TRANS-TASMAN TRIANGULAR TAXATION RELIEF
Part One

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INTRODUCTION

In March 2002 the finance ministers of New Zealand and Australia released a joint discussion document on trans-Tasman triangular taxation. The proposals represented are a significant step towards addressing one of the major taxation barriers to trans-Tasman investment. The discussion document invited interested parties to present submissions by 3 May 2002. This article examines:

- The origins of triangular taxation.
- The merits of the New Zealand and Australian government's joint proposal (called "The Pro rata Approach to Triangular Taxation").
- An alternative solution.
- Ad hoc solutions.

From the perspective of trans-Tasman individual shareholders, the pro rata proposal is an improvement compared to the current position, but it is not the optimal solution. From their perspective the most tax effective option is what is known as the "full streaming" solution. However both governments are concerned about the fiscal risks of the streaming alternative and the fact that it might signal a greater acceptance of streaming which is not the case.

WHAT IS TRIANGULAR TAXATION

a) Introduction

A triangular investment occurs when an investor resident in Australia or New Zealand invests in a company resident in the other jurisdiction that earns income and pays tax in the investor's home jurisdiction. When these investors receive dividends they are unable to obtain a credit for tax that has been already been paid in their home country. This results in triangular income being taxed twice; in the country in which it is derived and again in the hands of the investor. This is a major disincentive to trans-Tasman investment and has led to the development of structures to circumvent the problem.

b) From a New Zealand shareholder's perspective triangular taxation can occur in the following scenario

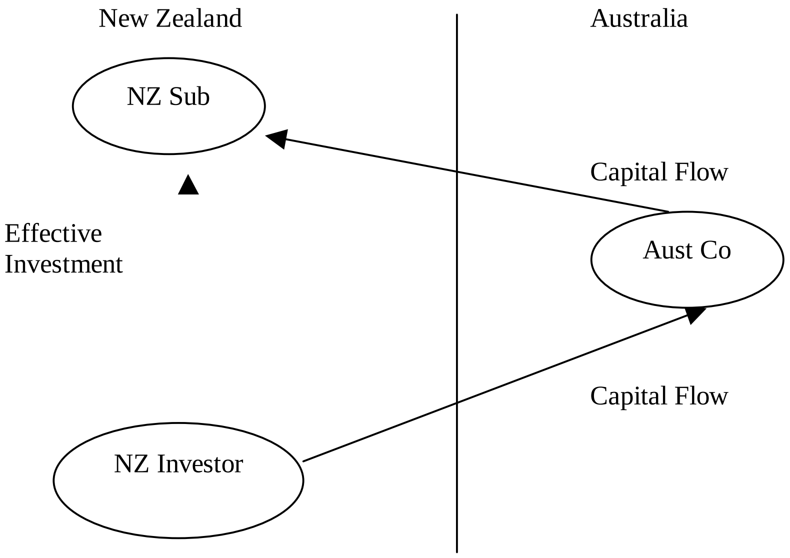

Diagram 1: Triangular investment

c) Triple Taxation

For simplicity the following calculations assume a 30% tax rate in both Australia and New Zealand.

Table I: Triple Taxation

New Zealand Subsidiary Company	*%*
Profit	100
NZ Company Tax	(21)
Dividend	79
Non-Resident Withholding Tax @ 15% [FITC]	(12)
Cash Dividend to Australian Parent	**67**
Australian Parent Company	%
Cash Dividend	67
Australian Tax	
Australian Non-Resident Withholding Tax @ 15%	(10)
Cash Dividend Paid to NZ	**57**
New Zealand Individual Shareholder	*%*
Cash Dividend	57
Personal Tax on Grossed-up Dividend @ 39%	(26)
Less Credit for NRWT	(10)
After Tax Available Cash	**41**
EFFECTIVE TAX RATE	**59%**

The effective tax rate is 59%. The problem summarised in Table 1 is a serious issue for any New Zealand individual shareholders who own shares in two of the leading Australian financial institutions which play a significant part in the New Zealand financial market, namely the ANZ Banking Group, and the National Australia Banking Group (which purchased the BNZ[1]).

