TRANS-TASMAN TRIANGULAR TAXATION RELIEF
Part Two

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Triangular Taxation Relief: A Critical Evaluation of the New Zealand and Australian Governments' Solution

1. INTRODUCTION

In March 2002, the New Zealand and Australian governments released a joint discussion document,[1] Trans-Tasman Triangular Tax. The joint media statement noted that:

> *Clearly, triangular tax reform requires a bilateral approach that preserves the Australian and New Zealand tax bases and is acceptable to business and government in both countries…The mechanism under consideration is one that allocates both Australian franking credits and New Zealand imputation credits to shareholders in proportion to their ownership of a company.*

This mechanism is known as the "pro rata allocation" model, and its adoption was confirmed in February 2003.

The discussion document noted that the following alternative methods to relieve triangular taxation had been considered by both governments, but were rejected:

- apportionment,
- mutual recognition (including pro rata revenue sharing),
- streaming.

The Ministers[2] invited interested parties to comment on the workability of the pro rata revenue sharing proposal, and said that their advice would be taken into account in deciding whether or not to proceed with this proposal.

This working paper examines the strengths and weaknesses of the pro rata allocation mechanism and contrasts that solution with the streaming alternative. From the perspective of a New Zealand individual shareholder, the analysis will demonstrate the significant additional taxation advantages associated with streaming. Accordingly it is possible that the latest initiative may not produce a feasible solution. Trans-Tasman companies may continue to devise tax-driven strategies that provide their individual shareholders with an after-tax rate of return which is comparable with what they would have received under the streaming model.

Also examined, will be a range of debt, equity, and profit repatriation strategies which are currently used to solve triangular taxation. These include floating special purpose subsidiaries, the use of hybrid instruments, and techniques to minimise Australian capital gains tax. The pro rata allocation model is unlikely to lead to any significant decrease in Trans-Tasman tax-driven investment.

[1] Policy Advice Division of Inland Revenue, New Zealand and Department of the Treasury, Australia. 2002. *Trans-Tasman triangular tax* [Online]. 2002 [cited 20 February 2003]. Available from: http://www.taxpolicy.ird.govt.nz/publications/files/html/transtasman/index.html. See also the media statement of 19 February 2003 and the accompanying technical appendix which is also available in electronic format at http://www.taxpolicy.ird.govt/publications/files/html/transtasman.html

[2] Dr Michael Cullen, New Zealand Minister of Finance and Mr Peter Costello, Australian Treasurer.

2. THE STORY SO FAR

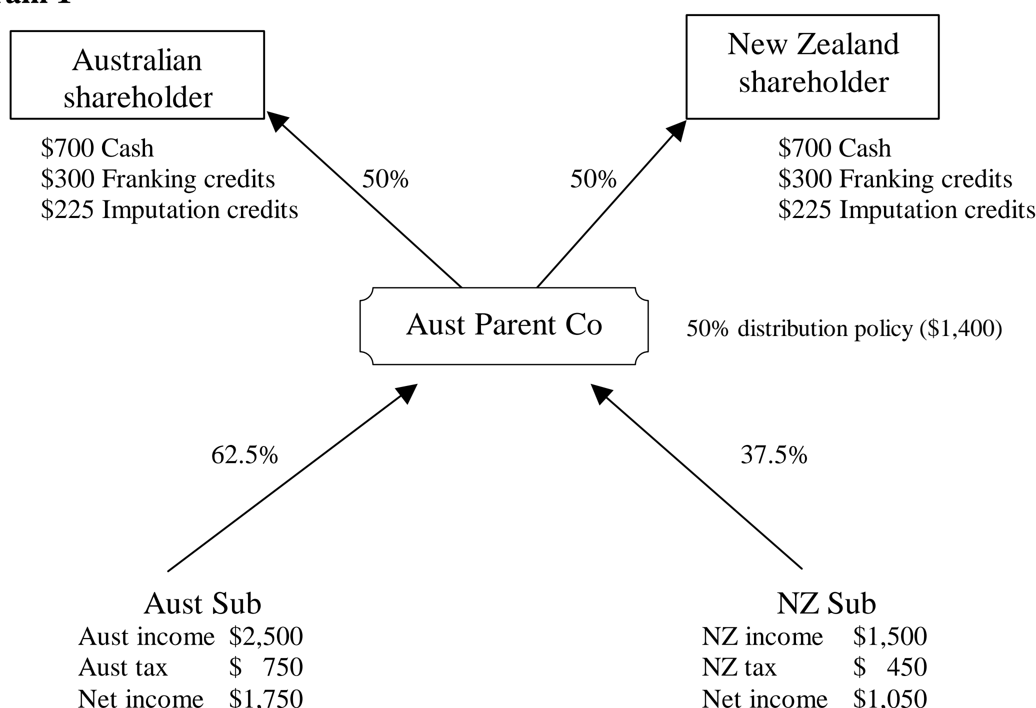
2.1 Previous analysis

An article published in March 2002[3] analysed, *inter alia,* the tax advantages of the latest proposal (pro rata allocation) and the three alternatives that had already been rejected by both governments. The following analysis is an update of the original hypothetical example which has been modified to reflect the comments contained in the discussion document. This will demonstrate the strengths and weaknesses of the pro rata allocation and streaming models.

2.2 The hypothetical example

Diagram 1 is based on the example in the discussion document.[4] For ease of comparison, the example has adopted a 30% corporate rate of tax in both New Zealand and Australia.[5] However, New Zealand's existing rate will not change in the foreseeable future.

Diagram 1



For the purposes of comparison, Australian Parent Company (Aust Parent Co) is a resident of Australia for tax purposes. New Zealand resident shareholders own 50% of the share capital. The remaining 50% of the share capital of Aust Parent Co is owned by Australian resident shareholders.

[3] DG Dunbar, "Trans-Tasman taxation reform : will it be third time lucky or will history repeat itself?" (2002) Vol 8: No 1 *New Zealand Journal of Taxation Law and Policy* pp 93-122.

[4] Policy Advice Division of Inland Revenue, New Zealand and Department of the Treasury, Australia. 2002. *Trans-Tasman triangular tax* [Online]. 2002 [cited 20 February 2003]. Available from: http://www.taxpolicy.ird.govt.nz/publications/files/html/transtasman/index.html p.19.

[5] Australian rate of corporate tax was cut to 30% on 1 July 2001. The New Zealand rate will remain at 33%.

Aust Parent Co owns 100% of the capital of an Australian resident operating subsidiary (Aust Sub) and a New Zealand resident operating subsidiary (NZ Sub). NZ Sub derived $1,500 of New Zealand source income and paid New Zealand company tax of $450. The after-tax income of $1,050 is paid as a dividend (including a supplementary dividend) to Aust Parent Co.

In addition to the net New Zealand cash dividend of $1,050, Aust Parent Co derives a dividend from its Australian operating company of $1,750. That subsidiary has an Australian sourced pre-tax income of $2,500 and pays Australian company tax of $750.

2.3 An important issue is the extent to which the hypothetical scenario modelled in Diagram 1 reflects the actual pattern of Trans-Tasman ownership. In cases where Australian resident shareholders dominate the ownership of an Aust Parent Co, there would appear to be few (if any) incentives for this type of company to support the pro rata allocation model. Australian shareholders own approximately 95% of ATA, AGL, ANZ, Goodman Fielder Wattie, NAB, Telstra and Westpac.

Under the pro rata allocation model at least 95% of the available imputation credits would be allocated to shareholders who were unable to utilise them.

2.4 The NZ corporate tax base relies heavily on the finance and business services sector which is dominated by Australian owned companies. In a paper presented by Robin Oliver (General Manager Policy) to the 2000 PricewaterhouseCoopers TLS conference, he noted that in 1998 approximately 40% of business income tax was paid by this sector. Three of New Zealand's four largest trading banks are dominated by Australian shareholders who are unlikely to support a model that does not provide them with a material improvement in their after tax dividend income.

3. THE PRO RATA ALLOCATION OPTION

3.1 Parent company's perspective

Table 1 (p.7) summarises the key changes associated with this proposal. It is based on the analysis contained in the discussion document summarised in 2.2 above. Under existing law, the dividend received by individual New Zealand shareholders would only contain an Australian imputation credit. However, the individual New Zealand shareholder cannot use that credit to offset against their New Zealand personal income tax liability. Under the proposal, New Zealand imputation credits could also be attached to the dividend. The imputation credit would be attached according to the shareholding, which in this example is 50%. The dividend received by the individual New Zealand shareholder would contain two credits. However, the shareholder can only utilise the imputation credit. Accordingly, franking credits allocated to New Zealand shareholders are effectively lost or wasted under both the current law and this proposal.

To achieve this proposed outcome, the Aust Parent Co would be permitted to maintain an imputation credit account which would record as a credit the $450 New Zealand company tax paid by the New Zealand operating subsidiary. The imputation account would record as a debit the allocation to the Australian shareholders of $225 and a

similar allocation to the New Zealand shareholders. To enable Aust Parent Co to distribute the tax paid by its two lower-tier operating subsidiaries, each subsidiary would have to pay a dividend with the respective credit attached. This requirement would be consistent with the current imputation and franking credit regimes.

Table 1 – Pro-rata allocation: The company's perspective

Distribution	NPBT*	NPAT**	Cash dividend	Imputation credit	Franking credit	Additional benefit
New Zealand shareholder	2,000	1,400	700	225	300	225
Australian shareholder	2,000	1,400	700	225	300	Nil
	4,000	**2,800**	**1,400**	**450**	**600**	**225**

50% Distribution of NPAT

*NPBT = Net Profit Before Tax
**NPAT = Net Profit After Tax

3.2 The shareholders' perspective

Table 2 (p.7) summarises the major changes associated with this proposal. The key point to note is that there would be no additional benefit for the Australian shareholders. The New Zealand shareholders would derive a significant benefit via their access to 50% of the imputation credits. The increase in the after-tax dividend from $427 to $564 represents a reduction in the effective tax rate from approximately 57% to approximately 44%. Despite this improvement in the after-tax return, the effective tax rate is still above 39%. This would occur because the dividend is not fully imputed. Figure 1 discloses that the Aust Parent Co would derive 62.5% of its earnings from its Australian operating subsidiary. Accordingly, the dividend derived by the individual New Zealand shareholders would partly be sourced from Australian income with Australian company tax paid on that income.

In view of the fact that Australian shareholders dominate the ownership of companies such as AXA Limited, AMP Limited, Westpac Limited, ANZ Banking Group Limited, why would those companies seriously consider implementing the pro rata allocation option? It would involve additional compliance and regulatory costs with no discernible benefit for their Australian shareholders.

Table 2 – Pro-rata allocation: The shareholders' perspective

Recipient	Cash dividend	Imputation credit	Franking credit	Gross dividend	Taxable dividend	Tax payable	Less imputation credit	Less franking credit	Additional tax to pay	After tax dividend	Additional cash benefit
New Zealand shareholder 37% tax rate	700	225	300	1,225	925	361	(225)	Nil	136	564	137
Australian shareholder 48.5% tax rate	700	225	300	1,225	1,000	485	Nil	(300)	185	515	Nil
Total	**1,400**	**450**	**600**	**2,450**	**1,925**	**846**	**(225)**	**(300)**	**321**	**1,079**	**137**

50% Distribution of NPAT

3.3 Full distribution of net profit after tax

Table 3 (p.8) and Table 4 (p.9) show the advantages that would be associated with the pro rata allocation option if Aust Parent Co were to distributeall of its net profit after tax (NPAT). Once again, the only shareholders who would derive any benefit in this scenario are the 50% New Zealanders who would receive 50% of the available imputation credits. There would be no improvement in the tax position of the 50% Australian shareholders. This outcome raises serious doubts about the viability of the pro rata solution. The joint discussion document invited interested parties to make submissions. A number of submissions expressed doubts about the suitability of the pro rata model. For example the submission from KPMG Australia and New Zealand:

> *We have serious misgivings that [sic] the proposals will meet their objectives. We would expect that the adoption of the preferred model by corporates will be low due to its limited benefit as compared to its complexity and hence likely relatively high compliance costs (p.4).*

Tables 2 and 4 illustrate the two kinds of tax leakage associated with this option. The first is the 50% allocation of the available imputation and franking credits to shareholders that are unable to utilise them. The second is the relationship between the source of Aust Parent Co's income and its distribution policy.

Aust Parent Co derives 62.5% of its income from Australian sources and 37.5% from sources in New Zealand. Aust Parent Co distributes either 50% or 100% of its net profit after tax. The percentage of profits distributed to the 50% New Zealand shareholders is significantly higher than the 37.5% profit generated from sources within New Zealand. Consequently, the 50% New Zealand shareholders will only receive a partially imputed dividend.

If for example Aust Parent Co was owned entirely by New Zealand shareholders, they would receive a cash dividend of $2,800 with, *inter alia,* an imputation credit of $450 (which is equal to the total New Zealand company tax paid by the New Zealand operating subsidiary). To pay a fully imputed dividend to the 100% New Zealand shareholders would require $1,200 of imputation credits. This extreme example illustrates the relationship between the additional benefit an investor will obtain from this solution and the percentage of income derived by the parent company from the investors' home jurisdiction. This is also a feature of the full streaming alternative solution.

Table 3 – Pro-rata allocation: The company's perspective

Distribution	NPBT	NPAT	Cash dividend	Imputation credit	Franking credit	Additional benefit
New Zealand shareholder	2,000	1,400	1,400	225	375	225
Australian shareholder	2,000	1,400	1,400	225	375	Nil
	4,000	**2,800**	**2,800**	**450**	**750**	**225**

100% Distribution of NPAT

Table 4 – Pro-rata allocation: the shareholders' perspective

Recipient	Cash dividend	Imputation credit	Franking credit	Gross dividend	Taxable dividend	Tax payable	Less imputation credit	Less franking credit	Additional tax to pay	After tax dividend	Additional cash benefit
New Zealand shareholder 37% tax rate	1,400	225	375	2,000	1,625	635	(225)	Nil	410	990	225
Australian shareholder 48.5% tax rate	1,400	225	375	2,000	1,775	860	Nil	(375)	485	915	Nil
Total	**2,800**	**450**	**750**	**4,000**	**3,400**	**1,495**	**(225)**	**(375)**	**895**	**1,905**	**225**

100% Distribution of NPAT

3.4 Creditable taxes

Both governments have agreed that any withholding taxes imposed by the other country will also create a credit in the relevant company's tracking account of taxes paid in the other jurisdiction. In the context of the hypothetical example, Aust Parent Co would maintain an imputation account which could also credit any non-resident withholding tax (NRWT) on interest, royalties and dividends. Furthermore, any non-resident contractor's withholding tax would also create an imputation credit. However, the payment of any approved issuer levy (AIL) would not create a credit to the imputation account. This distinction is conceptually correct, but has been applied inconsistently. AIL is not a tax liability of the Aust Parent Co. AIL is the liability of the New Zealand subsidiary, whereas the other withholding taxes are deductions on account of the Aust Parent Co's New Zealand tax liability. However, the proposed treatment of AIL is inconsistent because the underlying company tax is not a liability of the Aust Parent Co yet it will be creditable.

Foreign sourced dividends derived by New Zealand resident companies are subject to the foreign dividend withholding payment regime (FDWP). New Zealand companies that receive foreign dividends are not required to maintain a FDWP account. A company which elects to maintain a dividend withholding payment credit account is able to attach to a dividend, a dividend withholding payment credit. That credit is refundable to the extent it exceeds the New Zealand tax liability on that dividend.

In the case of an Aust Parent Co which received a dividend from a New Zealand subsidiary with a dividend withholding payment credit attached, the discussion document proposes that it[6] would receive the usual refund and that the non-resident withholding tax could then be credited to the Australian Parent Co's imputation credit account. If the New Zealand subsidiary did not maintain a dividend withholding payment account, then the Aust Parent Co would not receive a cash refund, but it would be able to credit its imputation account with the full amount of the dividend withholding payment credit.

[6] See n 1, pp 25-27.

4. FULL STREAMING

4.1 The parent company's perspective

One of the major criticisms of the pro rata allocation option is that it will force a parent company to allocate its available imputation and franking credits to individual shareholders that are unable to utilise them. Tables 2 and 4 demonstrate why an individual Australian shareholder is likely to be indifferent towards pro rata allocation. Only the individual New Zealand resident shareholders benefit from that option.

Tables 5 and 6 illustrate the additional benefit that would arise were the Australian Parent Co to allocate all of its imputation credits to its individual New Zealand resident shareholders and the corresponding franking credits to its individual Australian shareholders. The Australian shareholders would receive an additional $300 franking credit at 50% allocation of NPAT. This benefit would justify the extra compliance and administration costs associated with implementing this option.

Table 5 – Full streaming: The company's perspective

Distribution	NPBT	NPAT	Cash dividend	Imputation credit	Franking credit	Additional benefit
New Zealand shareholder	2,000	1,400	700	300	Nil	300
Australian shareholder	2,000	1,400	700	Nil	300	Nil
	4,000	**2,800**	**1400**	**300**	**300**	**300**

50% Allocation of NPAT

Table 6 – Full streaming: The company's perspective

Distribution	NPBT	NPAT	Cash dividend	Imputation credit	Franking credit	Additional benefit
New Zealand shareholder	2,000	1,400	1,400	450	Nil	450
Australian shareholder	2,000	1,400	1,400	Nil	600	300
	4,000	**2,800**	**2,800**	**450**	**600**	**750**

100% Allocation of NPAT

4.2 The shareholders' perspective

Tables 7 and 8 illustrate why both individual resident New Zealand and Australian shareholders would support this option. If Aust Parent Co were to distribute 50% of its NPAT, the individual New Zealand resident shareholders would receive a fully imputed dividend. Secondly, Table 8 demonstrates that a full distribution by Aust Parent Co of its NPAT would result in the allocation to its individual New Zealand

resident shareholders of all New Zealand company tax paid by the New Zealand Sub (see Diagram 1). Note however that the amount of New Zealand tax ($450) is insufficient to enable Aust Parent Co to fully impute the cash dividend of $1,400.

Table 7 – Full streaming: The shareholders' perspective

Recipient	Cash dividend	Imputation credit	Franking credit	Gross dividend	Taxable dividend	Tax payable	Less imputation credit	Less franking credit	Additional tax to pay	After tax dividend	Additional cash benefit
New Zealand shareholder 39% tax rate	700	300	Nil	1,000	1,000	390	(300)	Nil	90	610	300
Australian shareholder 48.5% tax rate	700	Nil	300	1,000	1,000	485	Nil	(300)	185	515	Nil
Total	**1,400**	**300**	**300**	**2,000**	**2,000**	**875**	**(300)**	**(300)**	**275**	**1,125**	**300**

50% Distribution of NPAT

Table 8 – Full streaming: The shareholders' perspective

Recipient	Cash dividend	Imputation credit	Franking credit	Gross dividend	Taxable dividend	Tax payable	Less imputation credit	Less franking credit	Additional tax to pay	After tax dividend	Additional cash benefit
New Zealand shareholder 39% tax rate	1,400	450	Nil	1,850	1,850	720	(450)	Nil	270	1,130	450
Australian shareholder 48.5% tax rate	1,400	Nil	600	2,000	2,000	970	Nil	(600)	370	1,030	300
Total	**2,800**	**450**	**600**	**3,850**	**3,850**	**1,690**	**(450)**	**(600)**	**640**	**2,160**	**750**

100% Distribution of NPAT

This occurs because the New Zealand operating subsidiary NPAT is $1,050 and the available imputation credits of $450 cannot cover a cash dividend of $1,400. This outcome will always occur when the percentage of profits distributed (i.e. 50% or 100%) exceeds the percentage of profits derived from a particular jurisdiction (NZ 37.5%). Conversely, in cases where the percentage of profits distributed is less than or equal to the percentage of profits received from New Zealand, the individual New Zealand shareholders should receive a fully imputed dividend.

5. ALTERNATIVE SOLUTIONS

The combined effect of the waste of credits associated with the pro rata allocation solution, its complexity and compliance costs will limit its appeal. The Aust Parent Co in the hypothetical example considered in the discussion document has very few (if any) incentives to implement a solution which would only benefit its 50% New Zealand individual resident shareholders. There is no benefit to the Australian individual shareholders and there would be inevitable compliance costs arising from any legislative solution that is based on the pro rata allocation model.

The rejection by both Governments of the full streaming alternative is likely to see a continuation of the *ad hoc* solutions which achieve the same underlying benefits associated with the full streaming option. Recent examples include:

?? capital-raising solutions,

?? equity instruments,

?? bonus issues,

?? computer software and management fees,

?? debt solutions, and

?? cross-border solutions.

