the treaty between the United Kingdom and the Republic of Ireland. The case involved the sale by UK residents of shares in UK resident companies to residents of Ireland immediately after which substantial dividends were declared from pre-acquisition profits. The taxpayer sought a refund of UK tax withheld on the payment of the dividend, relying on article 1(a) of the treaty which exempted residents of Ireland from UK income tax in respect of all properties situated and all profits or gains arising in the UK. Section 4 of the *Finance (No 2) Act*, 1955, was designed to prevent the practice of "dividend stripping". The taxpayers argued that the provisions of s4(2) should be limited and controlled so as to exclude residents of Ireland who were excluded from ambit of UK income tax by the treaty with Ireland, on the ground that not to do so would create a breach of the treaty, which would be inconsistent with the comity of nations and the established rules of international law. The House of Lords (Viscount Simonds, Lord Morton of Henryton, Lord Reid, Lord Radcliffe and Lord Guest) held that the claim to exemption arose under the Act which confirmed the treaty; that the exemption relied on, contained in s349 of the *Income Tax Act*, 1952, had been modified by s4(2) of the *Finance (No.2) Act*, 1955, in plain and unambiguous terms which could not on their true construction be limited so as to leave unaffected the rights of Irish residents.

41. See also for instance s812 of the UK *Income Tax Act* 1988, which allows the Inland Revenue to deny a tax treaty credit in certain cases to non-UK resident companies located in jurisdictions which impose a form of unitary tax.

42. (1959) 3 All ER 245.

43. See especially Lord Radcliffe at 514.

44. R T Bartlett, *"Making Double Tax Agreements"*, British Tax Review, No's 3 and 4, 1991 at 83-4.

45. 82 DTC 6281.

46. The problem arose due to article II(2) of Canada/Federal Republic of Germany treaty which so provided; cf the position particularly in Australia's recent treaties where the "undefined terms" article explicitly adopts the ambulatory approach. See Michael Rigby, *"A Critique of Double Tax Treaties as a Jurisdictional Co-ordination Mechanism"* Australian Tax Forum, Vol. 8, No. 3 1991 at 387. Also see Lee Burns, *"Introduction to Double Tax Treaties - Working Notes"*, International Tax Workshop - Current Developments in Double Tax Treaties, 1990, University of Sydney. Although the commentary to the OECD model does not consider the matter, Jean-Marc Dery of the OECD stated: *"Model Tax Treaty for the Region"*, a paper presented at the APTIRC and IPS Conference on Anti-Avoidance and Tax Treaty Policies and Practice in the Asian-Pacific Region, Wellington, 9-12 June 1989, that the OECD never intended that a static interpretation would apply to the undefined terms provisions in treaties. Also see David A. Ward, "*The Income Tax Conventions Interpretations Act"* a paper reported in the proceedings of the 35th Tax Conference (Montreal: Canadian Tax Foundation 1983) at 602 and David H Brockway, *"Interpretation of Tax Treaties and their Relationship to Statutory Law - a US Perspective"*, ibid at 619. The decision has been criticised by Avery-Jones et al *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model"* 1984 British Tax Review 14 at 27.

47. See for example, article 27(3) of the Canada/UK taxation treaty and s2 of the Protocol to the Canada/Israel taxation treaty

48. 124 US 190 (1888) at 194.

49. *Cook v US* 288 US 102 (1933). See generally concerning the "later in time" rule: S E Shay, *"The Relationship of the Tax Treaties to Domestic Law in the United States"*, Tax Treaties and Domestic Legislation IFA 1991. In *Pierre Boulez* (1984) 83 USTC No. 1 is was held that payments received by a record company from an orchestra conductor with respect to the sale of his recordings, were not "royalties" for the purposes of the US/Federal Republic of Germany treaty, but were taxable in the US as independent services income. Again, in a US case concerning regulations under the US/Switzerland treaty, the expression "not having a permanent establishment" in the US was held to mean not having it "at any time during the year", in accordance with the US statutory concept which was incorporated in the regulations issued under the treaty: *Samann* (1963) 313F.2d 462.