The common theme which underlines Diagram 1 and Table 2 is the unique nature of trans-Tasman investment. A parent company is owned by shareholders on both sides of the Tasman. Secondly, the parent company owns an operating subsidiary on the other side of the Tasman. Thirdly, the operating subsidiary is paying full local corporate tax. Fourthly, the dividend paid by the subsidiary to its parent company is usually not subject to non resident withholding tax (NRWT). Finally, the dividend derived by both groups of shareholders does not contain a tax credit for the corporate tax paid by the operating subsidiary. It is one of the ironies of the closer economic relations (CER) agreement that any "local" parent company who wishes to become an Australasian player will reward its shareholders with a punitive tax bill that is totally inconsistent with CER.

d) A hypothetical example of a New Zealand company

The seriousness of this problem is illustrated by what would happen if a hypothetical New Zealand brewer expanded into Australia. Let us assume that Lager Limited is a company paying New Zealand company tax at 33 percent and that it pays a fully imputed dividend to, inter alia, its individual New Zealand shareholders. Assume that Larger Limited is also producing beer for export into a highly competitive global market. The company identifies an opportunity in the Australian market. It merges with an established Australian beer manufacturer to exploit that opportunity. To fund the merge a new parent company (Super Lager) is formed which is listed on the Australian and New Zealand stock exchanges. As is so often the case, the parent company is based in Australia and the original New Zealand shareholders now hold shares in Super Lager. Despite the fact that the merger was fundamental to the long term viability of both the pre-merger companies and the clear benefits to the respective national economies, the New Zealand shareholders are rewarded with an increased tax liability from 33 percent to 59 percent. This occurs despite the fact that the same amount of New Zealand company tax is still paid and the New Zealand shareholding remains intact. Clearly something is wrong with both countries tax systems.

[1] Two financial institutions have sought to overcome this problem via the floatation of a separate subsidiary. In the Inland Revenue Department's Technical Information Bulletin (TIB) the details of the recent $800 million Westpac float are outlined, (IRD TIB Volume 11 No 10 (November 1999) pp7-12).

The New Zealand resident shareholders can argue with considerable justification that local New Zealand tax should be able to be attached to dividends paid to inter alia resident individual New Zealand shareholders. There is a prima facie case for arguing that such an outcome is consistent with the objectives of New Zealand imputation system. It is important to note that the New Zealand shareholders are not asking for any credit to be given to them for the Australian company tax paid by Super Lager. Their case is based solely on the fact that there is local tax paid, there are local shareholders and there is no apparent reason for preventing those shareholders receiving an imputation credit for the local company tax.

THE NEW ZEALAND TAX SYSTEM

a) Imputation Regime

Diagram 1 identifies a problem which only arises when a New Zealand or Australian company derives income sourced from the other country.

In the case of a domestic New Zealand company which does not derive any foreign sourced income, the tax paid at the company level is attached (imputed) to the after tax dividend paid to the New Zealand resident shareholder. The imputation credit and the cash dividend are included in the shareholder's gross income, and subject to tax at the shareholder's marginal rate. The shareholder claims the company tax as a credit against their personal tax liability. Depending on the shareholder's marginal rate, this will either result in additional tax to pay (39% marginal rate), no extra tax to pay (33% marginal rate), or a "refund" (19.5% marginal rate) of the surplus imputation credit of 13.5% in the form of a tax loss. Clearly the company's income is only taxed once.

Table 1 demonstrates how the New Zealand imputation system applies when inter alia a foreign parent company is interposed between the New Zealand resident shareholder. The key point to note is that the company tax paid by the New Zealand subsidiary does not create any imputation credits for the ultimate New Zealand individual shareholders. This outcome is no accident of history. It was a deliberate policy choice when New Zealand introduced a full imputation regime.

b) Tax havens

New Zealand officials have consistently adopted the view that one effective method of preventing a New Zealand resident company from changing its tax residence to a tax haven would be to create a significant tax cost for its New Zealand resident individual shareholders. This concern was adopted by the report of the Consultative Committee on *International Tax Reform Part I March 1988*. The Committee explicitly stated there is a need:

> "to discourage resident companies from 'going offshore', by penalising their New Zealand resident shareholders … Furthermore, the tax advantages are not one sided since the restructured company would lose the ability to pass imputation credits for New Zealand tax paid through to its resident shareholders. In addition, non-resident dividend withholding tax on dividends paid out of New Zealand and dividend withholding payments on income dividends might also be incurred."[2]

In April 1988 the same Committee issued their report on *Full Imputation*. A similar concern was noted at pages 53-54 of that report. After acknowledging that there was a clear link between the international tax regime and imputation, the Committee referred to submissions which argued that a non-resident company should in certain circumstances be able to pass on imputation credits for tax paid in New Zealand to its New Zealand shareholders. The Committee was referring to a scenario which has since occurred in the banking industry. The Committee noted that from an imputation perspective, there is no policy reason to prevent for example NAB/BNZ passing imputation credits on to its New Zealand resident individual shareholders. In opposing those submissions, the Committee reiterated their concerns expressed in the earlier report.[3]

c) The current level of Trans-Tasman Investment

There may have been some merit in the fear of tax havens when imputation was first introduced in 1989. The recent corporate migration of Brierley Investments Limited (BIL) to Singapore, and the simultaneous tax migration to Bermuda, demonstrates that these concerns are only valid so long as there is a significant New Zealand owned shareholding in the relevant company. Another well known example of the futility of this approach, is the recent migration by Lion Breweries to Australia following the "take-over" by Kirin Breweries.

Furthermore, the level of trans-Tasman investment has changed significantly since 1989. The BNZ was sold by the then Government to NAB in the early 1990's. Other former government departments or state owned enterprises (SOE's) such as Air New Zealand and Telecom have made significant investments in Australian companies, along with public companies such as Lion Nathan, Goodman Fielder Wattie, Tasman Properties, etc. The recent

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[2] p 33-34, para 3.2.3-3.2.4

[3] "The imputation system and the international tax reforms need to be mutually consistent and reinforcing. A non-resident company could 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" (para 4.2.2-4.2.3).

demutalisation of the insurance industry has left a significant number of individual New Zealand shareholders with investments in trans-Tasman insurance companies like AXA, Tower Corporation and AMP.

d) Summary

What this brief summary of the current imputation and international tax regimes shows is that triangular taxation is not an accident of history. The members of various Consultative Committees which were responsible for designing the main parameters were clearly aware that one of the consequences of their decisions would be the creation of the triangular tax problem.

They were for example concerned about companies such as BIL taking advantage of any attempt to accommodate trans-Tasman companies and their domestic shareholders. However, that corporate horse has already bolted and there would seem to be little point in trying to keep that stable door shut.

OVERVIEW OF THE PROPOSED SOLUTION

a) Pro rata allocation

After considering a number of alternative options (discussed later in the article) the two governments have settled on a relief mechanism known as "pro rata allocation". Under this solution, trans-Tasman companies can distribute both New Zealand imputation credits and Australian franking credits. Both types of credit must be distributed across all shareholders, as opposed to those shareholders who would derive the maximum benefit from the available credits.

b) Commencement date

If the proposed mechanism is adopted, it will mean that trans-Tasman companies will be required to operate memorandum accounts in both jurisdictions which would record imputation and franking credits. Under the proposal a company distributing a dividend will be required to attach both imputation and franking credits, even though a New Zealand resident shareholder could only use the imputation credit.

Clearly this will require trans-Tasman companies to change their existing accounting and information systems. Accordingly, the proposal would apply no earlier than the New Zealand imputation year commencing on 1 April 2003. Imputation and franking credits will only arise in respect of tax paid on or after that date.

c) Conceptual basis of pro rata allocation

The discussion document notes that this method of providing triangular relief was the preferred approach of both governments. The conceptual basis of the joint governmental approach is that pro rata allocation was the only method that apportioned the underlying tax benefits based on the shareholder's ownership in a way which was consistent with both countries current policy on imputation. The conceptual basis of pro rata allocation is the proposition that trans-Tasman shareholders merely have a right to a proportion of the total income derived by their company, as opposed to a specific source of income derived by that company. For example, an individual New Zealand resident shareholder is not entitled to receive a dividend sourced from the underlying net income derived by the New Zealand subsidiary described in diagram 1 and table 1 above.