6. THE GOVERNMENT'S CONCERN WITH STREAMING

6.1 The superiority of streaming

The pro rata allocation model represents a significant improvement over the current regime. However, under that model both types of credit are allocated to shareholders in proportion to their shareholding in the Aust Parent Co. Credits are wasted, which means this is clearly an inefficient method of solving the triangular tax problem. The full streaming option is superior because no tax credits are wasted since the credits are only allocated to the shareholders in the country in which the underlying corporate tax was paid. The streaming model provides the maximum tax benefit to both groups of shareholders and it achieves the objective of ensuring that no double tax occurs in respect of the same income.

6.2 Criticism of full streaming

The discussion document[7] outlines both governments' concerns about the implications of adopting the streaming model.

The main conceptual difficulty with the streaming model is that it provides tax benefits to the shareholders that are disproportionate to their shareholding. This model is contrary to both Australia's and New Zealand's current imputation rules which provide for the allocation of credits in proportion to the shareholder's interest in the relevant company.

[7] See n 1, pp 16-17.

Secondly, both governments have also stated they are concerned about the fiscal risks associated with the full streaming model because the available credits are allocated only to the shareholders of the country in which the underlying corporate tax was paid. Consequently, the credits will be used to reduce the shareholders' home country tax liability.

Thirdly, both governments were concerned that the adoption of the full streaming alternative could be misinterpreted as a signal that the streaming of credits would become acceptable. This would be contrary to one of the fundamental design features of both countries' imputation rules, which is the prohibition on streaming credits to different groups of taxpayers based on their ability to utilise the credit.

6.3 Allocation of credits that are disproportionate

The respective governments' concerns ignore the fundamental problem that the various methods attempt to solve. Both countries' imputation regimes seek to eliminate double taxation that would otherwise occur. The streaming model achieves this objective whereas the pro rata allocation model will not eliminate double taxation. Its effect is highly dependent on the source of the underlying income derived by the parent company and the mix of domestic and foreign source income reflected in the dividend. Under the streaming model, it is not possible for the shareholders of a company to receive a credit which is greater than the tax paid by the parent company (or a subsidiary). In the case of New Zealand, the maximum imputation ratio of 33/67 would apply. The current equivalent Australian ratio is 30/70. These mechanisms ensure that a shareholder could never receive a credit that is greater than the tax paid in their jurisdiction.

6.4 Fiscal risks

The discussion document merely notes that "both governments, however, are concerned about the fiscal risks of such a model, given that imputation credits would be allocated only to shareholders of countries in which the tax was paid".[8] Unfortunately, no empirical or anecdotal evidence is referred to that supports this stance. From a conceptual perspective, it is difficult to understand the basis of the respective governments' concerns. The streaming model would simply permit a resident individual shareholder to utilise the tax that has been paid in that country. It is difficult to see how the streaming model could pose a threat to either country's tax base.

Secondly, the streaming model merely solves the waste of credits which occurs under the current regime and under the pro rata allocation model. To the extent that the streaming model overcomes this problem, it can hardly be seen as putting the country's tax base at risk. It merely corrects a deficiency in the current law which does not occur in the case of a domestic investment.

Both governments may have lost sight of the fact that the streaming model does not allocate different amounts of credit to different categories of shareholder based on their marginal rate. It merely allocates the same level of credit to all shareholders in the relevant country, which is also a feature of a similar domestic equity investment.

[8] See n 1, p 16.

6.5 Anti-streaming rules

6.5.1 Historical background

The third and final concern with the full streaming model is that it could be incorrectly construed as an indication that the streaming of credits to shareholders (based on their marginal rate) had now become acceptable. In the case of New Zealand this is not a valid concern. The *Report of the Consultative Committee on Full Imputation* of April 1988 noted that from an imputation perspective there were no policy reasons to prevent the allocation of credits to New Zealand resident shareholders.

> *Where a New Zealand company has an overseas corporate shareholder and New Zealand shareholders hold shares in that overseas company, the New Zealand shareholders would not be able to receive credits for New Zealand taxes paid by the New Zealand subsidiary. Some submissions argued that a non-resident company in these circumstances should be able to pass such credits through to its New Zealand shareholders.*
>
> *In terms of the imputation system itself, there would be no reason to deny this pass through of credits.*[9]

The consultative committee's primary concern was not with the imputation regime but on ensuring that there were no "incentives" for companies to circumvent the controlled foreign corporation (CFC) and the foreign investment fund (FIF) regimes. The committee noted at pages 53-54 that a number of interested parties had submitted that a non-resident company should in certain circumstances be permitted to pass on imputation credits to its New Zealand shareholders. The committee noted that from an imputation policy perspective there were no theoretical reasons to prevent, for example, National Australia Bank (NAB)/ Bank of New Zealand (BNZ) from passing imputation credits to its New Zealand resident individual shareholders. The committee's concern was that:

> *The imputation system and the international tax reforms need to be mutually consistent and reinforcing. A non-resident company can avoid the international tax regime by holding its non New Zealand interests through a non-resident subsidiary. This advantage would be counterbalanced in part if such a company were not able to pass imputation credits through to its New Zealand shareholders. For this reason, the Committee does not favour allowing non-resident companies to allocate credits to New Zealand resident shareholders.*

This passage clearly demonstrates the interrelationship between New Zealand's international tax regime and the current imputation regime. The designers of both regimes correctly noted the interrelationship and that, from a purely imputation perspective, there were no issues arising from the streaming of credits to alleviate triangular taxation.

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[9] *Report of the Consultative Committee on Full Imputation* (Wellington, Government Printer, April 1988) pp 53-54.

Of greater concern are the significant changes in corporate ownership that have occurred since 1988. For example, Lion Nathan and Goodman Fielder Wattie are no longer New Zealand resident companies and therefore the concerns about the impact of the CFC and FIF regime on these taxpayers no longer apply.

Finally, the discussion document does not refer to the following anti-avoidance provisions that are designed to prevent the inappropriate use of the streaming model.

6.5.2 New Zealand

The primary mechanisms that prevent the streaming of imputation credits are the “benchmark dividend rule” and the maximum imputation ratio. These two rules ensure that any imputation credit attached to a dividend cannot exceed the rate of underlying corporate tax paid by the company.

Furthermore, the 66% continuity of shareholding rules ensure that the benefits of imputation credits only flow to those shareholders who incurred the risk associated with the economic ownership of the company. Those rules are designed to prevent the trafficking of imputation credits.

Additional legislative support is provided by the ratio declaration rules which ensure that the same ratio of imputation credit applies to all dividends paid by the company. Finally, there is a specific prohibition against trading in shares where the purpose of the arrangement is to provide a tax advantage to a shareholder.

6.5.3 Australia

The maximum franking ratio is similar to the New Zealand provision and it is also designed to ensure that any franking credits attached to a dividend do not exceed the rate of underlying tax paid by the company.

The share class rule was introduced to, *inter alia,* prevent companies using legal (but commercially insignificant) distinctions between different classes of shares. Under this rule, the shares in a company are treated as being of the same class if they have the same (or substantially the same) rights attached to those shares.

Furthermore, there is a 45 day holding period rule which requires a person to hold shares at risk for more than 45 days in order to qualify for any franking benefit. There is a 90 day rule which applies to certain classes of preference shares.

Finally, the exposure draft on the new Business Tax Systems (Entity Taxation) Bill 2000 proposes to introduce a benchmark dividend rule which is similar to the New Zealand provision. This rule will provide that all frankable distributions made by a company in the subsequent six month period must not depart from the “benchmark dividend” ratio by more than 20%.

7. CAPITAL RAISING SOLUTION

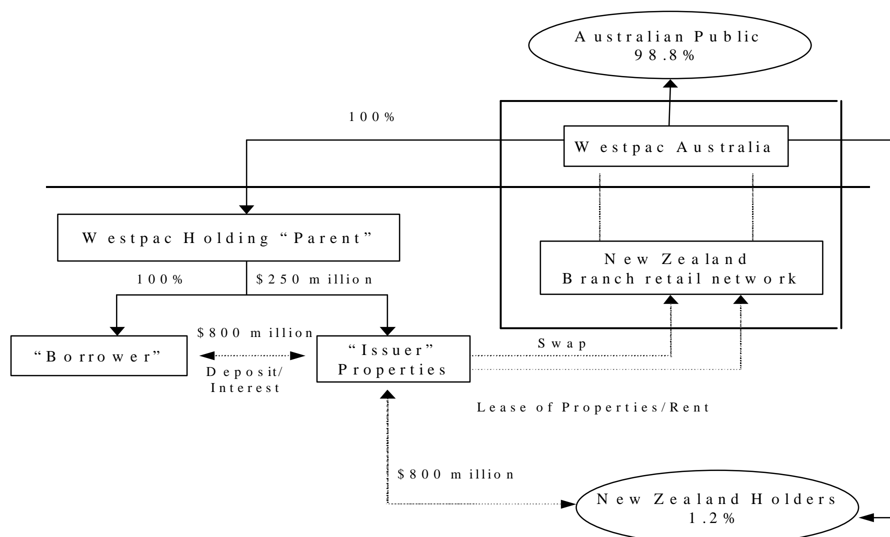
7.1 Introduction

An obvious solution to triangular taxation is for an Aust Parent Co to incorporate a special purpose New Zealand subsidiary which pays a fully imputed dividend to the New Zealand shareholders (who previously held shares in the Aust Parent Co) but have become direct shareholders of the New Zealand subsidiary company. The most significant example of this strategy is the recent $800 million successful capital-raising undertaken by Westpac in late 1999.

7.2 The Westpac share issue

As part of the capital-raising exercise, Westpac obtained a binding product ruling from the Inland Revenue Department which stated, *inter alia*, that the proposed float did not contravene the specific anti-imputation streaming provisions contained in the Act or the general anti-avoidance provision. The essential features of the proposal were described in Product Ruling BR 99/13.[10] They can be summarised in the following diagram.

Diagram 2



[10] *Tax Information Bulletin* Vol 11: No 10 (Nov 1999) pp 7-13. This Binding Ruling was replaced with Product Ruling BR PDR 02/14 reproduced in Tax Information Bulletin: Vol 14: No. 11 (Nov 2002).

7.3 Key features

The commercial rationale for the float was the fact that Westpac carried on business as a branch, which meant that the New Zealand branch was unable to raise separate equity in New Zealand. Secondly, there were significant commercial and regulatory constraints associated with any proposal to transfer the current branch operations into a separate company. The diagram summarises the relationship between the additional equity and the existing branch retail operation. The New Zealand operations of Westpac are predominantly conducted through a branch (the "Branch"), established by the Bank of New South Wales in 1861. The capacity to raise ordinary equity in New Zealand is constrained by Westpac's legal and operating structure.

The aim of this transaction was to raise ordinary equity in New Zealand. The equity raising was to be achieved in a way that did not involve the full incorporation of Westpac's New Zealand operations as this would involve considerable regulatory, reporting, taxation and accounting complexities (both in New Zealand and Australia). The New Zealand shares were issued by the Issuer, a New Zealand company that is an existing wholly-owned subsidiary of Westpac Holdings NZ Ltd ("Parent"). The Issuer owns properties used by Westpac in New Zealand, leasing these properties to the various Westpac branches and subsidiaries. It has shares on issue with paid-up capital and reserves of approximately $NZ250 million comprising both ordinary and redeemable preference shares. The existing New Zealand-based ordinary shareholders in Westpac amount to about 1.2% of the ordinary share capital of Westpac, and Issuer raised capital equivalent of up to 5% of the ordinary share capital of Westpac.

The key terms of the NZ shares were as follows:

(i) The issue price was related to the price of a Westpac ordinary share on the issue date, converted into New Zealand dollars.

(ii) The payment of dividends was to be at the discretion of the directors of the Issuer. However, if dividends were declared on the NZ Shares, they were to be based on the cash dividends of Westpac ordinary shares. The dividends on the NZ Shares will equal dividends paid by Westpac on the Westpac ordinary shares multiplied by the exchange fraction, converted into New Zealand dollars at the prevailing foreign exchange rates. If declared, full dividends were to be paid on the partly paid shares.

(iii) The Issuer was to "mirror" all bonus issues, share splits, consolidations and rights issues undertaken by Westpac in respect of Westpac ordinary shares.

(iv) The holders of the New Zealand Shares ("New Zealand Holders") were to have their voting rights in the Issuer restricted. Voting rights at Issuer shareholder meetings were to be limited to:

?? decisions concerning major transactions under the New Zealand Companies Act, and

?? amendments to the Issuer's constitution to the extent that such amendments affect the rights attached to the New Zealand Shares.

(v) Rights to receive distributions on liquidation of the Issuer will be on a pro rata basis with the Issuer's ordinary shareholders.

The offer was made primarily to the New Zealand public. The offer of NZ Shares was not specifically made to the current Westpac ordinary shareholders, nor was there any necessity for shareholders in Westpac to give up their shares and acquire shares in the Issuer. There was no stapling of shares.

The funds raised from the issue were lent by the Issuer to the Borrower, which is a New Zealand resident company that is another wholly-owned subsidiary of Westpac Holdings NZ Ltd. It was intended to attach imputation credits to the fullest extent possible to the dividends paid to the New Zealand Holders. Theimputation credits would arise from payments of tax made by the Issuer in respect of its taxable income (which would include the interest received on the deposit, the net fund flows (if any) arising under the swap and its property related income).

The purpose of the arrangement was to raise ordinary equity in New Zealand. Westpac wished to issue shares to the public in New Zealand as part of Westpac's broader capital management strategy including creating shareholder value and diversifying the capital base, and to support Westpac's regional banking and branding strategy.

These transactions were designed to ensure that the issuer derived sufficient gross income and paid enough New Zealand company tax to distribute a fully imputed dividend to its New Zealand shareholders which was equal to the equivalent dividend paid by the parent company to its Australian shareholders.

7.4 Key taxation issues to be resolved

The key taxation issue was whether the payment of dividends constituted an imputation streaming arrangement. The Act contains a number of specific anti-avoidance provisions which are designed to prevent the streaming of imputation credits to those taxpayers who can most effectively utilise them.

The two key anti-avoidance provisions are:

?? streaming of dividends (section GC 22), and
?? stapled stock arrangements (section GC 23).

Since the issuer will pay fully imputed dividends in New Zealand dollars to New Zealand individual shareholders both sections could potentially apply to the class of shares issued by New Co.

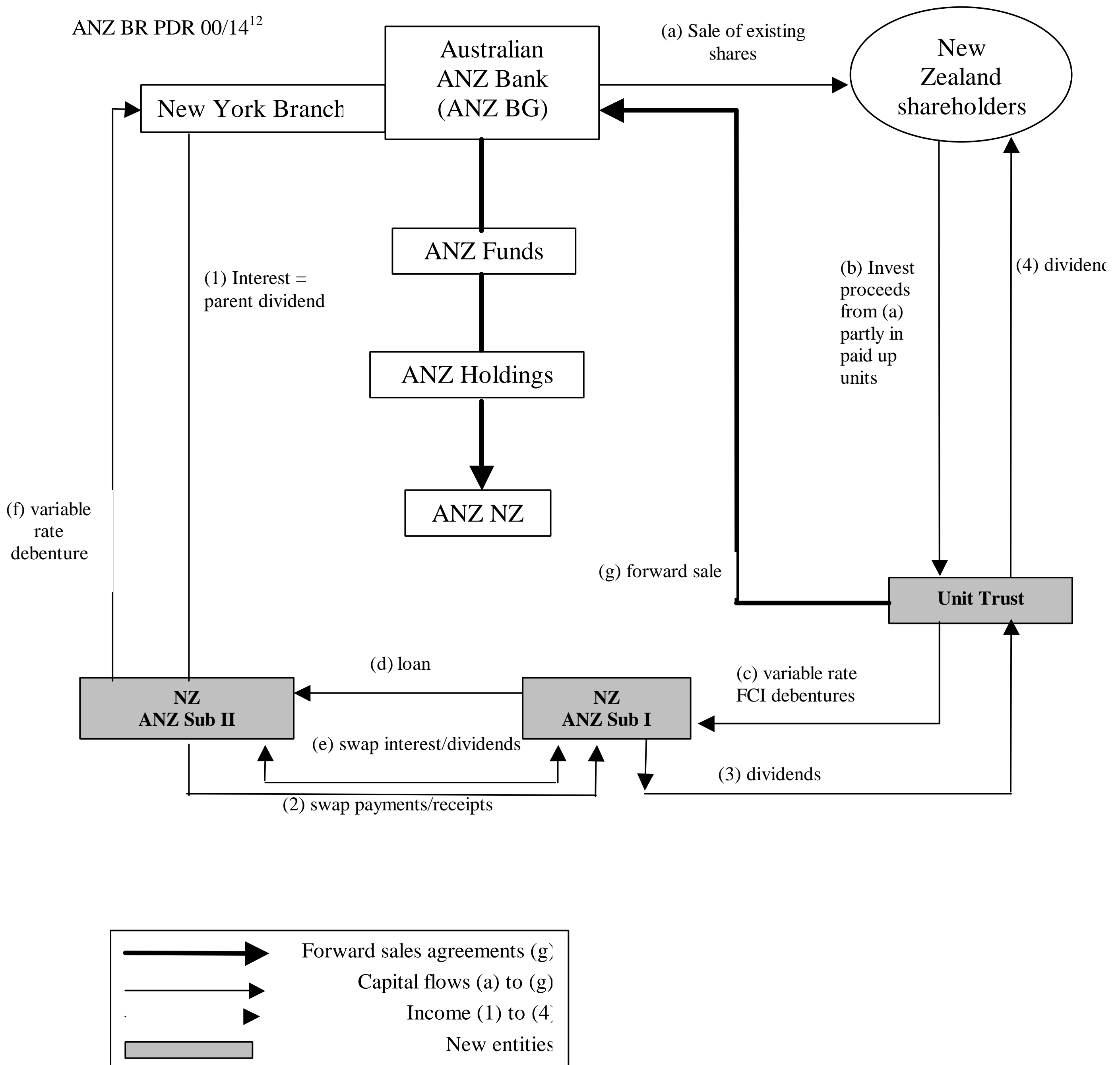
The ANZ share issue

7.5 Shortly after Westpac announced details of its capital raising proposal, ANZ obtained a similar binding ruling. However the ANZ proposal has not yet been implemented. The following diagram is based on the information contained in product ruling ANZ BR PDR OO/14.[11]

[11] *Tax Information Bulletin* Vol 13: No 2 (Feb 2001) pp 12-21.

Diagram 3

ANZ BR PDR 00/14[12]



[12]See n 11 pp 12-21.

7.6 Commercial objectives

The ANZ Group has its parent company (Australia and New Zealand Banking Group Limited ("ANZBG")) in Australia. ANZBG has, *inter alia,* the following subsidiaries:

- ?? ANZ Funds Pty Ltd ("ANZ Funds") which is incorporated in Australia,
- ?? ANZ Holdings (New Zealand) Limited ("ANZ Holdings") which is wholly owned by ANZ Funds and is incorporated in New Zealand, and
- ?? ANZ Banking Group (New Zealand) Limited ("ANZNZ") which is wholly owned by ANZ Holdings and is incorporated in New Zealand.

If the proposed float were to proceed. Three new entities would be established in New Zealand:

- ?? a wholly owned subsidiary of ANZNZ referred to in the binding ruling as ANZ Sub I would be incorporated in New Zealand,
- ?? a wholly owned subsidiary of ANZNZ referred to as ANZ Sub II would be incorporated in New Zealand, and
- ?? a Unit Trust in which ANZ Sub I would hold all of the ordinary units would be established in New Zealand

These three proposed entities would be set up for regulatory, corporate governance (primarily, prudential reporting), and marketing reasons. In relation to the prudential reporting purposes, the binding ruling noted that it was a priority that the Australian Prudential Regulation Authority ("APRA") classified the capital raised in New Zealand as Tier One capital. To achieve this objective it would be necessary for the funds to be traced from the issue of the capital in New Zealand through to ANZBG in Australia solely through non-operating entities. This is the reason why two new separate companies (i.e. ANZ Sub I and ANZ Sub II) would be incorporated in New Zealand. The binding ruling refers to three other considerations for setting up the new entities:

- ?? To achieve transparency for capital raising from both the bank's and the New Zealand Investors' perspectives.
- ?? From the Investors' perspective, it was considered preferable that the proposed entity in which they would be investing should have a simple and predetermined cash flow.
- ?? From the Investors' and the bank's perspectives, it was considered preferable that the new ANZ entities, rather than the issuing entity, were party to the swap and loan because this would allow greater flexibility to operate and react to commercial changes in relation to the swap and the loan.