50. Section 31 of the *Revenue Act* 1962 was described as follows in the report of the House of Representatives on HR 10650 (the bill that was enacted as the *Revenue Act* of 1962): "Some believe that certain provisions of this bill may contravene provisions of existing income tax treaties. Your committee in the interest of forestalling any possible litigation on this point desired to make it clear that s7852(d) is not to apply to any provision contained in this bill and if any provision of this bill should contravene any tax treaty, then the new statutory law is intended to have precedence over the prior treaty obligation" (HR Rep No. 1447, 87th Cong., 2d Sess. 96 (1962)).

51. Op cit 317.

52. In 1980 Congress enacted the Foreign Investment in Real Property Tax Act ("FIRPTA") which taxes gains from sales by non-residents of US real estate or shares in US corporations which predominately invested in US real

estate. After a transitional period of five years that legislation overrode all tax treaties which exempted such gains (s1125(c)).

53. The US *Tax Reform Act* of 1986 provided that certain provisions would override previous and subsequent treaties except to the extent that subsequent treaties specifically provide to the contrary. In addition, the *Tax Reform Act* of 1986 contained several specific instances - the branch profits tax and the second level withholding tax are the most prominent examples - where the provisions of the Act were expressly stated to override the provisions of any tax treaties.

54. The *Technical and Miscellaneous Revenue Act* of 1988 provides that the provisions of the *Tax Reform Act* of 1986 override the provisions of any existing treaty unless the Act provided otherwise.

55. In the *Revenue Reconciliation Act* of 1989, Congress enacted a provision which may deny a current deduction by a US corporation for payments of part or all of its interest to related tax exempt entities where certain conditions are not met. The provision applies to payments of interest from US subsidiaries to foreign parent corporations where the interest is partially or fully exempt from withholding tax under a treaty. Regardless of whether this "earnings stripping" provision technically violates US treaty obligations, Congressional committee reports accompanying the *Revenue Reconciliation Act* expressed a clear intent to override all earlier treaties. The reaction of the US treaty partners can be seem from various comments made in letters to the US Administration at the time these provisions were being drafted. In a letter dated 14 July 1986, the Secretary to the Treasury from the Confederation of British Industry, it is said: "...The legislation shows a disturbing willingness to disregard treaty obligations; the Committee's reports, after giving reasons (which we do not accept) for saying no breach of tax treaties is involved, concludes by saying that if that view proves to be mistaken, it nevertheless wishes the legislation to go ahead." In a letter dated 30 July 1986 to the Secretary of the Treasury, German Industry representatives specified: "Although, it is undisputed that the national legislature, to the extent it is explicitly declares to, can override treaty provisions, such a procedure should be opposed since the United States' international treaty policy would be severely affected. Agreements are concluded in order to be adhered to."

56. On 20 March 1990, members of the House of Representatives (followed later by the Senate) re-introduced the proposal in the *Foreign Tax Equity Bill* to impose US tax on a disposition of shares of domestic corporations by 10% foreign shareholders. The House had put forward a similar proposal (on 14 September, 1989 HR 3299) which was dropped from the final version of the *Revenue Reconciliation Act* of 1989. Ultimately this revised proposal was dropped partially in response to significant international outcry. Unlike the prior proposal, the *Foreign Tax Equity Bill* would not have overridden treaties in effect on 20 March, 1990 which would otherwise prevent the application of those rules. However, the final Bill would have overridden any subsequently effective tax treaties. It has been stated that such a provision would allow the US to try and renegotiate the relevant treaty to allow imposition of the tax: Renfroe, Fogarasi, Gordon and Venuti, *"1989 Tax Bill: Taxing Foreign Investors on Capital Gains"*, Tax Notes International, October, 1989. The rationale however, would appear more likely to be that the treaty country residents could re-arrange their affairs before the commencement of operations of the provisions and as such, the purported US taxation treaty override would by then be more

"palatable" to US treaty partners. Further US treaty override proposals are referred to in Philip D Morrison, *"Talking Past Each Other on Tax Treaty Policy and Subpart F",* Taxes, December 1991 at 1005-7.

57. Letter dated 18 July 1986 to the Assistant Secretary for Tax Policy by Coopers & Lybrand, letter dated 1 August 1986 by the Chairman of the Tax Section of the New York State Bar Association to the Chairman of the House Ways and Means Committee, extracted in "Taxes International", (UK) October 1986.