In the context of the available imputation and franking credits, this principle suggests that the credit allocation mechanism should require a trans-Tasman company that pays a dividend to its trans-Tasman shareholders to attach the same proportion of each type of credit to that dividend. Accordingly, the total New Zealand and Australian tax imposed on the respective shareholders will be consistent with their proportionate share of each source of income derived by the parent company.

The examples contained in the discussion document reflect this principle because the dividend that is distributed to the trans-Tasman shareholders is partly generated from Australian income with Australian tax paid on that income. Accordingly, it would be inconsistent with the imputation regimes of both countries if the dividend derived by an individual New Zealand shareholder merely contained imputation credits with the corresponding franking credits allocated solely to the Australian shareholders.

ALTERNATIVE SOLUTIONS

a) Compliance Costs

The discussion document acknowledges that the pro rata allocation method does not from an individual shareholder's perspective provide the optimal solution. This conclusion is based on the fact that only a proportion of the tax paid in each country is available to the resident shareholders of that country.

Secondly, the proposed solution will result in additional compliance costs for any company that elects to adopt the proposal. For example, the Australian parent company, described in Diagram 1 and Table 1, will be required to maintain an additional memorandum account which would track the imputation credits generated in New Zealand and the attachment of those credits to any dividend paid to its trans-Tasman shareholders. Unless there are significant additional tangible benefits associated with the pro rata allocation method, it is highly unlikely that an Australian parent company would be prepared to accept the inevitable additional compliance costs. One method of measuring the relationship between the additional tax advantages and the inevitable compliance costs, is to contrast the tax consequences of the alternative methods that were rejected by both governments.

b) The optimal solution

The pro rata model is not the optimal tax solution. From a company and shareholder perspective, the streaming of tax credits would provide significant additional benefits that are not available under the pro rata allocation method. If this alternative were adopted, then the Australian parent company and its New Zealand subsidiary would attach imputation credits to any dividend distributed to the New Zealand resident shareholders. Those shareholders would not receive a proportion of the available franking credits. Accordingly, the streaming of credits model does not result in any wastage, that is to say the misallocation of either imputation or franking credits.

There were three other alternatives which both governments considered but rejected. They were:

- Mutual recognition (including pro rata revenue sharing).
- Apportionment.
- Streaming.

c) Mutual recognition

Under this theoretical alternative, there are two possible solutions. The first would involve providing imputation/franking credits for the company tax paid in the other jurisdiction. The second method would involve extending the full benefits of, for example, imputation to individual shareholders resident in Australia. This would be done on a reciprocal basis.

In addition, compensation could be paid to the country that recognised the imputation credit from the country that received the company tax which created the credit.

Under this solution, the New Zealand government would recognise, as a New Zealand imputation credit, a franking credit that was attached to a dividend derived by a New Zealand individual shareholder, and vice versa. Under this solution the New Zealand government, as the resident country, would bear the cost of recognising the Australian franking credit. Accordingly, compensation could become payable to the country that recognised the imputation credit (New Zealand) from the country that received the tax which generated the franking credit (Australia). If this feature did not form a part of this solution, it would mean that the cost of the franking credit would be borne by New Zealand (the country of residence).

At the end of each income year, there would be a wash-up calculation and payment. The two revenue authorities would calculate the total credits claimed by their respective taxpayers and one country would pay to the other the net imbalance. For example, if the New Zealand government had recognised $100m in Australian imputation credits, and the Australian government had recognised $50m in New Zealand imputation credits, then the Australian government would pay to the New Zealand government $50m.

From the perspective of an individual New Zealand residence shareholder, this method would involve each country recognising the other country's imputation credits as if they were its own, but in turn receiving compensation from the other government. This theoretical solution was rejected by both governments because mutual recognition exceeds what was required to solve triangular taxation. One of the main conceptual concerns was that shareholders in either country would receive imputation credits, regardless of whether tax was paid in their respective home countries.