The binding ruling noted that the ANZ Group wished to raise capital in New Zealand for the following four reasons:

?? to increase the percentage of New Zealand shareholders,

?? to increase the level of retail investors,

?? to increase ANZ's profile in the New Zealand market, and

?? to raise Tier 1 capital.

If the transactions described in the binding ruling were to proceed then the following steps would be implemented.

7.7 The Unit Trust

If the proposal is implemented a Unit Trust would be established in New Zealand. The purpose of the Unit Trust would be to raise capital in New Zealand for the ANZ Group through the issue of debentures issued by ANZ Sub I.

The total cost per unit to investors would be based on the average of the ASX traded price of ANZ ordinary shares converted to New Zealand dollars at the NZ$/A$ exchange rate.

The units would have limited voting rights. The rights would be limited to extraordinary resolutions relating to the alteration of rights attached to the units.

Future distributions (dividends for tax purposes) would be paid on the units to coincide with any dividends paid by ANZBG on its ordinary shares. The amount of distribution on each unit would match, in New Zealand dollars, the cash dividend paid in Australian dollars by ANZBG on each ordinary share.

If ANZBG did not pay any dividends on its ordinary shares, there would be no distribution to the unit holders. To the extent that imputation credits would be available, they would be attached to the distributions paid to investors. However, the attachment of imputation credits would not be guaranteed, nor would the cash distribution be grossed up if it were not fully imputed.

7.8 Forward sale and purchase agreement

If the proposal is implemented, then, under the forward sale and purchase agreement, the investors would agree to sell and ANZBG would agree to buy the units for an agreed amount. In addition, investors would agree to purchase and ANZBG would agree to issue ANZBG shares for the same amount. These amounts would be offset against each other.

The forward sale and purchase agreement would be entered into on the date that the units are issued. On that date, ANZBG would pay for the units and the investors would pay for the shares. The price paid for the shares and units would be the same and would be the issue price of the units.

7.9 Loan to ANZ Sub I

If the proposal is implemented Unit Trust will enter into a variable rate debenture agreement with ANZ Sub I whereby the Unit Trust will lend funds invested by investors to ANZ Sub I by way of a number of debentures which will be perpetual.

Interest on the debenture would be paid to coincide with the dividends paid by ANZBG on its ordinary shares. The timing of the payments by ANZ Sub I would be triggered by the payment of dividends by ANZBG on its ordinary shares. At the same time as ANZBG pays dividends on its ordinary shares, ANZ Sub II would pay amounts under the swap and the loan to ANZ Sub I. When ANZ Sub I receives these amounts it would pay dividends on the ordinary shares to ANZNZ and interest on the section FC 1 debentures to the Unit Trust.

7.10 Loan to ANZ Sub II

ANZ Sub I would enter into a loan agreement with ANZ Sub II. The loan would be perpetual.

7.11 Loan to ANZBG NY

Under the proposal, ANZ Sub II would enter into a variable rate debenture agreement with ANZBG NY. The debenture would be denominated in New Zealand dollars. Interest would be payable to coincide with the dividend payable by ANZBG on its ordinary shares. The amount would be determined by a formula which would be based on the New Zealand dollar equivalent of the ANZBG cash dividend grossed up for withholding tax (if any).

7.12 Swap

If the proposal is implemented, an important transaction would be the dividend for interest swap. Under the swap agreement, ANZ Sub I would be obligated to pay ANZ Sub II an amount equal to the interest it receives from ANZ Sub II under the loan. In return, ANZ Sub II would be obligated to pay ANZ Sub I an amount equal to the net cash dividend received on the ANZBG debenture.

The payment that ANZ Sub I makes to ANZ Sub II under the swap would be made at the time ANZ Sub II makes the interest payment to ANZ Sub I under the loan. The payment that ANZ Sub II makes to ANZ Sub I under the swap would be made at the same time ANZBG NY pays a dividend to ANZ Sub II on its debenture.

The potential application of the anti-avoidance provisions contained in section GC 22 and section GC 23 of the Act are the main taxation issues which would arise if the proposed ANZ float were to proceed.

8. CURRENT LEGISLATIVE IMPEDIMENTS

8.1 Anti-credit streaming rules

The Act contains an extensive array of provisions that are designed to prevent a New Zealand resident company from allocating its available imputation credits to the shareholders who can best utilise them. The current prohibitions include:

?? the benchmark allocation rule,[13]

?? the maximum imputation credit rule,[14] and

?? specific anti-avoidance provisions.[15]

There is little doubt that the adoption of the full credit streaming option would breach the current provisions and legislative amendments would be necessary.

8.2 Historical rationale for the existing rules

The current regime was designed to, *inter alia*, deter New Zealand resident companies from circumventing the CFC and FIF regimes by preventing their New Zealand resident shareholders from gaining access to imputation credits.

Secondly, the bench mark allocation rule is designed to prevent a company paying the same cash dividend, but with different imputation credits that reflect the current three marginal rates of tax.

Thirdly, the current regime is also designed to prevent a company from streaming its available imputation credits to its resident New Zealand shareholders to the detriment of its foreign shareholders, who at the time the regime was set up, were unable to utilise New Zealand imputation credits.

8.3 Full streaming option

The adoption of the full streaming approach would not breach the current rules because the proposal would envisage all resident New Zealand shareholders receiving the same imputation credit. The current rules would protect the tax base.

However, the introduction of the foreign investor tax credit (FITC) regime has circumvented the third of the historical reasons for the anti-streaming rules. Under the FITC regime, foreign shareholders effectively receive their proportionate share of the benefit of New Zealand company tax via the supplementary dividend mechanism. Clearly the foreign shareholders receive an "imputation credit" which is proportionate to the tax that they have in effect borne in New Zealand.

8.4 Streaming of dividends

Streaming of dividends involves companies or shareholders seeking to obtain a tax advantage either through:

?? an arrangement for the sale or disposition of shares (GC 22(1)(a)), or

?? streaming credits to those shareholders best able to use them (GC 22(1)(b)).

Unfortunately, neither of the binding rulings explains why the IRD believe these two provisions did not apply. The following analysis is one possible interpretation.

[13] Section ME 8(2) of the Act.

[14] Section ME 8(1) of the Act.

[15] Sections GC 21, 22 and 23 of the Act.

8.5 Section GC 22(1)(a)(iii)

In order for there to be an arrangement for *inter alia* the issue of shares, all of the four separate criteria contained in section GC 22(1)(a) must be satisfied.

For the purposes of section GC 22(1)(a) both the Westpac and ANZ structures prima facie satisfy the first two requirements:

?? All shareholders can reasonably expect a dividend to be paid in respect of the New Zealand class of shares.

?? The New Zealand issuer can reasonably expect that imputation credits will be attached to any dividends paid on the New Zealand class of shares.

The third criterion is that the shareholder must be a party to an arrangement.[16] The ANZ and Westpac structures are clearly designed to benefit New Zealand resident shareholders, but does that mean those shareholders are automatically “a party”? If they are a party, are they a party to an arrangement? The term “arrangement” is defined in OB1 of the Act as any “contract, agreement, plan or understanding”, whether enforceable or not, and all steps by which it is carried into effect.

It is difficult to see how the mere subscription for shares by a passive investor pursuant to a public offer makes that shareholder a party to an agreement. A passive shareholder is not a party to any contract or agreement because they had no right to any shares. Nor are they a party to a plan or understanding because they knew nothing about the structure until it was announced in the media.

The recent decision of the Court of Appeal supports this line of analysis. In *CIR v BNZ Investments Ltd.*[17] Richardson P held that an essential element in the definition of an “arrangement” is:

> *...a meeting of minds between parties involving an expectation on the part of each that the other would act in a particular way ... The essential thread is mutuality as to content. The meeting of minds embodies an expectation as to future conduct. There is consensus as to what is to be done.*

In view of the relationship between the New Zealand resident shareholders, the underlying commercial objectives, the ownership, and operating structures, it is reasonable to assume that the shareholders were never consulted about what ultimately transpired. They were confronted with a “take it or leave it” option to invest in a new structure which provided them with an imputation credit. The shareholders may have been aware of the problem, but that level of knowledge does not make them a party to the solution, which was put in place without any prior shareholder consultation or discussion.

8.6 Section GC 22(1)(a)(iv)

Similar considerations arise in relation to paragraph (iv) of section GC 22(1)(a), which provides:

[16] Section GC 22(1)(a)(iii)(A) refers to a person who is a party to an arrangement that attaches an imputation credit to a dividend.

[17] (2001) 20 NZTC 17,103 at page 17,117 paragraph 50.

> *(iv) The purpose, not being an incidental purpose, of the arrangement is that a party to the arrangement would obtain any such tax advantage.*

The concept of "purpose" in relation to the general anti-avoidance provisions in the Act is discussed in the Commissioner of Inland Revenue's Policy Statement on the interpretation of what is now section BG I of the Act (Tax Information Bulletin Vol.1, No. 8, Appendix C).

The Policy Statement correctly notes the test to be applied in ascertaining the purpose or effect of an arrangement is objective. Regard is had not to the motive of the parties but to the effect achieved by their actions. If there is an income tax advantage then it is necessary to identify whether or not that advantage is merely an incidental purpose or effect of the arrangement.

The Policy Statement quoted from the judgement of Woodhouse P in *CIR v Challenge Corporation Limited* (1986):[18]

> *…the phrase 'merely incidental purpose or effect' in the context of section [BG1] points to something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant. Many taxpayers when considering a course of action are likely to appreciate and welcome an opportunity provided by the Act for achieving some tax benefit as an aspect of it. But this should not bring the transaction or transactions almost automatically within the avoidance provisions of s[BG1]. By itself conscious recognition and acceptance that a commercial transaction will be accompanied by a degree of tax relief is not the issue.*
>
> *…when construing s[BG1] and the qualifying implications of the reference to 'incidental purpose' I think the questions which arise need to be framed in terms of the degree of economic reality associated with a given transaction in contrast to artificiality or contrivance or what may be described as to the extent to which it appears to involve exploitation of the statute while in direct pursuit of tax benefits. To put the matter in another way, there is all the difference in the world between the prudent attention on one hand that can always be given sensibly and quite properly to the tax implications likely to arise from a course of action when deciding whether or not to pursue it and its pursuit on the other hand simply to achieve a manufactured tax advantage."*

In both cases the primary purpose of the arrangements was to raise additional capital in a tax-efficient manner within the meaning of the Woodhouse test. The purpose is not to obtain a tax advantage but rather to increase the funds available for distribution to shareholders. The fact that structuring the operations in this way is likely to result in a "tax advantage" via the payment of imputed dividends is clearly incidental to the primary purpose. The Westpac Group and ANZ Banking Group are entitled to raise additional equity in a tax-effective manner.

[18] 8 NZTC 5,001 at page 5,006 and 5,007

8.7 Section GC 22(1)(b)

Section GC 22(1) defines the second type of prohibited tax advantage.

> *(1) For the purposes of this section, there shall be an arrangement to obtain a tax advantage where ...*
>
> *(b) In respect of any one or more distributions (including bonus issues) by a company, whether occurring in the same imputation year or over more than one imputation year, the company streams the payment of dividends, or the attachment of imputation credits or dividend withholding payment credits or both to any dividends,* ***in such a way as will give higher credit values to persons who will obtain a tax advantage from them than to persons who will not so obtain a tax advantage,*** *or who may reasonably be expected to derive a lesser benefit from any tax advantage. (Emphasis added).*

Under the ANZ and Westpac solutions, fully-imputed dividends will be paid by both issuers to all their shareholders. The question is whether creating "the New Zealand class of shares", and incorporating the method of paying dividends on these classes of shares into the issuing entity's corporate constitutions, amounts to dividend or imputation streaming.

For the purposes of this analysis, the key phrase contemplates a comparison of benefits, to ascertain whether one party will receive a higher credit and thus obtain a tax advantage that is not received by the other shareholders.

No party will receive a higher credit and thus obtain a tax advantage. Both binding rulings suggest this provision will not be breached because there will only be one class of share issued by the issuer. Accordingly, there is nothing to compare. No comparison can be made between the impact on different groups of shareholders.

8.8 Stapled stock arrangements

Stapled stock arrangements usually involve non-resident companies arranging for dividends, with imputation credits attached, to be paid by a New Zealand resident company to New Zealand shareholders. For example, a company resident in Australia with New Zealand shareholders, which also owned a New Zealand tax paying subsidiary, would arrange for the New Zealand subsidiary to pay dividends to the New Zealand shareholders.

It is possible to enter into an arrangement whereby the non-resident company sets up a company in New Zealand and issues shares in the New Zealand company to its New Zealand shareholders. The shares in the New Zealand company are stapled to the shares in the non-resident company because they are allocated on the basis of the shareholding in the non-resident company. Often, the stapled New Zealand shares may only be disposed of with the parent company shares. Dividends can then be paid from the New Zealand company. By sourcing the dividends from New Zealand tax paid profits, imputation credits can be attached.

8.9 Section GC 23

This provision provides that:

> *(1) Where, in relation to a company and a shareholder in the company, there is an arrangement entered into for the purpose, or for the purposes including the purpose, that –*
>
> *(a) The shareholder or, where the shareholder is a trustee in relation to the share or shares held, any beneficiary of that trust, or any person associated with either the shareholder or any such beneficiary, may be paid a dividend* ***by another company,*** *whether directly or indirectly by any means whatever*
>
> *(b) The shareholder or, where the shareholder is a trustee in relation to the share or shares held, any beneficiary of that trust, or any person associated with either the shareholder or any such beneficiary, may acquire any shares* ***in another company*** *so that the* ***other company*** *may pay a dividend to the shareholder or the beneficiary or the associated person, whether directly or indirectly by any means whatever.*
>
> *Any dividend paid to the shareholder or, as the case may be, the beneficiary or associated person by that* ***other company*** *under the arrangement shall, for the purposes of the imputation rules, be deemed to be a dividend paid by the company. (Emphasis added).*

Section GC 23(1) does not apply to the arrangement described in either binding ruling because there is no "arrangement" within the meaning of section GC 23(1). Section GC 23(1) applies where there is an arrangement between the arranging company and a shareholder of the arranging company. In relation to the Westpac and ANZ binding rulings, this would require an arrangement to have been entered into between the issuer and its New Zealand shareholders. That will not occur.

However, under both binding rulings the arrangement is between the Aust Parent Co, New Zealand shareholders and the New Zealand issuer. Although the purpose tests set out in subparagraphs (a) and (b) bring in an associated person test, this is conditional on there being an initial arrangement to which the shareholder is a party. In the case of a public issue of shares, the ultimate shareholders are not a party to any arrangement.

Assuming for the sake of discussion that there was an "arrangement", the result from applying the rest of the section does not appear to fit within the mischief identified by Parliament. Who is the other company that the shareholders of the issuer will receive a dividend from? It is not the Aust Parent Co. Nor are the shares in the issuer attached to the shares of the Aust Parent Co.

9. EQUITY INSTRUMENTS

9.1 Introduction

Prior to the release of the discussion document, a Trans-Tasman company dominated by Australian individual shareholders had no incentive to encourage a New Zealand operating subsidiary to pay New Zealand company tax. From the Australian shareholder's perspective, the most tax effective strategy was to maximise the payment of Australian company tax at the expense of the New Zealand corporate tax base. The adoption of the pro rata solution will not provide any taxation incentives for this type of Trans-Tasman corporate group to modify its Australian tax strategy. It is more likely than not to be a case of business as usual.

Important subsets of the general tax strategy are techniques to reduce any New Zealand NRWT associated with the repatriation by the New Zealand operating subsidiary to its Australian parent company of:

?? realised capital profits, and

?? dividends sourced from profits which did not generate sufficient imputation credits to pay a fully imputed dividend. This would be the case if the operating subsidiary had access to tax losses, or entered into transactions which reduced its taxable income.

How then can the New Zealand operating subsidiary transfer to its Aust Parent Co "tax free" funds generated in New Zealand without triggering a liability to NRWT? The payment of a conventional dividend is not an option because it would be prima facie subject to NRWT at the reduced treaty rate with no supplementary dividend/FITC credit to fund the 15% NRWT.

9.2 Interest-free loans

A simple, commercial way for the New Zealand operating subsidiary to repatriate surplus tax free cash would be to make an interest-free loan to its Aust Parent Co. Those funds could be used in Australia to generate additional Australian taxable income and franking credits. The New Zealand corporate tax base suffers an opportunity cost because under the current law and the pro rata allocation model there would often be insufficient tax incentives for the Trans-Tasman group to use the available funds to generate imputation credits.

However, this strategy would immediately create an exposure to New Zealand NRWT. Section CF 2(2)(e) of the Act provides that an interest-free loan made by a company to a shareholder creates a deemed dividend. Section CF 2(1)(k) of the Act would catch any attempt by the New Zealand operating subsidiary to loan the tax-free funds to another member of the Australian group, that is, to an entity which is associated with the Aust Parent Co. Sections CF 2(11) and (12) of the Act deal with the quantification and derivation of any deemed dividend arising from the operation of section CF 2(1)(e) of the Act. Briefly, the deemed dividend is calculated having regard to the prevailing market interest rates applicable to that type of company.

9.3 Debentures

The taxation risks associated with an interest-free loan sourced from "tax free" funds could prior to 1 July 2002 be overcome by the Trans-Tasman group putting in place a hybrid instrument. The tax features were designed to:

?? create additional franking credits,

?? minimise New Zealand NRWT,

?? minimise Australian NRWT, and

?? create a net tax advantage for the Trans-Tasman group arising from the divergent tax treatment of the hybrid.

One type of instrument which achieved the four tax objectives was an FC 1 debenture. Section FC 1 was originally inserted into the Act to deal with a domestic problem. At the time it was enacted, the CFC, FIF, FDWP and imputation regimes did not exist. The current Trans-Tasman tax dilemma was beyond the contemplation of the legislature. The Government of the day cannot be criticised for enacting a provision which has created an opportunity for a Trans-Tasman group to repatriate tax-free funds without incurring NRWT.

The following structure was designed to eliminate the potential New Zealand income tax exposure and to maximise the payment of Australian corporate tax.

9.4 The Structure

Aust Parent Co owned Australian Finance Company (Aust Fin Co) and NZ Holdings Co. New Zealand Operating Company (NZ Op Co) and NZ Fin Co are owned by NZ Holdings Co.

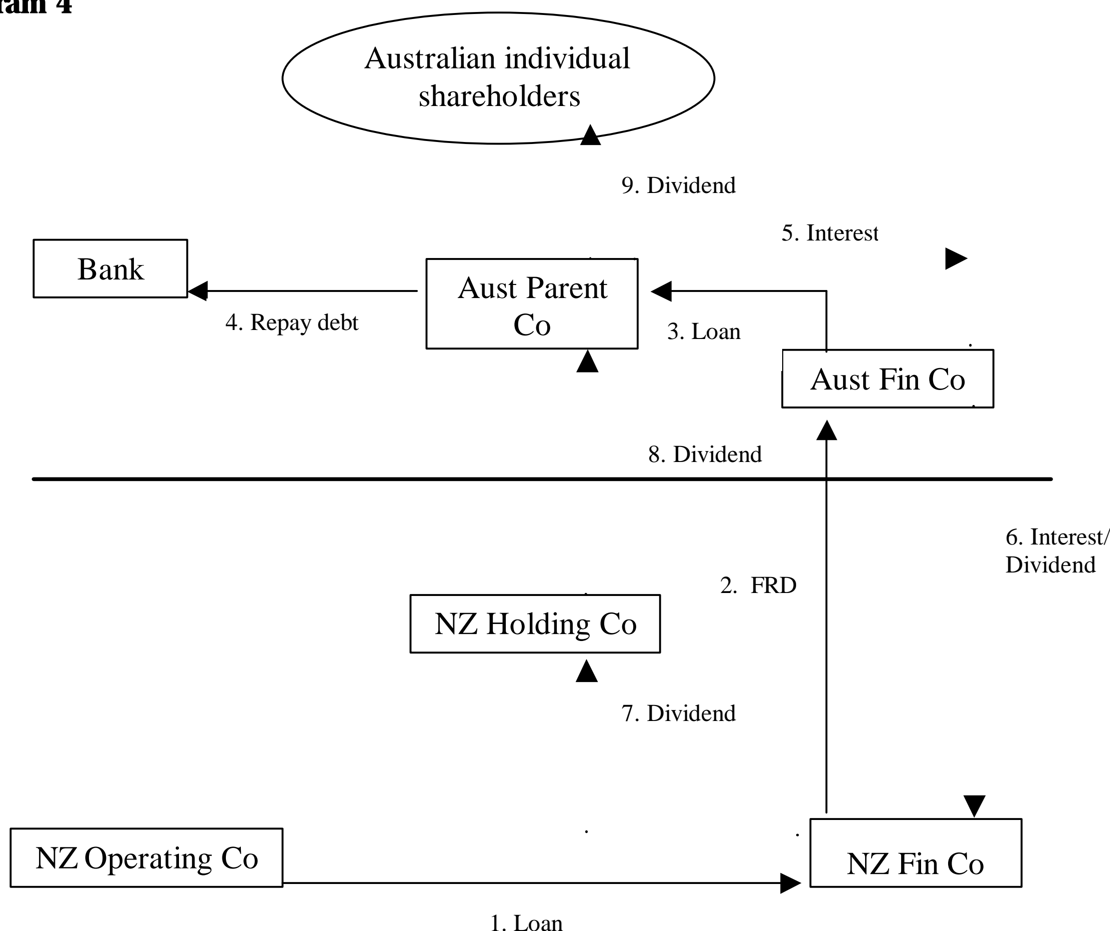
The following diagram summarises the key parties and the sequence of transactions:

?? NZ Operating Co loaned surplus funds to a sister company NZ Fin Co.