58. See now s163(j) *Internal Revenue Code.* Congress also added new "treaty based return" disclosure requirements. Where a taxpayer takes a position that a tax treaty overrides or modifies domestic law, disclosure must be made in the US tax return of the treaty position.

59. *Koorwarta v Bjelke-Petersen* (1982) 153 CLR 168 at 224. But see *Minister for Immigration & Ethnic Affairs v. Teoh* (1995) 128 ALR 353. The former Labour government announced it would amend the law to reverse the effect of *Teoh's* case, but the Coalition government announced on 10 September 1996 that the decision would be let stand.

60. See ss5-11S. As Australia is a signatory to the Vienna Convention on the Law of Treaties, the rules of interpretation there codified are to be used in applying taxation treaties: *Thiel v FC of T* at 4727.

61. *Salomon v Commissioners of Customs and Excise,* op cit.

62. On the authority of the decision of the Supreme Court of Canada in *The Queen v Melford Developments Inc*, because the amendments effected to s6(1) of the definition of "royalty" have been adopted by s3(8) of the Agreements Act the fact that the "deeming" is contained in the legislation adopting Australia's treaties would evidence sufficient intention on the part of parliament to effectively amend the operation of the treaty since the amendment is incorporated in the adopting legislation rather than in the ITAA.

63. See Avery-Jones et al op cit 25. Rigby op cit at 387 that article 3(2) of the Model convention does not make it clear whether the "static" or "ambulatory" interpretation is required.

64. Similar provision are found in subsequent treaties. Further, the protocol to the Singapore treaty amends article 2(4) of that treaty so that an ambulatory interpretation now applies. It is stated in the explanatory memorandum that the intention of this amendment is to "clarify" the position and "to guard against argument that the undefined terms be limited to meanings they had in the respective domestic laws at the time of signature of the agreement". Note that there was no similar "clarifying" amendment to article 2(3) of the France treaty in the recent protocol to that treaty.

65. *"Tax Treaty Overrides*", op cit.

66. This resolution arose out of the views expressed in *"Tax Treaty Overrides"*, op cit.

67. *"Double Taxation Conventions and the Use of Base Companies",* International Tax Avoidance and Evasion, OECD, 1987. In that OECD study and in some other literature, CFCs are referred to as "base companies".

68. Op cit. 331-333.

69. R J Vann, *"A Model Tax Treaty for the Asia-Pacific Region?"*, (1990) APTIRC Bulletin 392 at 401 (note 2).

70. Op cit 333.

71. "Future Directions in International Tax Reform", International Tax Workshop held by the University of New South Wales Taxation Business & Investment Law Research Centre, Terrigal 26-28 August 1988, at 18. Rigby op cit suggests at 425-6 that the appropriate response to a treaty partner wishing to implement CFC legislation is as the US approached the FIRPTA amendments by specifying the treaty override was to take place only after a period of years. Rigby notes that this would give treaty partners an opportunity to re-negotiate their treaties with a view towards obtaining concessions as compensation for the overrides. Rigby notes that for this suggestion to be effective it would be necessary for the state that overrides its treaties to give an undertaking to its treaty partners that it will promptly enter into negotiations with a view towards compensating them for the override.

72. *"The Background and Policy of the Australian International Accruals Regime"* 1989, University of Sydney at 19; C J Bevan, *"Foreign Source Income: The Achilles Heel,"* Taxation in Australia, Nov 1991 at 252 puts it more emotively and describes the CFC provisions as having the "subversion" of Australia's taxation treaties as one consequence, if not their "secret objective."

73. Vann no doubt would be encouraged by the fact that effective 8 January 1991, s456A applies to relieve the double tax situation to which he referred, at least where only two CFC regimes apply to the same income. Where more than two CFC regimes apply, only one relief is provided by s456A. It should be noted that Sweden and Norway have now adopted CFC legislation. Stig Sollund, *"Taxation of Norwegian-controlled Companies Resident in Low-tax Countries"*. European Taxation, October, 1992, p364 at 365-6 notes that Norway has taken into account the considerations expressed in the above quoted OECD report.