> "Neither government is willing, therefore, to pursue mutual recognition further at this stage."[4]

d) Apportionment

This theoretical solution is similar to pro rata allocation except that the imputation credits are allocated in proportion to the residence of the shareholder and in proportion to the country in which the income was earned. Under the pro rata allocation solution, the credits do not reflect the sources of the underlying income of the parent company.

If the hypothetical parent company in Diagram 1 and Table 1 earned 50% of its income from sources in Australia and 50% of its income from its New Zealand subsidiary, the shareholders would receive 50% of a full Australian imputation credit and 50% of a full New Zealand imputation credit. The solution would be advantageous to the hypothetical New Zealand individual resident shareholders who do not receive any of the New Zealand imputation credits. However, it would create a significant disadvantage to the resident Australian shareholders who currently receive a fully franked dividend from the Australian parent company. Accordingly, this theoretical solution is unlikely to find any support from an Australian parent company with a significant Australian individual shareholding.

Secondly, this method was rejected because it is inconsistent with the current imputation regime of both countries, which provide that imputation/franking credits must be allocated across all shareholders. Thirdly, the current regimes do not recognise different sources of income that are contained in a dividend distribution.

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[4] Joint Discussion Document p15.

e) Streaming

Under this alternative, all tax paid by the hypothetical Australian parent company would be allocated to the Australian shareholders whereas the tax paid by the New Zealand subsidiary would be allocated solely to the New Zealand shareholders in the Australian parent company. From a trans-Tasman shareholders perspective, this is the optimal solution because it does not involve the wastage or misallocation of a proportion of the available imputation and franking credits and is therefore superior to the proposed pro rata solution. It would appear from the discussion document that both governments rejected this alternative because they did not wish to signal that the streaming of available credits was becoming more acceptable.[5] One of the four design features of both country's imputation regimes which have not altered since their introduction, is the principle that credits must be allocated equally to all shareholders irrespective of their ability to utilise the credit. For example, a shareholder on a marginal rate of 19.5 who receives an imputation credit of $33 is not able to effectively utilise the surplus imputation credit, unless they have alternative sources of unimputed income.

AN EXAMPLE OF THE PRO RATA ALLOCATION METHOD

a) A hypothetical example

The example below is based on an example in the discussion document. For simplicity, this example assumes a 30% tax rate in both Australia and New Zealand. Aust Co earns Australian source income, and receives a dividend from its wholly owned New Zealand subsidiary. This example is based on an Australian parent company that owns a wholly owned New Zealand subsidiary. Aust Co is owned by Australian and New Zealand individual shareholders. The shareholding is owned 50% by each class of shareholder. Aust Co earns $2,500 of Australian source income, and receives $1,050 dividend from its New Zealand subsidiary. For the purposes of illustration the effective tax rate in both countries is assumed to be 30%. Finally Aust Co has a 50% distribution policy.