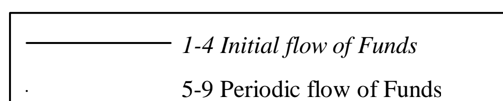
?? NZ Fin Co loaned the surplus funds via a floating rate debenture (FRD) to a special purpose finance company that was a member of the Australian group, Aust Fin Co.

?? Aust Fin Co then lent the funds at interest to its present parent company to retire existing third party debt.

Diagram 4



N.B. All subsidiaries in this table represent 100% ownership



9.5 Summary of interest and dividend flows

The annual interest and dividend flows were as follows:

- ?? Aust Fin Co paid interest to NZ Fin Co and claim a corresponding tax deduction. Interest withholding tax (NRWT) in Australia must be deducted at the rate of 10% of the gross interest.
- ?? For New Zealand tax purposes the Floating Rate Debenture (FRD) was classified as a share. All interest paid on the FRD was reclassified as a dividend. The dividend received by NZ Fin Co was treated as exempt income for income tax purposes.
- ?? NZ Fin Co was required to deduct foreign dividend withholding payment (FDWP). The amount is 33% of the gross interest paid by the Australian finance company less the NRWT paid in Australia.
- ?? NZ Fin Co then paid interest or a dividend to NZ Op Co or NZ Holding Co.

?? NZ Holding Co paid a dividend to Aust Parent Co. The dividend was equal to the net of tax interest received. NZ Holding Co could offset the FDWP payment against the NRWT liability on the dividend. The excess FDWP would then be reclaimed by the Aust Parent Co.

?? NZ Holding could also add imputation credits to the dividend. The amount of credits equalled the NRWT deducted in Australia.

?? Aust Parent Co could then reinvest the periodic dividend into the Australian group of companies.

The following table summarises the tax consequences based on a $100m FRD at 10% interest.

Table 9

			FRD 10%
	Principal sum		100.00m
	Australian interest @ 10%		(10.00m)
A	Gross Australian tax saving @ 30%		3.00m
	After tax cost		7.00m
B	Australian NRWT @ 10%		(1.00m)
	NZ Gross interest/dividend		10.00m
C	NZ net FDWP (less NRWT)		(2.30m)
D	NZ net tax on interest (less NRWT)		Nil
	NZ cash available for dividend		6.70m
	NZ cash, plus FDWP credit for NRWT purposes	9.00m	
	NZ NRWT @ 15% on 9.00m	(1.35m)	
	Less NZ FDWP credit	(2.30m)	
E	**Refund of excess FDWP**		0.950m
	Cash dividend to Aust Parent Co		7.650m
	Tax (Cost) benefit to group **(A-B-C-D+E)**		0.650m

3.0 m – 1.0 m – 2.3 m – 0 + 0.950 m = 0.650m

9.6 Comparative advantages of floating rate debenture loan

For the reasons summarised above, if funds that had been sourced from a realised capital gain were lent by a member of the New Zealand group to the Australiangroup, this would trigger a non-cash dividend equal to the difference between the market rate of interest that should be paid on the loan and the actual interest, if any, paid by the Australian group.

That dividend would be subject to a non-utilisable New Zealand NRWT cost of 15% of the deemed dividend, unless imputation credits were used to fully impute the

deemed dividend. Under New Zealand's accrual regime, a tax exposure would also arise from foreign exchange fluctuations on the principal amount of the $A loan.

If the initial available tax-free cash were remitted to Australia via a Floating Rate Debenture (FRD), there would be no adverse New Zealand or Australian corporate income tax consequences. From a New Zealand perspective, the New Zealand operating subsidy is deemed to have acquired equity in a "Grey List" country. The Australian entity was treated as having borrowed a sum of money which, prior to the introduction of the new debt/equity rules, did not, everything else being equal,[19] create any insurmountable Australian tax problems. The above table shows the overall tax saving to the Australian group associated with the annual cash flow that was used to overcome any potential New Zealand NRWT created by New Zealand deemed dividend rules. It is important to note that the net tax cost was borne by the Australian Tax Office (ATO).

This technique involves setting in place a debt instrument that constitutes an FRD in terms of section FC1 of the Act.

For New Zealand purposes, the Act re-characterised the instrument as equity. For Australian purposes, the Income Tax Assessment Act 1936 (the 1936 Act) treated the instrument as debt. The impact of the new Australian debt equity rules which came into effect on 1 July 2002 have not been taken into account. This example is designed to illustrate how Trans-Tasman companies have successfully exploited the asymmetrical tax treatment to develop *ad hoc* solutions. FRD may no longer be a tax effective technique. However, under the grandfathering provisions existing, FC 1 debenture structures will not be adversely affected until 1st July 2004.

9.7 Commercial characteristics of a section FC1 FRD

For New Zealand tax purposes, an FRD is a loan where the interest payable is not set at a fixed rate. Instead the interest is calculated by reference to either:

- the dividend payable by the company which borrowed the funds, or
- the company's profits, however measured.

It is essential that the interest payable should be calculated by reference to the company's profits. For this reason it would be useful for a special purpose Australian company to be set up to act as the designated borrower. That would enable the Aust Parent Co and NZ Fin Co to control the annual interest/dividend flows thereby ensuring the instrument satisfied the requirements of section FC I of the Act. Secondly, the payment of interest under the FRD would allow Aust Fin Co to claim an interest deduction in Australia. Any tax loss created by that payment would be grouped against the Aust Parent Co's other income.

9.8 Taxation Features of the Section FC 1 FRD

A debenture that satisfied section FC 1 is expressly defined as a "share" for the purposes of the New Zealand Act. For Australian purposes, it was treated as "loan" capital. No deemed dividend implications arose from the fact that the interest on the

[19] The only issue to consider was the Australian thin capitalisation rules. This was unlikely to be an issue if the tax-free funds were used to retire an equivalent amount of existing debt.

debenture may have been less than the market value since the debenture issued by Aust Fin Co was treated as a share, not a debt.

The debenture would be issued in Australian dollars. Shares and section FC 1 FRDs are excluded from New Zealand's accrual regime, therefore no adverse New Zealand foreign exchange tax consequences arise from fluctuations in the exchange rate.

When the debenture matured and the loan was repaid the repayment proceeds would be treated as a return of "share capital" for New Zealand tax purposes. This is important because a FRD comes within the definition of a "non-participating redeemable share" and is therefore excluded from the dividend rules.

Finally, foreign exchange gains and losses associated with the redemption of an Australian denominated "share" are ignored under the return of capital rules, therefore no adverse tax consequences arise from repayment of the loan principal.

9.9 Taxation features of interest paid under a FRD

Subject to the potential application of the Australian debt creation rules, interest paid on the FRD would have been deductible to Aust Fin Co, and could have provided a 30% gross tax benefit in Australia. The interest did suffer a 10% Australian non-resident withholding tax payment.

The interest receipt was treated as a "dividend" when received by NZ Fin Co. The foreign dividend received by NZ Fin Co was exempt from New Zealand income tax under section CB 10(1). NZ Fin Co was required to deduct FDWP under section NH 1 of the Act.

The FDWP liability was calculated at 33% of the gross dividend, less the amount of Australian withholding tax deducted from the interest payment. FDWP is a liability of NZ Fin Co and should be paid to the IRD during the quarter in which the "dividend" is received.

Underlying foreign tax credits are not available to reduce the FDWP liability because the dividend created a deduction for Australian income tax purposes. See section LF 2(2) of the Act.

9.10 Payment of interest by NZ Holding Co

When the funds were received by NZ Holding Co it had to pay a dividend to Aust Parent Co in order to obtain a refund of the surplus FDWP. When the dividend was on-paid by NZ Holding Co, it could have attached to it the FDWP credit and an imputation credit. The FDWP credit was refundable in cash to Aust Parent Co after offsetting the New Zealand NRWT liability of 15% on the gross dividend (including the supplementary dividend).

The cash dividend was only credited (with FDWP credits) to the extent of approximately $23.00 on a cash dividend of $67. This leaves an unimputed portion which was subject to NRWT unless surplus imputation credits were attached.

10. CONDUIT TAX RELIEF

10.1 Introduction

In relation to the periodic cash flows that are made to avoid any potential deemed dividends, the New Zealand group of companies can be completely relieved from its FDWP liability by taking advantage of the conduit tax regime. A conduit tax relief company that receives a dividend subject to FDWP may be partially or completely relieved of the obligation to deduct FDWP by section NH 7 of the Act. The extent of the tax relief is dependent on the percentage of the company's shareholders who are not resident in New Zealand. In the table below, the Australian shareholding is assumed to be 100%.

10.2 An example

The main advantage of using conduit tax relief (CTR) is that it can eliminate the payment of any New Zealand tax. This would reduce the total tax leakage to Australian NRWT of 10% ($1m), thereby enhancing the net tax saving available to the Australian shareholders.

Table 10

		Conduit Relief	**FDWP**
(a)	*CFC Income*	Nil	Nil
(b)	*FDWP Relief NH 7*		
	Net Cash	9.0	9.0
	Add Aust NRWT	1.0	1.0
	Gross Dividend	10.0	10.0
	FDWP 33%	3.3	3.3
	Less Aust NRWT	(1.0)	(1.0)
	Less UFTC	Nil	Nil
	FDWP	2.3	2.3
	Less UH7(1) CTR	(2.3)	Nil
	Net FDWP	Nil	2.3
	Net Cash	9.0	6.7
(c)	*Dividend Paid Aust Parent Co 100%*		
	Cash	9.0	6.7
	FDWP Credits	Nil	2.3
	LG1 CTR Dividend	2.3	Nil
	Gross Dividend	11.3	9.0
	NRWT 15%	Nil*	Nil*
	Add Excess FDWP Credits		(0.95m)
	Net Cash Aust Parent Co	9.00m	7.65m

*Sufficient imputation credits would be attached to the gross dividend to eliminate the amount of NRWT which would otherwise have been payable.

11. BONUS ISSUES AND NRWT

11.1 An unresolved problem

One issue which is unlikely to be solved by either the pro rata allocation solution or the streaming model is the tax effective repatriation of New Zealand-sourced, realised capital profits to Australia. The fundamental problem is that a realised capital profit by definition does not involve the payment of any New Zealand company tax, and consequently there are no imputation credits arising from the transaction. Any dividend which is sourced from the realised capital profit is, *prima facie*, subject to NRWT.

11.2 A hypothetical example

Consider the case of an Australian Parent Company (Aust Parent Co) which owns a New Zealand subsidiary, which owns a capital asset that has been realised, thereby creating a tax-free capital gain in the hands of the New Zealand subsidiary. The Australian parent wishes to distribute the New Zealand sourced gain to its Australian shareholders.

Assume the New Zealand subsidiary owns no other assets. If the New Zealand subsidiary were to repatriate the realised capital profit, NRWT would be payable on the grounds that the New Zealand subsidiary does not have sufficient imputation credits to fully impute the proposed dividend.

The tax objective would be to remit the realised capital profit to the Australian shareholders in a manner that:

?? minimises the exposure to New Zealand NRWT, and

?? reduces the overall level of tax to the top Australian marginal rate, which is currently 48%.

11.3 A possible solution

Prior to 1 July 2002, FC 1 debentures were one possible mechanism to provide a solution. A second method of re-characterising the profit was based on the distinction between a taxable and a non-taxable bonus issue. Briefly, this methodology involved the conversion of the available cash "dividend" into a non-taxable bonus issue, and the sale of the non-taxable bonus shares to a related party. The key steps were as follows:

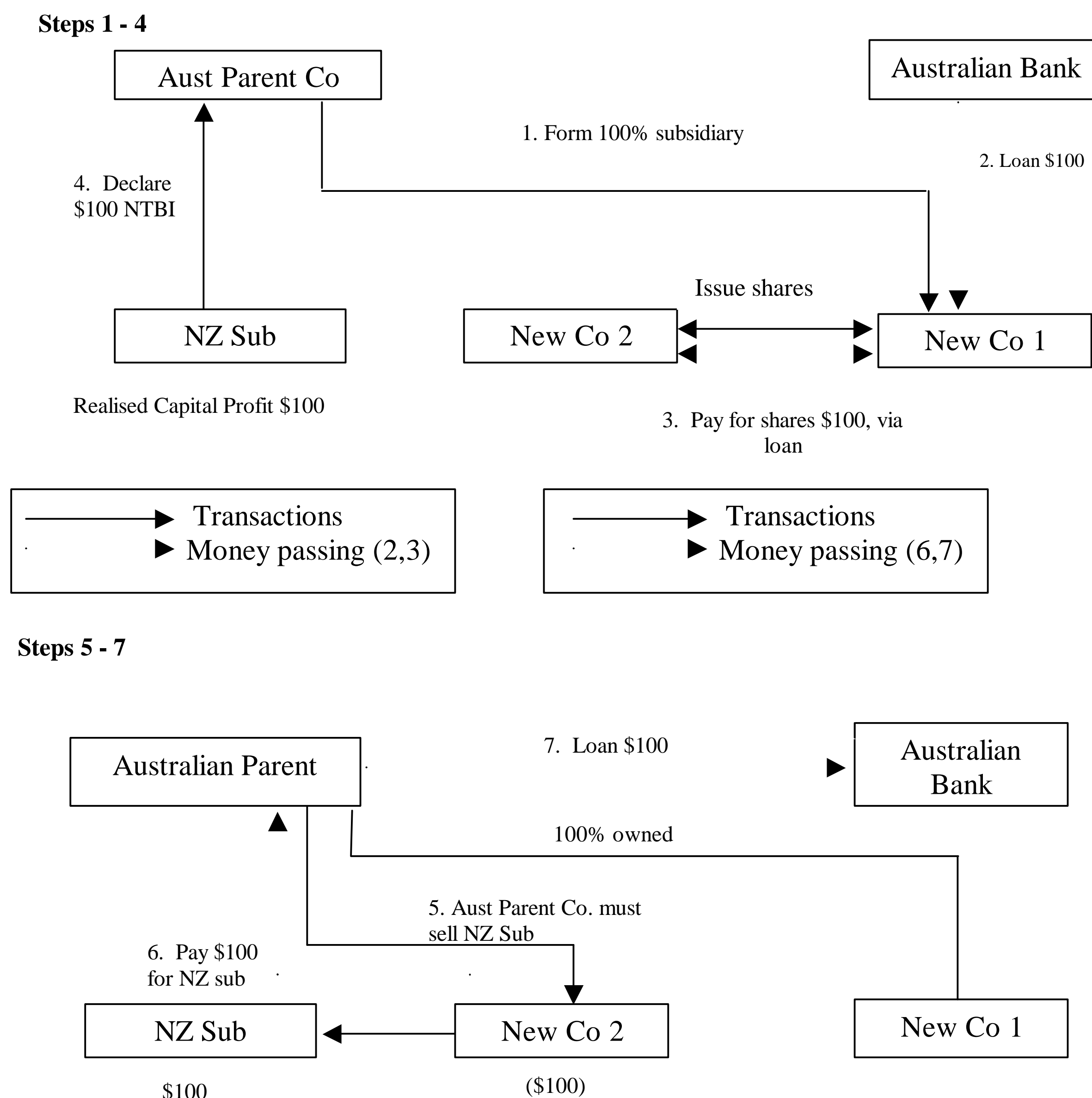
1. Aust Parent Co owned a NZ Subsidiary (NZ Sub). Aust Parent Co would incorporate a new New Zealand subsidiary, New Co 1.
2. New Co 1 would borrow $100 from an Australian bank and obtain AIL status.
3. The $100 would be used by New Co 1 to subscribe for shares in a subsidiary called New Co 2, which would be a New Zealand resident. This step is designed to achieve an interest deduction in New Zealand.
4. NZ Sub would declare a non-taxable bonus issue to its Aust Parent Co.
5. Aust Parent Co would sell the NZ SUB to New Co 2, including the NTBI.
6. New Co 2 would pay the Aust Parent Co $100 for the NZ Sub.

7. Aust Parent Co would deposit the proceeds from the sale of the NTBI with the Australian Bank, which would have lent the money to New Co 1.
8. NZ Sub would pay a cash dividend of $100 to New Co 2, which would be sourced from the realised capital profit.
9. New Co 2 in turn would pass the $100 dividend to New Co 1.
10. New Co 1 would use the cash dividend to repay principal and interest to the Australian Bank.
11. The Australian Bank would repay the $100 loan from the Aust Parent Co.

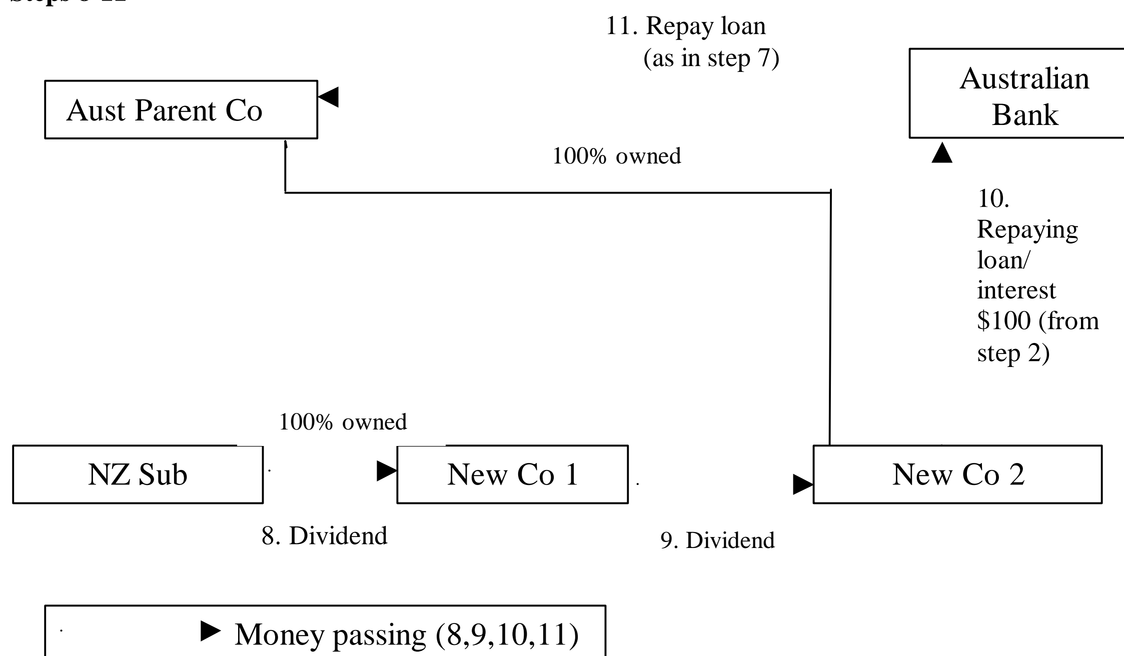
11.4 Diagrammatic Summary

The following diagrams illustrate this sequence of events.

Diagram 5



Steps 8-11



<u>Summary of transactions between companies</u>

<u>NZ Sub</u>:
Cash out from: pay ($100) cash dividend [out of Realised Capital profit $100 – as in diagram for steps 1-4]

<u>New Co 1</u>:
Cash in from: Dividend received from NZ Sub $100
Cash out from: Dividend paid to New Co 2 ($100)

<u>New Co 2</u>:
Cash in from: Dividend received from New Co 1 $100
Cash out from: Repayment of loan to Australian Bank ($100)

11.5 Anti-avoidance issues

The main issue is whether the IRD could apply section BG 1 of the Act and its associated definitions of "tax avoidance" and "tax avoidance arrangement." The successful application of the general anti-avoidance provision will ultimately depend on how the court interprets the discussion in *Challenge Corporation* (and subsequent cases) and whether it accepts that the use of a non-taxable bonus issue (NTBI) is consistent with the scheme and purpose of the Act. Has the taxpayer company merely exercised a structural choice and therefore section BG 1 should not apply so as to deprive the taxpayer of that opportunity?