74. Vann, *"A Model Tax Treaty for the Asia-Pacific Region?"* op cit.

75. As reported by T. Dwyer, *"The CFC Tax versus Double Tax Agreements",* Butterworths Weekly Tax Bulletin, 5 Nov 1991 at para 813. R J Vann, "*Trans-Tasman Taxation of Equity Investments",* op. cit at 82, notes that the "separate entity" assumption underlies not only the "business profits" article but also the "dividends" article and the "associated enterprises" article.

76. Cf s98.

77. The same approach was taken with the FIF provisions: s470 definition of "Pt XI Australian resident", but not under Div 6AAA.

78. *"The Relationship between Controlled Foreign Company Legislation and the Tax-Sparing Provisions in Tax Treaties "* Tax Notes International, July 1989 at 27.

79. Op cit 320.

80. Op cit 322. Another point noted by Rigby is that CFC regimes place pressure on CFCs to distribute their income. Therefore, because pressure is placed on CFCs to distribute income that would otherwise be used in their businesses, the burden of the tax imposed under the CFC legislation is arguably on the foreign company. He notes however that this does not mean in legal terms, that there is any conflict between taxation treaties and CFC legislation.

81. 84 ATC 4230.

82. (1913-14) 17 CLR 665.

83. Burns, *"Controlled Foreign Companies: Taxation of Foreign Source Income",* op cit at 103 also notes that the "subject to tax" test and the reg. 159D(1)(a) test focus on the "particular item derived". Section 456A also focuses on "items of income."

84. (1959) 12 ATD 9 at 13.

85. (1961) 12 ATD 277 at 285-6.

86. Terrence M Dwyer *"The CFC Tax versus Double Tax Agreements"* op cit and "*Foreign source income proposals 'To deem the impossible deem'!"* Butterworths Weekly Tax Bulletin No. 56, 1990.

87. Hansard, 13 February 1991 p457.

88. Dwyer op cit. On Australian interpretation of taxation treaties generally, and in *Thiel v FC of T,* see D H Bloom, *"Interpretation of Double Taxation Conventions"* IFA Florence Congress, 1993 at 179.

89. (1946) AC 119 at 142.

90. (1932-33) 48 CLR 192. The most celebrated case where the High Court allowed double taxation was in *Country Magazine Pty Ltd v F C of T* (1967-68) 114 CLR 192 - where pursuant to a change of tax accounting method to take into account the decision in *Arthur Murray (NSW) Pty Ltd v Commissioner of Taxation* (1965) 114 CLR 314 double taxation resulted.

91. Rigby op cit at 326 notes that timing differences may result in income being subject to tax twice.

92. s160 AF.

93. Arnold, Tax Notes International, op cit 29 observed (before Australia adopted such legislation) that under the CFC legislation of all seven countries which then had CFC legislation a credit is provided for the foreign taxes paid by a CFC to the extent such taxes are attributable to the portion of its undistributed income included in the income of resident shareholders of the CFC. With the exception of the US election provisions noted by Arnold, if his analysis is correct the Australian provisions in relation to credits are out of step.

94. "Tainted rental income" is defined in s317 to include in relation to a company: rent in respect of any of: (a) a lease to which an associate of the company was a party at the time the income was derived; (b) a lease where any or all of the rent was paid or given by an associate of the company;

95. "Tainted interest income", as defined in s317 in relation to a company, means: (a) interest or a payment in the nature of interest; or (b) an amount that, if the company was a resident within the meaning of s6, would be included in the assessable income by Div 16E of Part III; or (c) factoring income; but does not include offshore banking income within the meaning of Div 18 of Part III"

96. Section 317 defines "tainted royalty income" to mean: "Royalties derived by the company except where all of the following conditions are satisfied: (a) the royalties are derived in the course of a business carried on by the company; (b) at the time the royalties were derived, the entity liable to pay the royalties was not an associate of the company ; (c) either of the following subparagraphs applies: (i) the matter or thing in respect of which the royalty is consideration originated with the company; (ii) the company has substantially developed, altered or improved that matter or thing with the result that its market value was substantially enhanced."