The Act clearly distinguishes between a NTBI and a taxable bonus issue. This is clear from section CF 2(1)(f) of the Act, which provides that a taxable bonus issue is a

dividend for tax purposes. Furthermore, the company may attach imputation credits to that dividend in accordance with subpart ME of the Act. If the company elects to declare a taxable bonus issue and does not attach imputation credits, then resident withholding tax must be paid by the company.

An NTBI is specifically excluded by section CF 3(1)(a) of the Act from the definition of a dividend. Note, however, that an NTBI does not result in an increase of a company's available subscribed capital. If the company were to undertake a share repurchase or if the company were wound up then the NTBI could not be distributed to the shareholders as a tax free dividend.

Given the clear tax distinction between the two types of bonus issues, it is arguable that a company that simply chooses to declare one form of bonus issue as opposed to another, is simply exercising a structural choice contained in the Act. The company does not frustrate the scheme and purpose of the Act by simply electing to make the most tax-effective form of distribution.

An example of this principle was the declaration of a taxable bonus issue (with a full imputation credit attached) in 1998 by Trustbank prior to the successful take-over by Westpac. The clear tax objective of that strategy was to utilise the available imputation credits that would have been lost after the take-over.

11.6 Recent cases

This type of structural choice was recognised by the IRD in the 1991 policy statement on BG 1. The policy statement contains numerous references to the scheme and purpose analysis put forward by Richardson J in *Challenge Corporation* and contains a number of helpful examples which illustrate the circumstances in which section BG 1 should or should not apply. The closest analogy is the IRD discussion of a taxpayer who deliberately uses the valuation options contained in the trading stock regime to manipulate the amount of tax which otherwise would have been payable. The example involves a change in the rate of company tax from 48% to 28% followed by an increase from 28% to 33%. By changing the valuation method, a taxpayer can clearly influence the level of assessable income and can consequently advance the derivation of income into the 28% income year and defer the derivation of income when the corporate rate of tax switches to 33%. The IRD state in their policy statement that a taxpayer who deliberately sets out to achieve this objective is not subject to section BG 1 on the grounds that they have merely exercised a structural choice contained in the Act.

It is arguable that a taxpayer who simply elects one form of bonus issue over another is doing no more than a taxpayer exercising their right to change the method of trading stock valuation.

Recent support for this approach can be found in the judgement of the Privy Council in *O'Neil v CIR*.[20] Lord Hoffman. in the course of delivering the Board's advice on a "contrived deduction/loss utilisation" scheme. made the following important observation. The potential application of section BG 1 must take into account the numerous structural choices contained in the Act:

[20] (2001) 20 NZTC 17,055.

10. It may be more fruitful to concentrate on the nature of the concepts by reference to which tax has been imposed. In many cases (though by no means all cases) the legislation will use terms such as income, loss and gain, which refer to concepts existing in a world of commercial reality, not constrained by precise legal analysis. A composite transaction like the Russell scheme, which may appear not to create any tax liability if it is analysed with due regard to the juristic autonomy of each of its parts, can be viewed in commercial terms as a unitary arrangement to enable the company's net profits to be shared between the shareholders and Mr Russell (Compare MacNiven v Westmoreland Investments Ltd [2001] 2 WLR 377.) Their Lordships consider this to be a paradigm of the kind of arrangement which [s BG 1] was intended to counteract. **On the other hand, the adoption of a course of action which avoids tax should not fall within [s BG 1] if the legislation, upon its true construction was intended to give the taxpayer the choice of avoiding it in that way.** *(Emphasis added)*

11.7 Consequences

At the beginning of the exercise, NZ Sub had available $100 of retained earnings which have been repatriated to Aust Parent Co in a tax free form. Aust Parent Co can utilise the $100 to invest in Australian assets, thereby increasing the amount of tax payable which in turn will create additional franking credits for its shareholders.

12. PLAYING GAMES

12.1 Introduction

If the Aust Parent Co distributed all of the New Zealand-sourced after-tax net profit to its resident Australian individual shareholders, the total tax cost is 65%. This compares unfavourably with the Aust Parent Co distributing its after tax Australian sourced net profit to its shareholders where the total tax cost would only be 48%.

It is therefore not surprising that the current Trans-Tasman tax system provides a strong incentive for the Aust Parent Co to minimise the cost to their individual Australian shareholders. One simple and obvious method is to switch the payment of New Zealand company tax from the New Zealand subsidiary to the Aust Parent Co.

Table 11

	Before	**After**
NZ Subsidiary Company	%	%
Gross Income	100	100
Allowable Deductions	Nil	(100)
Tax Payable	33	Nil
Australian Company	%	%
Gross Income	67	100
Tax @ 30%	Nil	(30)
Cash Dividend Paid	67	70
Australian Shareholder	%	%
Cash Dividend	67	70
Franking Credit	Nil	30
Tax @ 48%	32	48
Less Franking Credit	Nil	(30)
Additional Tax Payable	(32)	18
After Tax Available Cash	35	52
Effective Tax Rate	**65**	**48**

12.2 Impact of profit repatriation strategies

It would be a relatively low-cost exercise for an Aust Parent Co to enter into a transaction with its New Zealand subsidiary, creating an allowable deduction for the subsidiary and assessable income in the hands of the Aust Parent Co. The above table demonstrates the potential tax saving with this technique. Note that the tax cost would be borne by the New Zealand revenue base.

The benefits to Australian individual shareholders would be significant. Based on the current Trans-Tasman taxation rules a 49% increase in the after tax rate of return to Australian individual shareholders could be achieved by this simple technique (i.e. an increase in available cash from $35 to $52).

12.3 Computer software

A relatively simple and tax effective method of shifting the payment of tax from the New Zealand subsidiary to its Aust Parent Co would involve the Aust Parent Co selling an accounting package to its New Zealand subsidiary. The terms of the agreement would provide that the New Zealand subsidiary could not duplicate the software for external distribution, and that copyright in the software should remain the property of the Aust Parent Co.

The only New Zealand potential tax impost is the imposition of NRWT on the grounds that the transaction constitutes a royalty for the purposes of section OE

4(1)(r) of the Act. If the hypothetical transaction were a royalty for New Zealand tax purposes, then the New Zealand subsidiary would be required to deduct 10% of the gross payment which would reduce the franking credits.

12.4 Previous IRD rulings

Prior to the release of Draft Interpretation Guideline IG007 (Draft Guidelines) the IRD policy was outlined in Public Information Bulletin 168, issued in January 1988. In that document, the IRD stated that all payments for computer software satisfied the definition of a royalty irrespective of the specific terms and conditions of the contract. That statement was inconsistent with the approach taken by the Australian Tax Office (ATO), and statements issued by the OECD.

In July 1998, the IRD announced that it was withdrawing PIB 168. Shortly thereafter the IRD released the Draft Guidelines and in September 2002 a revised draft was issued. However, the Draft Guidelines must have been amended, as they are consistent with the policy adopted by the ATO and the OECD.

12.5 Draft interpretation guideline IG007 (September 2002)

The Draft Guidelines correctly note that the New Zealand income tax consequences of the transaction, introduced at section 12.3 above, depend on the nature of the agreement between the Aust Parent Co and its New Zealand subsidiary. The possibilities are as follows:

- A sale by the Aust Parent Co of its copyright in the software programme to the New Zealand subsidiary.
- A licensing of the copyright in the software by the Aust Parent Co to its New Zealand subsidiary.
- A sale of a copy of the software programme to the New Zealand subsidiary.
- A lease of the software programme to the New Zealand subsidiary.
- The provision of services relating to the Aust Parent Co's know-how which involve a modification of the software programme.
- The supply of know-how by the Aust Parent Co relating to software provided to the New Zealand subsidiary.

12.6 A Trans-Tasman example

In relation to an outright sale of the copyright to the New Zealand subsidiary, the IRD accept that the transaction is not a royalty on the grounds that the contract does not provide for the "use of the rights" in the copyright. This conclusion is consistent with the decision of the High Court in *DB Group Ltd v CIR*.[21] Accordingly, the transaction is not a royalty and there is no New Zealand tax payable. However, there are commercial reasons why the Aust Parent Co is unlikely to sell its copyright in the computer programme to the New Zealand subsidiary.

[21] (1996) 17 NZTC 12,446.

A second possibility would involve the Aust Parent Co granting to the New Zealand subsidiary a licence to use its copyright, thereby permitting the New Zealand subsidiary to modify the source code. This transaction would constitute a royalty for New Zealand tax purposes, and having regard to the commercial relationship between the parties, is unlikely to occur in practice.

The third possibility is a sale of the copyrighted article to the New Zealand subsidiary. The IRD accept that this transaction is analogous to the sale of any other item such as a textbook or a video which is subject to copyright. The New Zealand subsidiary does not acquire any copyright. The most common examples are pre-packaged or "shrink wrapped" software. Under this type of contract, the licence is not for the use of the copyright and therefore the transaction does not fall within the definition of a royalty.

The fourth possibility is a lease of the copyrighted programme. This transaction is unlikely to occur in practice because it could expose the Aust Parent Co to a New Zealand NRWT liability. The transaction could constitute a royalty or, alternatively, it may constitute a "finance lease" which could create an exposure to NRWT on the deemed interest component of the lease rentals. The final two possibilities (i.e. the supply of services and/or the supply of know-how) will be considered in the next paragraph.

Given the commercial relationship between the parties, the most suitable arrangement would be to structure the contract as the sale of an article that is subject to copyright. The copyright would remain with the Aust Parent Co, and the New Zealand subsidiary would obtain the right to use, for its own internal business purposes, the computer programme. The New Zealand subsidiary does not obtain a "production" licence and therefore the transaction is not a royalty as defined in section OB1 of the Act. There are no adverse New Zealand NRWT implications.

12.7 The provision of labour

It is more likely than not that the initial computer programme provided by Aust Parent Co to its New Zealand subsidiary would require some form of modification or enhancement during its life. Assume that the upgrade work would be carried out by the employees of Aust Parent Co. For the purposes of illustrating an important tax planning point, assume that the modification of the initial software package would involve up to 12 of the Aust Parent Co's employees working in New Zealand for no more than 6 months. In view of the extensive amount of work required, Aust Parent Co and its New Zealand subsidiary would enter into a separate contract whereby the Aust Parent Co provides its employees to the New Zealand subsidiary in exchange for a secondment fee. This fee would constitute an allowable deduction to the New Zealand subsidiary.

Clearly the payment by the New Zealand subsidiary to its Aust Parent Co would constitute business income and would have a New Zealand source within the meaning of section OE4(1)(a) (income derived from any business carried on in New Zealand) or alternatively under section OE4(1)(q) (income derived from any contract partly performed in New Zealand).

However, Aust Parent Co would obtain Treaty protection because Article 5(3) provides that the presence of the employees would only constitute a permanent establishment if the installation of the software lasts for more than six months, which

will not occur in the hypothetical example. However, Article 5(2) of the definition of a permanent establishment refers to, *inter alia* a branch, an office, and a place of management. Will the presence of Aust Parent Co's employees in New Zealand for less than 6 months fall within that provision?

12.8 *Wise v CIR* (1992) 14 NZTC 9,032

This decision provides a useful insight into how Aust Parent Co and its New Zealand subsidiary should structure the contract of secondment. Provided the principles established in *Wise* are followed, it is highly unlikely that the physical presence of the employees for less than six months would create a permanent establishment (PE).

This case concerned the interpretation of Article 15(2) of the Double Taxation Relief (USA) Order 1983. That Article provided that the remuneration of a resident of the US was only subject to tax in New Zealand if, *inter alia,* the remuneration was borne by a permanent establishment, or a fixed base which the employer established in New Zealand. The taxpayer, Wise, was a resident of the US. He was employed by a company incorporated in the US and known as "SSI". That company successfully tendered for the provision of diving services for a major offshore oil platform located in New Zealand. SSI incorporated a wholly-owned subsidiary in New Zealand which was referred to as SSINZ. The New Zealand subsidiary was required to perform the diving contract. To enable this subsidiary to carry out the contract, SSI made its employees available to it. Wise was an employee of SSI. He remained on the payroll of SSI throughout the duration of the contract.[22] The IRD argued that the relief provided by Article 15(2) was not available on the grounds that the remuneration paid to Wise was borne by a permanent establishment of his employer, namely the New Zealand subsidiary, SSINZ.

The High Court rejected this argument.[23] It noted that SSI did not have any branch, workshop, factory or any other premises in New Zealand.[24] SSI had no nameplate, telephone, facsimile or any other connections in New Zealand. The Court held that the evidence went no further than establishing that employees of SSI worked in New Zealand.

> *The objector's main argument is that SSI does not carry on any activities in New Zealand. What it does, it does in the US. Everything else of relevance is done in New Zealand by SSINZ. SSI, it was argued, makes staff available to others for the operations of those others, but it is not carrying on business wherever its employees happen to be working.*[25]

This argument was accepted by the High Court, which held that SSI did not have a permanent establishment or fixed base in New Zealand:

> *The work of direction and control of the repairs, service and maintenance of the rig may have been carried out by SSI's employees, ie people on the United States payroll, but there is nothing in the evidence*

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[22] The costs of Wise's remuneration package plus the costs of travel were charged by SSIto SSINZ.

[23] The IRD did not appeal the judgement.

[24] The terms of the contract between SSI and SSINZ were such that SSI could perform all of its contractual obligations without having to maintain, equip, staff or operate any offices or base of operations in New Zealand.

[25] (1992) 14 NZTC 9,032 at page 9,039.

to suggest that they were answerable to or under the control of SSI for the manner in which they did particular work, so that the suggestion that their acts were in a vicarious sense the acts of SSI has nothing to support it. The contractual relationship as to what work was to be done existed between SSINZ, not SSI, and the Maui field operators or their contractors. The requisitioning of necessary staff was done by SSINZ and in the first instance, at least, it would be to SSINZ that the field operators would look in the case of faulty work. [26]

12.9 Conclusion

These two simple hypothetical examples illustrate the likely consequences which would continue to occur if the prorata allocation model becomes the official solution. It would not discourage Australasian companies from engaging in profit repatriation techniques to the detriment of the New Zealand tax base.

13. DEBT SOLUTIONS

13.1 Introduction

In view of the inherent tax inefficiency of the pro rata solution, its introduction is unlikely to see a reduction in debt-driven profit repatriation strategies.

There are two ways for the Aust Parent Co to fund the New Zealand Subsidiary in a tax-efficient manner, and create assessable income and franking credits in Australia.

The first is for the Aust Parent Co to enter into a back-to-back agreement with an Australian bank. The second is for the loan documentation to separate out the New Zealand Subsidiary's obligation to repay the principal sum lent from the interest coupons.

In both of these scenarios, the underlying assumption is that the magnitude of the interest payments means that the payment of Approved Issuer Levy (AIL) is greater than the transaction cost of inserting an Australian bank into the structure.

13.2 Back-to-back funding: AIL

This is by far the most common method. Aust Parent Co lends the required funds to the Australian bank which are used as security for the Australian bank agreeing to lend a similar amount to the New Zealand subsidiary. Any default by the New Zealand Subsidiary will allow the Australian bank to access the "secured deposit" made by the Aust Parent Co.

The following diagram illustrates the relationship between the three parties and the respective cash flows. Note that the after-tax cost of the AIL option is 1.34%, and the underlying assumption is that the net margin charged by the Australian bank is less than this amount.

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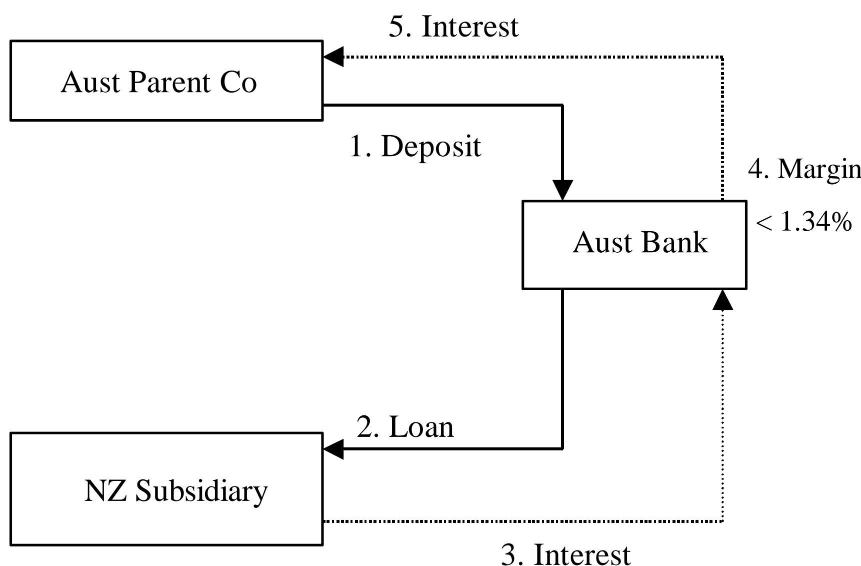
[26] (1992) 12 NZTC 9,032 at page 9,041.

Diagram 6



13.3 Key points and issues

The AIL regime was introduced in the 1991 Budget and it is designed to reduce the amount of NRWT which would otherwise have been payable. To qualify for the AIL regime, the New Zealand subsidiary must obtain "approved issuer" status from the IRD. This is governed by section NG 6 of the Act. After the New Zealand subsidiary obtains approval, it can then register the loan from the Australian bank (Aust Bank).

The role of the Aust Bank is designed to satisfy the statutory criterion that the payer and payee of the interest are not "associated persons". However, it is clear from the scheme of the regime, that the associated person test is only applicable at the first tier (i.e. the loan between NZ Subsidiary and Aust Bank.) Unlike other regimes in the Act, there are no look-through rules which permit the Commissioner to attack the transaction on the grounds that Aust Bank has obtained finance from a second tier associated party (i.e. Aust Parent Co).

There is nothing unusual in the implementation of this type of structure. It does not constitute tax-avoidance, because it is clear from the July 1991 Budget and the associated Budget papers that the Government was aware of a wide range of complex structures which had been successfully used to avoid NRWT. Accordingly, the AIL regime was designed to eliminate the transaction costs associated with those structures which were replaced with a modest payment of tax to the New Zealand Government.

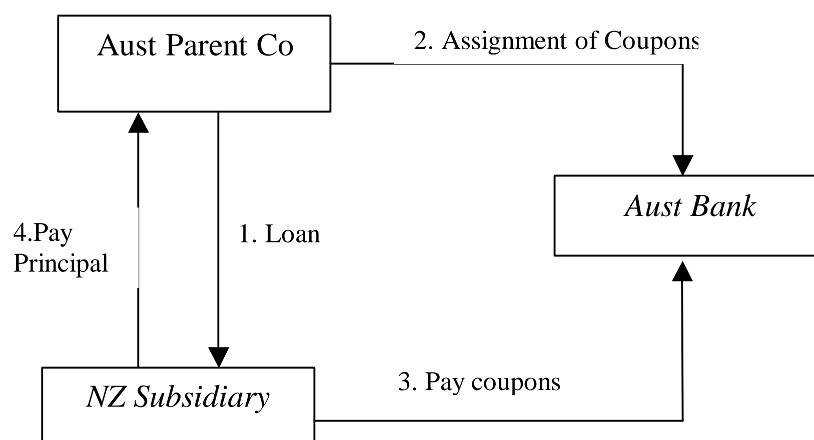
A second reason why this type of structure is unlikely to be affected by section BG 1 is that the AIL regime is a "soak up" tax. Non-resident lenders have a clear structural choice. They can either pay NRWT and claim a credit for the NRWT against their home country tax liability, or they can structure the investment to achieve AIL status. The choice depends on the non-resident lender's domestic tax profile. If they can't utilise the credit for NRWT then the most tax-efficient solution is to develop an AIL

compliant structure. Given that AIL does not create a foreign tax credit the payment of NRWT would be the optimal solution if the foreign lender can "soak up" the New Zealand NRWT credit. In that scenario, the foreign lender, everything else being equal, will be better off by the saving of AIL.

13.4 Detachable coupons

The same tax efficiencies can be achieved via a similar method that involves segregating the New Zealand subsidiary's obligation to repay the principal and interest via detachable interest coupons. The documentation should provide that, once the coupons have been detached, the obligation to pay interest is independent of the principal debt obligation.

Diagram 7



13.5 Additional tax issues concerning detachable coupons

The NZ Subsidiary will claim a full deduction on an accrual basis for the interest payments it makes on the debt, notwithstanding the assignment of the future interest payments to the Aust Bank. From the perspective of the NZ Subsidiary, after the assignment, there is still only one financial arrangement. The amount and deductibility of NZ Subsidiary's interest expense is not affected by the assignment by Aust Parent Co of the future interest payments.

13.6 Derivation of interest

For the interest to be derived by the Aust Bank, it is essential that the detachable coupons are assigned prior to the time that the interest is due and receivable. The first key issue is, if Aust Parent Co assigns the coupon just prior to the interest payment date, has Aust Parent Co derived accrued interest income up to the time the coupon is assigned to the Aust Bank? Under New Zealand's accrual regime, interest income is

deemed to be spread over the term of the financial arrangement. However, the accrual regime does not apply to non-residents.

13.7 Validity of the assignment

Whether the assignment of the interest coupons is valid or not depends upon the application of complex principles of common law and equity. The central issue of who derives the income depends upon how the assignment is classified.

There are two lines of cases that apply to the assignment of income. The first line of cases is based on the Australian case of *Norman v FCT* [27] and the New Zealand case of *Williams v CIR*. [28] They classified a purported assignment of income as a mere assignment of an *expectancy* to a future receipt. The effect was that the party transferring the interest was deemed to have derived the income notwithstanding the purported assignment. Consequently when the transferee received the income, it was held to be an application of income.

The second line of cases is based on the Australian case of *Shepherd v FCT* [29] and the New Zealand case of *McLeay v CIR*.[30] They classified an assignment of income as an assignment of an existing right to future receipts. Since the right was held to have existed at the date of the assignment, the assignee was held to have derived the income. In *Shepherd's* case, the taxpayer assigned his right to royalties under a licence agreement for the manufacture of furniture castors. The majority of the High Court of Australia held that the deed of assignment was an effective assignment on the grounds that the contractual right to royalties, payable in the future, was an existing chosen action. Being an existing chosen action it was capable of being presently assigned. This was despite the fact that the quantum of income assigned could not be known at the time of the assignment.

13.8 Potential NZ tax liability for Aust Parent Co on the payment for the assignment

Assuming the assignment is valid, the next issue is whether the cash consideration paid by the Aust Bank to Aust Parent Co for the assignment is "interest" within the definition of section OB1. If so, then New Zealand domestic law would impose NZ NRWT of 15%.

"Interest" is defined in section OB1 as:

> Every payment (not being a repayment of money lent and not being a redemption payment), whether periodical or not and however described or computed, made by the first person to any other person (in this definition referred to as the 'second person') in respect of or in relation to money lent to the second person making the payment or to any other person.

On a literal interpretation of this definition, the payment made by the Aust Bank to Aust Parent Co could arguably constitute "interest" and therefore be subject to NZ

[27] *Norman v FCT* [1963] 109 CLR 9.

[28] *Williams v CIR* [1965] NZLR 395.

[29] *Shepherd v FCT* [1965] 113 CLR 385.

[30] *McLeay v CIR* [1963] NZLR 711.

NRWT. The argument is that the consideration paid by the bank to Aust Parent Co is a payment made to a person (Aust Parent Co) by any other person (the bank) in respect of or in relation to money lent to any other person (NZ Subsidiary).

The better view is that the payment made by the Aust bank to Aust Parent Co should not constitute interest and consequently NZ NRWT should not apply. The payment is in consideration for the assignment of future interest payments. It is not a payment made "in respect of or in relation to money lent". At the time the payment is made, no amount of interest would be due on the money lent to NZ Subsidiary (i.e. the payment is not in respect of accrued interest on the notes). The only payments made in respect of or in relation to money lent are the subsequent interest payments which will be made by NZ Subsidiary to the Aust Bank who is holder of the interest coupons.

14. AUSTRALIAN CAPITAL GAINS TAX

14.1 Introduction

One of the major differences between the two TransTasman tax systems is the absence in New Zealand of a capital gains tax (CGT). Australia introduced a comprehensive CGT into the Income Tax Assessment Act 1936 in 1985. Everything else being equal, the Australian CGT regime represents an additional layer of Australian tax which would not create any imputation credits in New Zealand. Secondly the allocation of franking credits under the pro rata allocation solution to New Zealand shareholders will still encourage Trans-Tasman companies to avoid Australian CGT.

14.2 A hypothetical investment

Consider the case of a New Zealand parent company that wishes to purchase a commercial property in Australia. The company believes the value of the property will double during the next four years. Can it structure the acquisition and anticipated disposal in a way that reduces its prima facie exposure to Australian CGT?

14.3 Australian CGT

Taxable gains are included as part of a taxpayer's ordinary assessable income, and are subject to tax at the ordinary rate.[31]

An Australian resident company is subject to Australian CGT on its world-wide assets. However, non-residents are only subject to Australian CGT on taxable Australian assets which are:

?? land and buildings in Australia,

?? any asset that has been used by a taxpayer in carrying on business through a permanent establishment,

[31] Indexation does not applyto assets acquired after 21/9/1999.

?? shares and interests in a resident Australian private company (equivalent to a New Zealand close company),

?? shares or interests in a public company where the taxpayer (and associates) owns at least 10% of the issued share capital in that company,

?? interests in Australian partnerships or unit trusts, provided that the interest is greater than 10%, and

?? options and rights to acquire any of the above assets.

For reasons which will become apparent later, it is important to establish the precise relationship between the CGT provisions and the "income tax" provisions of both the 1936 and 1997 Acts. The key point to note is that there is a single tax imposed by both Acts which reflects the limitations contained in Section 55 of the Australian constitution. There is no separate "capital gains tax" imposed in Australia. Amounts described as "capital gains" form part of the calculation of taxable income. This conclusion is based on the following short summary of the schemeof the 1997 Act.

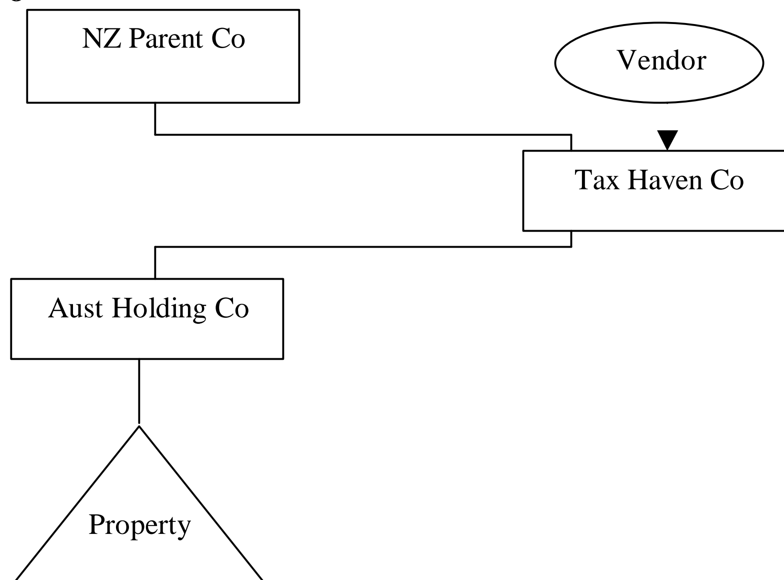
The 1997 Act imposes "capital gains tax" on chargeable gains by including in a taxpayer's assessable income "your net capital gain (if any) for the current year" (section 102-5(1)). The phrase "assessable income" is defined as including amounts included in assessable income by provisions of the Act (i.e. statutory income). This principle is contained in section 6. Income tax is imposed on taxable income. The phrase "taxable income" is defined as being the amount remaining after subtracting allowable deductions from assessable income (see Section 4-15). Accordingly, under the 1997 Act, a capital gain is (or maybe) taxed but, if it is, the tax imposed is **income tax** and it is imposed on the capital gain because it forms part of **taxable income**. This analysis is crucial when interpreting, *inter alia,* Article 2 of the Netherlands Double Tax Agreement (DTA) which deals with "taxes imposed".

14.4 Dual company structures. Option A

If the New Zealand Parent Company (NZ Parent Co) were to directly acquire the Australian property, the anticipated disposal would be subject to CGT. Furthermore, if the NZ Parent Co were to incorporate an Australian Holding Company, which in turn acquired a property, a disposal of the Australian Holding Company would also be subject to Australian CGT.

One method of overcoming the risk of CGT is for the NZ Parent Co to incorporate a subsidiary which is not a resident of Australia, which in turn incorporates an Aust Holding Co that acquires the property. This structure is summarised in Diagram 8, below.

Diagram 8



If NZ Parent Co were to sell Tax Haven Company (Tax Haven Co), that transaction would not fall within any of the charging provisions contained in the 1997 Act. However, the purchaser may feel uncomfortable acquiring a tax haven company as a vehicle for obtaining control of the Australian property. An alternative structure is to use a Treaty country such as the Netherlands.

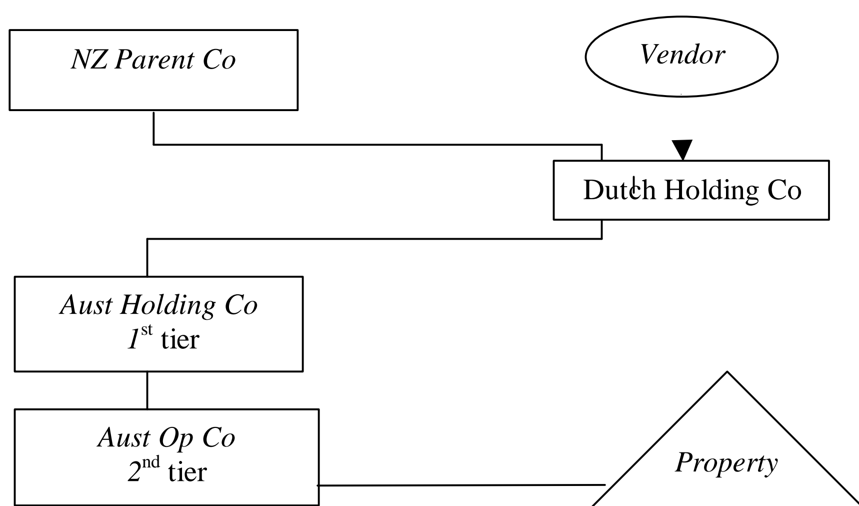
14.5 Dual company structures. Option B

There are two major differences between this structure and Option A. NZ Parent Co incorporates Dutch Holding Company (Dutch Holding Co) which is designed to rely on the favourable provisions contained in the Dutch DTA network.

Secondly, NZ Parent Co (via Dutch Holding Co) forms an Australian Holding Company (Aust Holding Co) which in turn incorporates an Australian Operating Company (Aust Op Co) (second tier).

The relationship between the parties is summarised in the following diagram.

Diagram 9



The exit strategy would involve the NZ Parent Co selling its indirect interest in the first tier Aust Holding Co. That transaction is designed to take advantage of Article 13 of the Australia-Netherlands DTA.

14.6 Article 13 of the New Zealand-Australia DTA

What would be the position if the NZ Parent Co omitted the Dutch Holding Co and directly acquired the share capital of the Australian first tier company. The difficulty with that proposed structure is that Article 13 of the NZ-Australian DTA would permit the ATO to impose CGT on the disposal of the first tier Australian company.

The mere holding by NZ Parent Co of shares in the first tier Australian company is not sufficient to create a permanent establishment in Australia. Accordingly, Article 7 would, *prima facie*, provide Treaty relief on the grounds that a shareholding does not of itself create a permanent establishment and therefore Australia cannot tax the proceeds. However, Article 7(8) provides that where any item of income is dealt with under another provision of the agreement, then the other Article which is applicable is not overridden by Article 7.

Article 13 of the DTA deals with the alienation of personal property. The main provisions are:

> *Article 13(1) Income, profits or gains derived by a resident of [New Zealand] from the alienation of real property situated in [Australia] may be taxed in that other State. [Australia]*
>
> *Article 13(3) Income, profits or gains derived by a resident of [New Zealand] from the alienation of shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in [Australia], may be taxed in that other State. [Australia]*
>
> *Article 13(5) Nothing in this agreement affects the application of a law of [Australia] relating to the taxation of gains of a capital nature derived from the alienation of any property other than that to which any of the preceding paragraphs of this Article apply.*

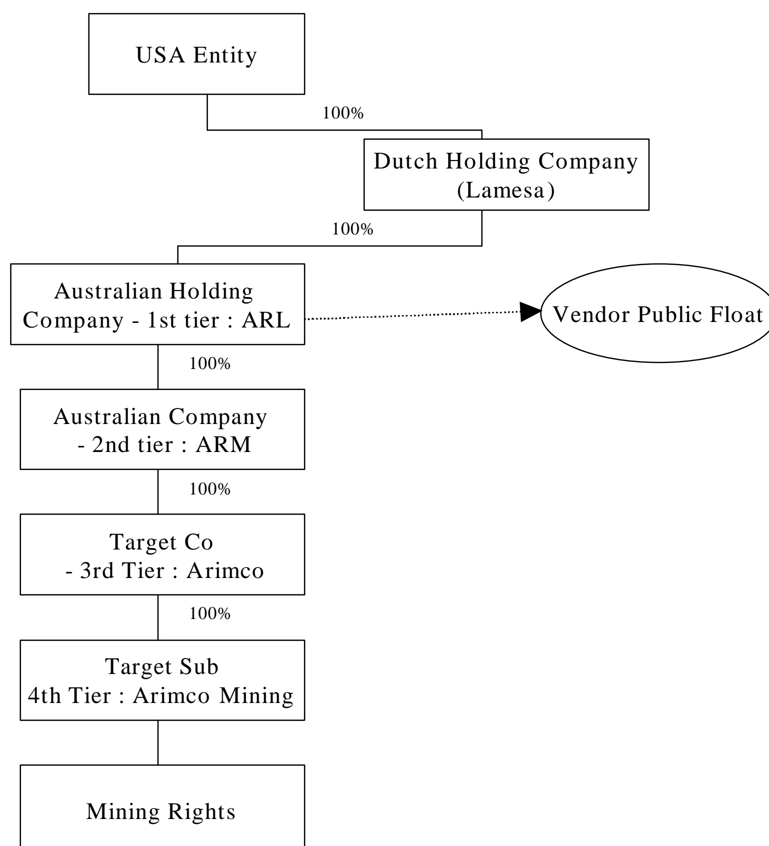
Article 13(5) was inserted into the DTA to overcome the problem associated with the decision of the Australian Federal Court in *FCT v Lamesa Holdings BV*.[32]

14.7 *Lamesa*

This case is a classic case of Treaty shopping. An Australia Target Company (Aust Target Co) was acquired via a Dutch Holding Co which in turn was owned by an American entity. The structure is illustrated in the following diagram.

[32] *FCT v Lamesa Holdings BV* (1977) 36 ATR 589.

Diagram 10
From case: *FCT v Lamesa Holdings BV* (1977) 36 ATR 589.



The US entity was a limited partnership and it acquired the taxpayer *Lamesa*, which was a company incorporated in the Netherlands (Dutch Holding Co). *Lamesa* acquired an Australian company (Aust Holding Co – 1st tier) called *Australian Resources Limited (ARL). ARL* acquired another Australian company called *Australian Resources Mining Pty Ltd (ARM* – 2nd tier). *ARM* made a successful on the market takeover (Aust Target Co– 3rd tier) of an Australian resource company known as *Arimco NL (Arimco)* which had as one of its wholly owned subsidiaries Target Subsidiary Company (Target Sub Co – 4th tier) (a company called *Arimco Mining Pty Ltd (Arimco Mining).* That company held valuable gold mining leases.

Two years after the takeover, the group was offered to the public via the issue of new capital, which was quoted on the Australian stock exchange. *Lamesa* made a profit in excess of $A200m from selling its stake in ARL (Aust Holding Co – 1st tier) in two tranches. *Lamesa* accepted that the profit was part of its assessable income under the 1936 Act. However, it claimed the protection of the business profits article in the Australia/Netherlands DTA. Its case was based on Article 7 (Business Profits) which

is based on the 1997 OECD model convention. The facts in *Lamesa* clearly disclosed that the taxpayer (Dutch Holding Co) did not carry on business in Australia via a permanent establishment.

14.8 Article 13 of the Australian-Netherlands DTA

The Dutch DTA is similar to the New Zealand-Australia DTA. In both instances Article 7 contains the general rule that the country of source can only tax a resident of the other country if the resident has created a permanent establishment (PE) in the country of source. In Lamesa, the Australian Tax Office (ATO) accepted that *Lamesa* had not created a PE in Australia. Article 7(5) of the Australian-Netherlands DTA provides that any transaction falling within, *inter alia,* Article 13 is subject to tax in Australia (the source country). Article 13(1) of the Australia-Netherlands DTA provides that income from the alienation of real property may be taxed in Australia.

Article 13(2)(a)(iii) provides that the term "real property" includes, *inter alia,* shares in a company the assets of which consist wholly or principally of direct interests in or over land in Australia. Diagram 10 clearly demonstrates that *Lamesa* sold its shareholding to the public in the Aust Holding Co. If Article 13(2)(a)(iii) is read literally, then the disposal of the holding company is not a transaction that falls within that paragraph. It would only constitute a taxable event if the Treaty permitted the ATO to look through the chain of companies and adopt a substance-based interpretation.

14.9 Article 13 of the New Zealand-Netherlands DTA - A double edged sword

It is important to note, that there is nothing to prevent an Aust Parent Co from adopting a reverse structure to eliminate the payment of either New Zealand income tax, or alternatively the payment of NRWT on the remission (via a dividend) of any profit derived from the disposal of a New Zealand sourced asset. In view of the similarity between Article 13 of the Australia-Netherlands DTA, and Article 13 of the New Zealand-Netherlands DTA, the approach taken by the Federal Court in *Lamesa* is equally applicable to a New Zealand-based investment which seeks to rely on the New Zealand-Netherlands DTA.

The key feature of the New Zealand-Netherlands DTA is that business profits are also dealt with in Article 7, which contains the general rule that New Zealand can only tax a Dutch resident on any New Zealand sourced business income that is effectively connected to a PE. The mere ownership of shares in a New Zealand company by a Dutch resident does not create a PE. The essential features of Article 13 are as follows.

> *Article 13(1). Income or gains derived by a resident of [the Netherlands] from the alienation of real property referred to in Article 6 and situated in [New Zealand] may be taxed in that other State.*
>
> *Article 13(4). Income or gains from the alienation of any property other than that referred to in paragraphs 1…shall be taxable only in the State of which the alienator is a resident [i.e. the Netherlands].*

Note that Article 13 of the New Zealand-Netherlands DTA is easier to circumvent than Article 13 of the Australia-Netherlands DTA, because the comparable New Zealand provision does not contain an equivalent to Article 13(2)(a)(iii) of the

Australia-Netherlands DTA. Accordingly, the structure can be simplified via the deletion of a second tier New Zealand company.

14.10 The judgement of the Federal Court in *Lamesa*

The disposal mechanism consisted of *Lamesa* arranging for the Aust Holding Co to float its Australian share capital to the Australian public. The profit realised by *Lamesa* was approximately $200 million. That gain would constitute assessable income if the transaction were caught by Article 13 of the DTA.

The issue before the Federal Court was whether the assets owned by the initial target subsidiary could be treated as assets of the Aust Holding Co.

The ATO's primary submission was that the phrase "shares or comparable interests in a company" authorised a substance approach. The corporate veil of the subsidiary companies, which were interposed between *Lamesa* and the mining leases, should be lifted for tax purposes, thereby treating the mining leases as constituting the assets of ARL. Under this interpretation, Australia would have had the primary taxing rights because the assets of the group were comprised "principally of direct interests in or over land" in Australia within the meaning of Article 13(a)(iii).

14.11 "…The assets of which…"

The Federal Court was not prepared to construe the phrase "…the assets of which…" as extending down the chain of subsidiaries to the mining leases. The phrase was given a literal meaning. The assets of *ARL* (the Aust Holding Co) comprised the 100% shareholding in *ARM* (the 2nd tier company), and not the mining licences owned by *Arimco Mining* (the 4th tier company). The Federal Court was clearly concerned about the implications of authorising a look-through in situations where the ownership was not via a chain of 100% owned subsidiaries. How would the ATO interpret this Article if, for example, *Lamesa* had only owned 51% of the 1st tier company? This was clearly a real possibility, because *Lamesa* had sold down its shareholding in two public floatations. The Court observed that:

> *… it is equally possible as a matter of policy that the legislature chose to limit the assimilation in Art 13 of shares to realty only to one tier of companies so as to avoid the kinds of melancholy complication [sic] which arise where multitudinous tiers are involved and with potentially varying percentage ownership interests.*
>
> *The degree of complexity required would, no doubt, depend upon whether the policy was to deal only with wholly owned subsidiaries on the one hand or whether it would be intended to extend to lesser percentage ownership. While it will be recalled that in the 1994 year of income Lamesa held virtually 100 per cent of ARL, that was not the situation in 1996, by which time Lamesa held only 67.35%. But what if ARL had, instead of owning 100% of ARM, owned 75%? Would the assimilation be intended to operate as a matter of policy? What if the percentage ownership were 51%? The same questions can be asked at other levels in the chain of ownership to which the facts of the present case relate.* [33]

[33] See n 32, p 598 line 10 and line 20.

15. DO AUSTRALIAN DTAs PROVIDE TREATY PROTECTION?

15.1 The significance of *Lamesa* structures

The US investors entered Australia indirectly via the Netherlands. Why did they do that, and what would have been the position if they had made a direct investment? These questions have been answered by Ian Gzell in an important article.[34]

Gzell notes at page 75 that under the Netherlands participation exemption, dividends and other profit distributions, including capital gains arising on the disposal of shares in a foreign entity, are excluded from Dutch corporate income tax. The participation exemption effectively meant that the Netherlands became a "dividend trap" to defer the payment of any US tax arising from the float of the Australian investment. According to Gzell, subpart F of the US Code was unlikely to apply because the limited partnership could satisfy the "safe harbour" rules. This was because it had fifteen special partners.[35]

In *Lamesa,* the ATO did not rely on Part IV(a) (the general anti-avoidance provision) of the 1936 Act. Could the ATO have argued that the imposition of the Dutch company between the US investors and ARL (1st tier company) should be set aside for tax purposes under Part IV(a) on the grounds that, but for the "scheme", the US investors would have invested directly into Australia? The answer is no. The $A200m would still have qualified for treaty protection. Article 7 (business profits) of the Australian-US DTA would have provided treaty protection, because the American partnership would not have created a PE in Australia. Secondly, Article 13 (taxation of capital gains) of the Australian-US DTA is similar to the Australia-Netherlands Treaty in that it only deals with the taxation of real property.

Article 13(2)(b) defines the term "real property" as land and also "shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia." Once again, there is no look-through provision in this article and any attempt by the ATO to impose Australian CGT under Article 13 would also have failed.

Lamesa is important whenever the investment involves immovable property and/or the share capital of a company whose principal asset consists of the immovable property. *Lamesa* established that Article 13 of the Australia-Netherlands DTA did not contain a look-through rule and accordingly it is a relatively simple exercise to devise a multi-tier structure, which circumvents the limited taxing right conferred by that article. The same is true of Article 13 in the Australia-USA DTA, and Article 13 of the New Zealand-Netherlands DTA.

15.2 Moveable property

What then is the level of treaty protection available to a non-resident investor who acquires **moveable property** or **intangible property?** Is there any treaty protection?

[34] Ian Gzell QC, "Treaty-shopping" (June 1998) Vol 27 *Australian Tax Review* pp 65-78.

[35] See n 34, p 76.

Recently the ATO stated publicly that a non-resident of Australia cannot obtain treaty protection against CGT under Australia's pre CGT Double Tax Agreements.[36] This important issue will be considered in the context of two of the twenty-three pre CGT DTAs, namely the Netherlands (1976) and Denmark (1981). These two treaties have been selected because of the fact that neither country taxes Australian-sourced income under its domestic law. They are suitable dividend trap countries.

From a New Zealand perspective, they can also play an effective role despite the fact that both the Netherlands and Denmark are CFCs. A New Zealand company investing in Australia via Denmark or the Netherlands is able to avoid Australian corporate tax and thereby create imputation credits for resident New Zealand shareholders.

15.3 TR 2001/12

This final ruling deals with the controversial topics of income tax, capital gains tax, and pre CGT tax DTAs. The importance of this debate is confirmed by the fact that the New Zealand-Australia DTA contains a specific article which preserves Australia's right to tax capital gains under the 1936 and 1996 Acts. Accordingly, the debate revolves around the absence of any comparable provision in Australia's pre-CGT treaties. The ATO's position is summarised in the following quotation.

> *While noting there are alternative arguments the ATO adheres to the view that Australia's right to tax capital gains was not limited by pre CGT treaties. The ATO considers that taxes on capital gains are not taxes to which pre CGT treaties apply. Even if this is not the case, the source rules of pre CGT treaties do not limit domestic law taxing rights of capital gains.*[37]

The correctness of the ATO view is not based on any particular point or argument. Their case revolves around a number of indicators. The context in which the twenty treaties were negotiated is central to the ATO interpretation of those treaties. For example, context is said to be relevant in deciding under the "taxes covered article" whether CGT is similar to the "Australian income taxes", which existed prior to the introduction of CGT.

Despite the judgement of the Federal Court in *Lamesa* and the earlier decision of the High Court in *Thiel v FCT*, the analysis contained in final ruling TR 2001/12 has not been rigorously tested in the Australian courts. From a potential New Zealand investor's perspective there is some doubt surrounding the validity of the ATO position. The following arguments, which are discussed more fully by Ian Gzell[38], strongly suggest that the views expressed by the ATO in the final ruling is mistaken.

The competing arguments are summarised by the ATO[39]. In considering whether CGT is a tax to which a pre-CGT treaty applies, a key requirement is that the CGT

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[36] ATO final taxation ruling TR 2001/12 "Income tax and capital gains tax: capital gains in pre CGT treaties" 62 pages issued on 19 December 2001.

[37] See n 36, pp 5-7 paragraphs 14-18.

[38] Ian Gzell QC, "Treaty-shopping" (June 1998) Vol 27 *Australian Tax Review* pp 65-78.

[39] ATO final taxation ruling TR 2001/12 "Income tax and capital gains tax: capital gains in pre CGT treaties" 62 pages issued on 19 December 2001, pp 10-11 paragraphs 26-28.

was considered to be one of the taxes imposed at the time of signature (usually by Australia as "Australian income tax") or that CGT was substantially similar to an existing tax. According to the ATO, the CGT regime does not satisfy either of these tests. The alternative view argues "Australian income tax" effectively included a capital gains tax at the time when most of the pre-CGT treaties were signed. Section 26AAA, for example, was always seen as a pure tax on capital gains. The CGT merely extended the range of transactions subject to tax. Accordingly CGT is "an existing tax" or alternatively is substantially similar to an existing tax and is therefore a tax to which pre-CGT treaties apply. The views of international tax authors and decisions of a foreign tribunal are quoted to support the view that the insertion of Part IIIA into the 1936 Act did not amount to the introduction of a new tax.

15.4 Taxes covered

In the context of the Australia-Netherlands DTA, the key point is that there is no reference to capital gains in Article 2 (taxes covered). This could indicate that the treaty does not apply to CGT. However, the term "Australian income tax" is undefined. Therefore Article 3(3) includes the domestic law interpretation. The commentary on the corresponding article of the model convention states that article 3(3) of this treaty is ambulatory. Terms which are not defined should be interpreted according to the domestic law which is in force at the time when the treaty is being applied. This approach is supported by Article 3(2) of the 1992 model which was amended in 1995 to support the ambulatory approach.

If Article 2 applied today, then for the reasons noted above there would be a strong case for arguing that the reference to "Australian income tax" in this treaty covers capital gains. Section 4-10 of the 1997 Act provides that income tax is calculated by reference to taxable income. That phrase is equal to assessable income less allowable deductions (ss4-15). As noted above, net capital gains are included in assessable income by virtue of ss102-5 of the 1997 Act. Under the ambulatory approach CGT would constitute Australian income tax and would be eligible for the treaty protection contained in Article 7.

It is also significant to note that the second protocol to the Netherlands treaty was concluded in 1986, which was after the introduction of CGT. There is no reference in the description of taxes covered to CGT. An inference can be drawn that it is unlikely Australia's comprehensive CGT regime was unintentionally omitted when the protocol was negotiated thereby ensuring that it did not cover CGT.

Furthermore, a negative inference can be drawn from the fact that there is no specific reference to CGT as an "existing tax" in any Australian post-CGT treaties. Similar expressions are used to describe "Australian income" tax in both pre- and post-CGT treaties. This also suggests that pre-CGT treaties were intended to cover capital gains tax.

Finally, the specific extension of Australian income tax to cover any identical or substantially similar tax creates further problems for the ATO. Section 26AAA is a form of capital gains tax and was in force at the time the Netherlands treaty was entered into. Accordingly, the introduction of a comprehensive CGT regime merely extended the range of transactions which were covered by that tax. Therefore, CGT is either an "existing tax" or is substantially similar to an "existing tax" and is a tax to which the Netherlands treaty applies.

These interpretations are supported by the weight of academic opinion. For example, Professor Vogel[40] has stated that the taxation of capital gains is normally dealt with within income tax law, and any new capital gains tax will normally be considered for treaty purposes as being at least similar to income tax.

For all of these reasons the Ruling's conclusion is highly questionable because Australia does not have a separate CGT. Part IIIA added net capital gains to the classes of income that are taxable under the 1936 and 1996 Acts.

15.5 Practical considerations

Finally there are a number of serious practical difficulties which would arise if the ATO views are correct. Under all of the pre-CGT Treaties, the treaty partner is required to give a credit for taxes paid in Australia. Are the treaty partners required to ignore tax paid by Australian resident companies on capital gains, when calculating the available credit to non-resident shareholders for underlying Australian tax?

If so, how is the amount of the CGT to be determined? What if the company had a large net capital gain but because of other transactions derived no taxable income, and therefore paid no Australian tax? To treat the introduction of CGT as a new tax for DTA purposes would be also inconsistent with the practical application of pre-CGT treaties.

15.6 Article 7 Business profits

Article 7 of the Australia-Netherlands DTA provides that Australia can only tax the "profits of an enterprise" of the Netherlands if that enterprise carries on business in Australia through a permanent establishment. Assuming there is no PE, the issue then becomes whether the expression "profits of an enterprise" encompasses capital gains. If the answer to that question is 'yes' then CGT is not applicable. The views of the ATO are summarised at pages 30-35 of TR 2001/12. The corresponding arguments are summarised by Gzell[41] at pp 27-29 of his second important article on this topic.

The ATO argument is that where a country such as Australia distinguishes between income and capital gains you would not expect article 7 to deal with capital gains. The argument is based on the fact that Australia has made a reservation to article 13 of the OECD model (which deals with capital gains) and did not make a reservation against article 7.

The answer to the ATO's contentions lies in a combination of the following provisions. Section 3(2) of the International Tax Agreements Act 1953 provides that in relation to "Australian tax" a reference to "taxable income derived from an activity or business shall be read as a reference to taxable income derived from that activity unless the context otherwise requires". As noted above, "taxable income" is defined in ss4-15 of the Income Tax Assessment Act 1997 (the 1997 Act) as assessable income less allowable deductions. Sections 102-5 of the 1997 Act specifically includes net capital gains in a taxpayer's assessable income. Accordingly, the term "profits" in Article 7 must include availability of capital gains and treaty protection.

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[40] Klaus Vogel, "Klaus Vogel on double tax conventions" in *Kluwer Law International* (3rd ed, The Hague, Kluwer Law International, 1997) p 157.
[41] Ian Gzell QC "Treaty protection from capital gains tax" (March 2000) Vol 29 *Australian Tax Review* pp 25-49.

Further support for this interpretation is contained in Article 6(a) of the first protocol to the Australia-Netherlands DTA. That provision states:

> *Where one of the states is entitled to tax the profits of an enterprise, that state may treat as profits of an enterprise, profits on the alienation of capital assets of the enterprise, not being profits that consist of income to which paragraph (1) of article 13 applies.*

Finally, further support is provided by *obiter dicta* comments of the full Federal Court in *Lamesa* that:

> *...generally, the double tax treaty leaves profits from the alienation of shares to be dealt with under article 7 in the context of an enterprise.*

15.7 Would the activities of a Dutch dividend trap company constitute an "enterprise of one of the states"?

This issue is not discussed by either Gzell or the ATO. The term "enterprise" is not defined in the Australia-Netherlands DTA. However, in *Thiel*, the High Court considered the application of Article 7(1) of the Australia-Switzerland DTA, which is identical to Article 7 of the Netherlands treaty. The majority of the High Court concluded that the term "enterprise" may include an activity, or activities, that consist of one or more transactions provided they were entered into for business or commercial purposes.

Based on the decisions of the Australian courts in *FCT v Total Holdings Pty Ltd* [42] and *Esquire Nominees Ltd v FCT*[43], the holding of shares can constitute a business.

15.8 Will the Dutch treaty apply if there is no double taxation because of the participation exemption in the Netherlands?

The structure adopted by the taxpayers in *Lamesa* was designed to eliminate Australian and Dutch income tax payable on the realised capital profit. If Dutch law does not impose any tax on the gain, is it open for the ATO to argue that the treaty does not apply on the grounds that there is no double taxation?

This argument is not discussed by either the ATO in TR2001/12 or Gzell. It is however a straw man.

The full Federal Court in *Lamesa* held that unless it could be shown that one of the objects and purposes of the Netherlands Treaty was to ensure that tax was paid in one of the contracting states, the treaty would still be applicable. This was in spite of the fact that there is no double taxation (or for that matter any taxation) payable in either treaty country.

[42] *FCT v Total Holdings Pty Ltd* 79 ATC 42719.

[43] *Esquire Nominees Ltd v FCT* 73 ATC 41141.

16. THE IMPACT OF THE PARTICIPATION EXEMPTION IN THE NETHERLANDS AND DENMARK

16.1 Treaty shopping

The facts of *Lamesa* are a classic example of how treaty shopping occurs. Instead of investing directly into Australia, the limited liability partnership established a Dutch company that undertook the investment.

The rationale for treaty shopping has been summarised by Edwardes-Ker[44] as follows:

> *Because tax treaty benefits cannot be denied to those proving their entitlement to such benefits, treaty shopping may be advantageous. Treaty shopping typically arises because no (or only an unattractive) tax treaty exists between an investor's resident state and a source state. The treaty shopping investor will then typically decide to establish a (base or conduit) company or other entity allegedly resident in a third state. This entity will then seek to claim the benefits of an attractive tax treaty between this third state and the source state.*

16.2 Participation exemptions

Treaty shopping is not only synonymous with tax havens. The Netherlands is not the only European country to include as part of their domestic law the concept of a "participation" exemption. Austria, Belgium, Denmark, France, Germany, Ireland, Luxembourg, Spain, Sweden, Switzerland and Turkey have enacted similar legislation. One of the most popular participation exemptions is the Dutch regime, which is briefly discussed by Gzell at page 75.[45] Subject to commercial considerations, there is very little to choose between the participation exemptions contained in some of the other countries. For the purposes of contrast, the participation exemption offered by Denmark will be examined.

The tax advantage sought by the taxpayer in *Lamesa* primarily depended upon the role played by the Dutch holding company. Whilst it is true that the Australia-US DTA had comparable articles to the Australia-Netherlands DTA, the whole point of the Dutch company was to shelter the Australian profit from US corporation tax. As noted above, the US CFC regime (subpart F) did not apply. The Dutch holding company could play the role of a classic "dividend trap".

An understanding of the "participation exemption" will provide a useful insight into this aspect of international tax planning. Because of the extensive Dutch treaty network, countries such as the Netherlands are, everything else being equal, superior to classic tax havens such as the British Virgin Islands, Bermuda or the Cayman Islands.

In addition to the participation exemption there are a number of aspects of the Dutch tax system which could be of interest to a New Zealand parent company with Australian investments. These include:

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[44] Michael Edwardes-Ker, *Tax Treaty Interpretation, the International Tax Treaty Service* (London, Indepth Publishers, 1997 update) paragraph 58.02.

[45] Ian Gzell QC, "Treaty-shopping" (June 1998) Vol 27 *Australian Tax Review* pp 65-78.

- ?? an extensive network of double tax agreements,
- ?? no withholding tax on interest payments,
- ?? no withholding tax on royalty payments,
- ?? no withholding tax on dividends where the European Community (EC) parent-subsidiary directive applies, and
- ?? the ability to obtain an advance ruling from the Dutch revenue authorities.

These are some of the reasons why Dutch holding, finance, and royalty companies are becoming a common feature of international tax structures.

For example, under the Netherlands' treaty network, the rate ofwithholding tax on dividends varies between nil, 5%, 10% or 15%.[46] In respect of interest and royalty payments the withholding tax rate is nil where the shareholding qualifies for the participation exemption and the shares form part of a company whose activities are carried on in the Netherlands.

16.3 The Netherlands participation exemption

One of the main advantages of the participation exemption is that dividends received by a Dutch company from an equity participation in a foreign company are exempt from Dutch corporation tax. The underlying philosophy is that dividends, which are paid out of profits that have already been subjected to corporate tax, should not be taxed a second time. Furthermore, the exemption also applies to capital gains realised on the disposal of the shares in the foreign subsidiary.

To qualify for the participation exemption the following conditions must be satisfied:

- ?? The participation must be at least 5% of the nominal paid up share capital of the participant.
- ?? The participation may not be held as inventory or trading stock.
- ?? The profit derived by the foreign participant must have been subject to a form of income tax levied by the foreign state.
- ?? The participation must not be held by the Dutch company solely as a "portfolio" investment, which means the Dutch company should generally conduct business that is considered as an extension of its parent company's business.

Furthermore, it is possible to obtain an advance ruling that determines whether the shareholding in the foreign subsidiary is held as a portfolio investment or as a current asset and whether the shareholding qualifies for the participation exemption. The advance ruling will last for four years with an option to renew it for a further four year period.

16.4 Netherlands-Antilles

It is no coincidence that multinational structures often incorporate a Netherlands Antilles entity. That company is designed to reduce Dutch withholding tax on the repatriation of the profit from the Netherlands to the ultimate holding company. In

[46] J Von Haaren, "Netherlands" in *Guides to European Taxation: the Taxation of Companies in Europe,* ed. J Kesti (The Hague, International Bureau of Fiscal Documentation, October 2001) p 421.

the context of Trans-Tasman profit repatriation (where the objective is to maximise home country taxation thereby creating shareholder credits) the reduction of all foreign taxes is an important feature of the structure.

A key feature of the Netherlands-Antilles domestic law is that dividends received from foreign participations are taxed at one-tenth of the corporation's normal tax rate, provided the profits on which the dividends are sourced have been subject to tax in the country of origin. Generally speaking, a participation is defined as a shareholding that is not held as a portfolio investment. The primary test is that a shareholding will qualify as a participation if it constitutes 10% or more of the share capital of the foreign company.

Under the Netherlands-Antilles DTA[47] the rate of withholding tax is 5%. Consequently the total withholding tax in the Netherlands, and corporate taxation in the Netherlands-Antilles, amounts to approximately 8%. On 7 September 2001, the Dutch under-secretary of Finance, Wouter Bos, announced that a Bill to amend the tax agreement for the Kingdom of the Netherlands (which is the tax treaty between the Netherlands, the Netherlands-Antilles and Aruba) would adjust the effective total tax burden to 8.3%.

16.5 The Danish participation exemption

Danish Holding Companies – A Tax Paradise in International Tax Planning[48] is the title of a recent article that extols the virtues of the new Danish holding company regime which took effect on 1 January 1999. The main advantage that the Danish regime has over a typical Dutch-Netherlands-Antilles structure is that Denmark has abolished dividend withholding tax. Under the new regime, Danish holding companies can receive dividends free of Danish tax even if the dividends are sourced from a tax haven subsidiary. Furthermore, there is no Danish dividend withholding tax on any dividend paid to the foreign parent company, even if it is also located in a tax haven. The only restriction is that the Danish holding company must not constitute a "financial company".

One Danish legal adviser predicted that:

> *Many multinationals from the United States, Japan, Canada and many other countries will be looking closely at Denmark. So, too, will all investors investing via tax havens into countries with a dividend withholding tax. As a consequence of the latter group investing via Denmark, it is expected that the majority of investments held in Netherlands-Antilles owned Dutch holding companies will move from the Dutch company to a Danish company. This is expected to cost the Netherlands and Netherlands-Antilles hundreds of millions of dollars. Not only will the new law have a very significant impact on the Netherlands-Antilles and the Netherlands, but it will also be noticed in Switzerland, Belgium, Luxembourg, Cyprus and Malta.*[49]

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[47] For further information see PricewaterhouseCoopers "Corporate Taxes 2001-2002 Worldwide Summaries" John Wiley & Sons pp 568-577.

[48] (2001) [Online]. [Cited 21 September 2001]. Available from: www.hallerup.com/dokumeter/nyheder/Danish%20Holdings%20Companies.htm.

[49] Sheltons-International Tax Counsel. 2001. *The Danish Holding Company* [Online]. [Cited 21 September 2001]. Available from: http://www.enbfn.com/arts/shelton.htm pp 1-17 at p 8.

The following is a summary of the balance of the above article.[50]

In view of Denmark's extensive treaty network, and everything else being equal, a Danish holding company would have considerable attraction in view of the fact that the treaty network reduces the rate of dividend withholding tax to nil in respect of qualifying companies.

The main restriction is that the dividends must not be derived by a "financial company". At first sight this appears to constitute a significant restriction because a financial company is defined as an entity which earns at least 33.33% of its gross income in the form of financial income or whose assets are at least 33.33% financial assets. Financial income is defined as income from interest, dividends, royalties, real estate, lease premiums, insurance premiums and any profit on the sale of financial assets. The sale of financial assets is defined as assets which create financial income.

However, there is an important restriction known as the "same country holding company."[51] In the context of Trans-Tasman investment structures, the exemption would apply to a structure whereby a Danish company owned an Australian holding company which in turn owned a second Australian company. The top tier Australian company would constitute a financial company but if the second tier Australian company was an operating company, then the top company is consolidated with the operating company and the tests are applied to the consolidated group's income. Provided a member of the consolidated group is earning sufficient active income, the structure would not constitute a "financial company".

The only apparent downside of a Danish holding company is that the exemption from Danish capital gains tax only applies if the Danish subsidiary has held its 25% shareholding in the subsidiary for at least three years. The comparable Dutch provision provides that the participation is based on a minimum shareholding of 5% and there is no three-year time limit.

In the context of Trans-Tasman repatriation strategies, there appears to be an advantage in incorporating a Danish holding company into the structure because of the lower effective tax cost, compared with an 8.3% rate associated with a Netherlands, Netherlands-Antilles structure.

17. WAYS TO COMBAT TREATY SHOPPING

17.1 Introduction

According to Gzell[52], treaty shopping has only become a problem for Australia since the 1980s. He notes that a 1978 study of international tax avoidance (Rotterdam Report) contained only one short mention on the abuse of tax treaties. However, by

[50] For further information see PricewaterhouseCoopers "Corporate Taxes 2001-2002 Worldwide Summaries" John Wiley & Sons pp 568-577.

[51] Sheltons-International Tax Counsel. 2001. *The Danish Holding Company* [Online]. [Cited 21 September 2001]. Available from: http://www.enbfn.com/arts/shelton.htm pp 1-17 at p 10.

[52] I V Gzell, "Treaty protection from capital gains tax" (March 2000) Vol 29 *Australian Tax Review* pp 25-49.

1987, treaty shopping had become more fashionable. In 1987, the OECD Committee on Fiscal Affairs published a series of reports on international tax avoidance and evasion. The third report, *Double Taxation Conventions and the Use of Conduit Companies,* analyses a number of ways in which treaty shopping could be countered. They include the following.

17.2 Domestic law solutions - Australia

One possible solution would be for a country to rely on its general anti-avoidance rule (GAAR). However, care must be taken in the drafting of such a provision to ensure that it correctly encompasses the essential mechanisms whereby double taxation is eliminated under a DTA. The Australian experience demonstrates a GAAR will often not apply because it is directed towards domestic tax avoidance arrangements.

The Australian general anti-avoidance provision was inserted into the 1936 Act as Part IVA. What would have happened if the ATO had attempted in *Lamesa* to argue that the imposition of the Dutch company between the US special partnership and ARL in Australia (top tier company) should be ignored on the grounds that it constituted a scheme? The ATO would have presumably argued that a direct investment would not have created the tax advantages applicable under the Australian-Netherlands treaty. For the purposes of argument only, it must be assumed that there are no comparable provisions in the Australia-USA DTA.[53]

However, Part IVA of the 1936 Act only applies to a scheme that produces a tax benefit, as defined. The only type of benefit which could apply is defined in s177C(1)(a) which refers to an amount which is not included in the taxpayers assessable income, which, but for the scheme, might reasonably have been expected to be included in the taxpayers' assessable income.

The issue becomes whether the scheme created a benefit which was comprised of an exclusion of the $A200m profit from the Dutch company's assessable income. The answer is clearly no because the facts in *Lamesa* disclosed that the profit was taxable under s25(1)(b) of the 1936 Act. However, the effect of the Australia-Netherlands treaty was to eliminate Australia's prima facie right to tax the profit under that provision. The scheme did not create an exclusion from assessable income for the purposes of Part IVA of the 1936 Act.

Under Australian domestic law, the profit from the sale of *ARL Ltd* was **included** in the taxpayer's assessable income but, under the Australian-Netherlands DTA, Australians' right to tax that income was repealed. In other words, the treaty did not operate upon the taxpayer's assessable income. Its effect was to limit the ability of the ATO to impose income tax under Australian domestic law.

17.3 Do Treaties over-ride the New Zealand position?

If double tax treaties were to over-ride New Zealand domestic law, they could prevent, or at the very least limit, the application of any subsequent legislation which was designed to prevent treaty shopping.

[53] Clearly this is not the case because Article 7 and Article 13 of the Australia-USA DTA achieve the same effect as the comparable provisions in the Australia-Netherlands DTA.

Section BH 1 of the Act outlines the relationship between a DTA and New Zealand domestic law. The general principle is outlined in section BH 1(3) that provides that a DTA shall have effect notwithstanding anything in the Act or in any other enactment. Similar provisions are contained in Australia which, via the Income Tax (International Agreements) Act, incorporates into Australian domestic law the impact of a DTA.

However this principle is limited when domestic legislation is subsequently enacted that is clearly intended to over-ride the DTA. The doctrine of parliamentary sovereignty prevails. Given the similarity between subpart BH of the Act, and the comparable United Kingdom provision, the decision of the House of Lords in two well known cases effectively means that New Zealand could enact legislation to prevent treaty shopping and it would be given effect despite any contrary provision in a DTA.

17.4 *Collco Dealings Ltd v IRC* [54]

This case concerned a dividend-stripping scheme which was designed to take advantage of the UK-Irish DTA. After the treaty was entered into, legislation was enacted to limit the impact of dividend-stripping arrangements. The House of Lords correctly held that where the legislation was unambiguous it must be given effect even if it was contrary to international law. The anti-dividend-stripping legislation applied to all shareholders, including an Irish shareholders, even if its application resulted in a breach of the UK-Irish DTA.

17.5 *Woodend (K V Ceylon Rubber & Tea Co Ltd) v IRC*[55]

The DTA between United Kingdom and Ceylon contained a non-discrimination article. Subsequently, the Ceylonese Legislature imposed a tax on certain remittances by resident companies, and the legislation appeared to conflict with the relevant provision in the DTA. The Privy Council held that the legislation prevailed because it was intended to tax all remittances, including those paid to United Kingdom residents.

17.6 Domestic law : a specific GAAR

In 1997, s894 was introduced into the *US Internal Revenue Code*. That provision effectively provides that reduced treaty rates under US DTAs will only apply if the payment to the entity is treated as income derived by a resident of the applicable treaty country, the resident is the beneficial owner of the income, and all other requirements under the treaty are satisfied.

There was extensive US authority which established that this type of unilateral action would override USA's international treaty obligations.[56]

17.7 Bilateral solutions

According to Gzell,[57] the USA inserted into a number of double tax treaties a general provision[58]. The provision allows that any reduction in the rate of source country tax

[54] *Collco Dealings Ltd v IRC* (1961) 1 All ER 762 HL.

[55] *Woodend (K V Ceylon Rubber & Tea Co Ltd) v IRC* (1970) 2 All ER 801 PC.

[56] Ian Gzell QC, "Treaty-shopping" (June 1998) Vol 27 *Australian Tax Review* pp 69-70.

[57] See n 56, pp 69-70.

[58] See n 56, p 70.

on dividends, interest or royalties will not apply if the recipient pays less than the general rate of corporate tax and is not owned to at least 75% by individuals who are resident in the other contracting state.[59]

In the case of the Australia-USA Treaty, there is a similar Article that contains an additional requirement that the shares are traded on a recognised stock exchange.

A complicated example of the US stance against treaty shopping is article 26 of the 1992 USA-Netherlands Treaty. This article has formed the basis of subsequent USA DTA negotiations.[60] Article 26 contains a number of tests, one of which must be satisfied. In the case of a company which derives income from the United States, it is only entitled to the reduced treaty rates if the principal class of its shares are listed on a recognised stock exchange located in either state, and the shares are substantially traded on one or more recognised stock exchanges.

There are a number of exemptions from this test. An important one is the activity test which provides that the reduced treaty rates are available if the substance of the business operations in the country of residence and the income in the country of source are connected to an active business.

Secondly, the treaty benefits will still be available if the company is a headquarters company for a multinational corporate group.

17.8 The New Zealand experience

To date, New Zealand has not sought to insert any anti-treaty shopping provisions into its DTAs. The latest DTA (New Zealand-Russia signed on 5 September 2000) does not contain any similar provisions to those which have been inserted by USA into its treaty network. It would appear that treaty shopping is not seen as a threat to the New Zealand tax base. However, the facts of *Lamesa* clearly demonstrate that the underlying methodology can be exported and readily used against the New Zealand tax base.

18. CROSS-BORDER LEASING

18.1 Background

The specified lease regime was introduced by the Muldoon administration as part of the August 1982 Budget. The regime was designed to close down two perceived forms of tax avoidance. The 1981 Budget achieved this through two methods. Finance leases were used to circumvent the $10,000 cap on the depreciation base of motor vehicles. Finance leases also provided the ability to obtain a full deduction for prepaid lease payments. Secondly, the regime was introduced to prevent the practice of loss companies selling depreciation deductions which circumvented the loss carried forward and grouping provisions which are now contained in Parts IG and IF of the Act.

[59] Trinidad, Norway, Iceland, Korea, Morocco, Egypt, Malta, United Kingdom.

[60] Treaties with the Slovak Republic, Kazakhstan, Sweden, Turkey, Austria, Thailand and South Africa.

18.2 Cross-border implications

The new part FC 8A – 8I and its associated definitions do not alter the substance of the cross-border implications of leasing an international asset into New Zealand.

In the context of Trans-Tasman tax reform, this regime provides Australian companies with a simple method of reducing New Zealand tax to either 1.34% or zero, and a corresponding increase in Australian company tax.

18.3 The re-characterisation regime

The 1982 legislation and the current regimes re-characterise the ownership rights of the lessor and the lessee. Under a finance lease, and the old specified lease, the lessor was not treated as the legal owner. The lessee was deemed to be the legal owner of the asset and the lessor was deemed to be a financier. The provisions apply notwithstanding anything else in the Act, and therefore the specified lease regime was a complete code which governed the taxation consequences of that type of lease. The old Section FC 6 and the new Sections FC 8A, 8F and 8G deem the following to have occurred for tax purposes:

?? the lessor is deemed to have sold the lease asset to the lessee,

?? the lessee is deemed to have purchased the asset for a price equal to the lessor's cost price of the asset,

?? the lessor is deemed to have financed the sale to the lessee by way of a loan to the lessee equal to the cost price of the asset,

?? the lessee is deemed to have used the loan to purchase the asset,

?? the lessor is specifically denied a deduction for depreciation in respect of the asset,

?? only the lessee is entitled to the available depreciation deductions,

?? the income of the lessor is deemed to be interest in respect of the loan made to the lessee, and

?? the lessee is deemed to have incurred interest expenditure equal to the deemed interest income of the lessor.

18.4 The definition of a lease asset

This definition is used for both regimes. It is defined in section OB 1 as:

> *Any personal property which is subject to the lease, but does not include any livestock or bloodstock.*

The specified lease regime only applied to personal property and could not cover a lease involving land. However, in practice, this restriction has not seriously curtailed the scope of the regime. For example, if the subject matter of the lease consisted of plant and machinery, only the external shell of the building and land would be excluded from the transaction.

18.5 The definition of a specified lease

This was defined in section OB 1 as, *inter alia,* any lease with a guaranteed residual value. The old specified lease regime was therefore purely optional because taxpayers could enter the regime by including in the lease a guaranteed residual value (GRV) of $1.00.

18.6 The definition of a "finance lease"

The definition of a "finance lease" is narrower than the old definition of a "specified lease", and therefore it may be more difficult to bring an asset into the regime. The test is whether:

?? the lease asset is transferred to the lessee at the end of the term, or

?? the lessee or an associate has an option to purchase the lease asset at below market value, or

?? the lease term is for more than 75% of the asset's estimated useful life.

In the case of previous specified leases involving infrastructure assets the method of making them into specified leases was to insert a GRV. However the first two tests appear to be capable of manipulation to ensure the lease is treated as a finance lease.

18.7 Guaranteed residual value

Paragraph (a) of the definition of "specified lease" referred to a lease which had a GRV. That term was defined in section OB 1 as an amount which was agreed on as the value of the asset at the expiry of the lease. Secondly, the lessee guaranteed to pay that amount to the lessor. A GRV was designed to cover the risk of technical obsolescence associated with many assets which were leased by a financial institution that was not prepared to carry the risk that, at the expiry of the lease, the market value of the asset was less than the outstanding loan balance. The financial institution did not wish to take possession of the leased asset (at the termination of the lease) because of difficulties in disposing of the asset. Given that in many cases the market value of the asset was difficult to determine, the lessee was required to guarantee a minimum value for the asset, binding the lessee to pay the difference if the asset sold for less than this sum. Invariably the GRV equalled the amount of the outstanding loan.

It was a relatively simple exercise to circumvent that provision. If the lessor's residual value was guaranteed by a third party then that guarantee would not fall within the definition of a GRV as defined in section OB 1 because it was not guaranteed by the lessee.

This concept is still important because the new section FC 8B(3)(a) refers to a GRV.

18.8 Non-resident withholding tax

In view of the approved issuer levy regime, there are clear advantages in structuring a cross-border lease as a specified lease. This will ensure that the lessor can take advantage of the deemed income stream (in the nature of interest) which will qualify for the favourable AIL treatment. However, it is possible for an Australian company to implement a treaty shopping structure to avoid the cost of the AIL regime. The solution is to use the Dutch DTA.

18.9 The impact of double taxation agreements

In many of New Zealand's DTAs there is an unresolved tension between the royalty article and the interest article because the royalty article often includes payments for the use of industrial, commercial and scientific equipment.

Furthermore, a number of New Zealand's DTAs include in the interest article a reference to income which is assimilated to income from money lent under New Zealand's domestic law. This type of terminology is clearly a reference to the finance lease and old specified lease regime. It would enable New Zealand to tax the deemed interest income at the higher treaty rate in any case where the lease does not qualify for AIL approval (which in practice is extremely unlikely).

The Australian DTA illustrates these principles. In the case of large cross-border leases, AIL can be a significant tax cost which can be solved via the Dutch DTA.

18.10 The 1995 Australian DTA

Article 7 contains the general rule. An Australian enterprise is only subject to tax in New Zealand if the activity constitutes a permanent establishment. Article 5 defines the term "permanent establishment" as including, *inter alia,* substantial equipment that is used in New Zealand by, for or under contract with an enterprise of New Zealand. Consequently, there is no treaty relief available under Article 7. However this leaves open treaty relief for interest or royalty income.

Article 11(3) does not provide any effective relief because the term "interest" is defined as including "all other income assimilated to income from money lent by the law, relating to tax, of [New Zealand] in which the income arises".

18.11 The Impact of the Netherlands DTA

18.11.1 Article 5

Article 5 provides that a Dutch lessor is deemed to have created a permanent establishment in New Zealand if substantial equipment is in New Zealand for more than 12 months, and the equipment is linked to the exploitation of natural resources.

18.11.2 Commentary on Article 5 of the definition of a PE

In what circumstances will the presence of a lease asset, which is not linked to natural resources, in New Zealand create a PE? The answer is contained in paragraph 8 of the OECD commentary on Article 5 (which discusses the concept of a PE). This paragraph provides that where an enterprise of the Netherlands leases industrial, scientific or commercial equipment, without maintaining any facilities or a fixed place of business, the "lease facility, industrial, commercial, scientific (ICS) equipment, building or intangible property will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment".

This remains the case even when, for example, the lessor supplies personnel (after installation) to operate the equipment provided that the responsibility of the lessor is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities that include for example, participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain

the equipment under the responsibility and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute a PE.

However, Article 7 of the Dutch DTA provides that if any other articles also apply to the same income, then those articles will override the positive impact of Article 7. Accordingly, it is necessary to ensure that neither the interest nor royalty articles apply. If that is the case, then the Dutch lessor is entitled to treaty relief which means New Zealand cannot impose AIL.

18.11.3 Article 11 (interest)

Article 11(5) effectively creates treaty relief because it defines the term "interest" for the purposes of the treaty in a manner which cannot be interpreted as including deemed interest income. For treaty purposes, "interest" is defined as income from any "debt claim" which includes mortgages, bonds, debentures, etc. etc.

All commentators agree that the deemed interest is not interest for the purposes of the Dutch Treaty. A similar conclusion applies in the case of royalties but the analysis is slightly different.

18.11.4 Article 12 (royalties)

This definition is similar to the definition contained in the 1995 Australian DTA. The Dutch definition refers to a payment for, *inter alia,* the right to use any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience. This Article would clearly encompass a Trans-Tasman cross-border lease and, *prima facie,* New Zealand would have a right to tax the deemed interest income.

18.11.5 Protocol

The Dutch Treaty is unusual in that a protocol was added to it shortly after it came into effect on 15 October 1980.

Protocol (ix) amends article 12 by providing that a payment for the use of scientific or commercial equipment is deemed to constitute income which is subject to Article 7 (business profits) unless the payment is:

> *...based on production, sales, performance or any other similar basis related to the use of the said equipment.*

Any cross-border Australian/Dutch lease which provides that the lessor will, for example, pay the stipulated lease rental on a "take or pay basis", irrespective of the actual use of the lease asset, will satisfy the requirements of paragraph (ix) of the protocol. Accordingly, the deemed interest income of the lessor falls outside the scope of Article 12 and New Zealand cannot impose tax under its domestic law.

18.12 Conclusion

Given that a carefully drafted cross-border lease will not create a permanent establishment in New Zealand, it follows that a Dutch lessor would qualify for treaty relief on the grounds that it has not created a PE in New Zealand and neither Article 10 or Article 12 apply. Consequently, the New Zealand lessee is not required to pay AIL.

19. CONCLUSIONS

19.1 The legacy of history

The current imputation regime discriminates against individual New Zealand shareholders who have invested in Australian companies which in turn derive New Zealand-sourced income. Triangular taxation is a feature of, *inter alia,* the banking and insurance industry which are dominated by companies like ANZ, AMP, AXA, NBA, Tower and Westpac. The two previous attempts to solve the problem have failed.

Triangular taxation is not an accident of history. The current dilemma is the direct result of a series of deliberate policy choices made in 1987 and 1988 which were discussed in numerous reports from the Consultative Committees that examined, *inter alia,* the design parameters of the current imputation and international tax regimes. Those reports consistently alluded to the risk to the New Zealand tax base of permitting imputation credits to flow through to New Zealand shareholders via dividends received from non-resident companies which had received a dividend sourced from their New Zealand subsidiary.

The commercial world has changed since 1987. Companies such as BIL and Lion Nathan are no longer New Zealand residents, and Australia is not a tax haven.

19.2 The best solution

The best alternative, from a New Zealand individual shareholder's perspective, is streaming. However, this has been rejected by both governments who prefer the pro rata allocation solution. If the latest initiative fails to produce a feasible solution, the problem will not go away. Trans-Tasman companies will continue to devise strategies that provide *ad hoc* solutions that reflect the commercial environment within which they operate.

19.3 Behavioural implications

The binding rulings obtained by ANZ and Westpac highlighted the kinds of commercial solutions which are likely to become more prevalent if the pro rata allocation model becomes law. There are numerous other debt/equity solutions which will often appeal to companies who do not need to raise additional capital.

The "deficiencies" in Australian pre-CGT treaties clearly demonstrate how it is possible for New Zealand resident companies to put in place tax effective investment strategies that enable them to reduce the creation of Australian franking credits. *Lamesa* structures are a good example of how Trans-Tasman companies can exploit any loopholes in domestic and international tax law to alleviate the negative impact that the current tax regimes have on their individual shareholders.

Finally, New Zealand's existing network of DTAs does not contain any articles which would prevent Australian companies from taking advantage of employee secondment structures, or cross-border leasing. Given the limited appeal of the pro rata allocation

model, it is highly unlikely that the preferred solution will lead to any significant reduction in the pursuit of Trans-Tasman corporate tax solutions to the problem of double taxation which was deliberately created to prevent NZ companies trying to circumvent the CFC and FIF regimes. That horse has already bolted, yet the stable door still remains firmly locked.

David Dunbar, 01 June 2003.