[5] Joint Discussion Document p16 para 3.27

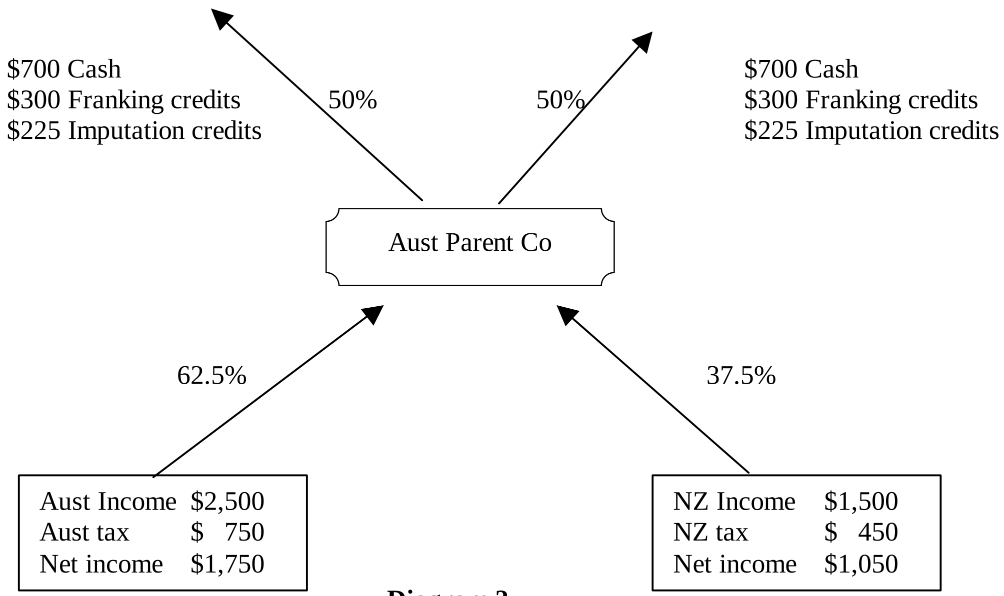

Diagram 2

b) Recording the tax consequences

Aust Co's memorandum accounts will record as follows:

	Franking Account			Imputation Account		
	Dr	**Cr**	**Bal**	**Dr**	**Cr**	**Bal**
Tax paid		$750	$750		$450	$450
Dividend to Aust shareholder	$300			$225		
Dividend paid to NZ shareholder	$300		$150	$225		$0

Table 2

Under the current distribution rules, Aust Co is only able to attach Australian franking credits to the dividend paid to both the Australian and New Zealand shareholders. However, the 50% New Zealand shareholders are not able to effectively utilise the franking credits. Secondly, the available imputation credit cannot be used by either group of shareholders.

Under the pro rata allocation solution, Aust Co could attach imputation credits to the hypothetical dividend. The imputation credits must be attached in proportion to the shareholder. Accordingly, the dividend could have both a franking credit and an imputation credit and consequently could be both fully franked and fully imputed.

c) The shareholder's perspective

The tax treatment for the New Zealand shareholder in the above example before and after the proposed reform is illustrated in the following table:

	Before reform	Pro rata allocation
Cash dividend	$700	$700
Imputation credits	Nil	$225
Franking credit	Nil	$300
Gross income	$700	$925
Tax due @ 39%	$273	$361
Imputation credits	Nil	$225
Franking credit	Nil	Nil
Tax payable	$273	$136
Net dividend	$427	$564
Effective tax rate	57.3%	43.6%

Table 3

This table is designed to illustrate two key features. Although the New Zealand shareholder will receive an imputation and franking credit, they can only use the imputation credit to offset against their personal income tax liability. From a New Zealand shareholder's perspective the franking credit is of no value.

The second key point to note is the impact caused by the 50% Australian shareholding in Aust Co. The New Zealand shareholders are only entitled to receive 50% of the available imputation credits. In this example, there are insufficient imputation credits to fully impute the dividend. Under the full streaming option, it would be possible for Aust Co to pay to its 50% New Zealand shareholders a fully imputed dividend.[6] The inability of Aust Co to pay a fully imputed divided to its New Zealand shareholders explains why the effective rate of tax is 43.6% and not 39%. From a tax policy perspective, both governments believe this is the correct outcome because the dividend was partly generated by Australian source income which naturally were not subject to New Zealand corporate tax. Whilst it is true that the pro rata allocation method does provide an improvement in the after tax return of a New Zealand individual shareholder, it is not (from the shareholder's perspective) the optimal solution.

d) Additional key points

There are a number of additional key points which are not reflected in the above tables and diagrams. These include the following features.

(1) *Flow through mechanism*

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[6] Section ME 8(1) of the Income Tax Act 1996 (the Act) provides that the maximum imputation credit which can be attached to a dividend *assuming* that the company tax rate is 30%, is $^{30}/_{70}$ or 0.4285 of the cash dividend.

The proposed tracking account summarised above, would enable Aust Co to record the payment of New Zealand and Australian company tax, and record the allocation of the available tax credits to dividends paid to shareholders. In the case of an ultimate parent company which proposes to distribute tax paid by a lower tier company (which may or may not constitute a wholly owned subsidiary) it will be necessary for the lower tier company to pay a dividend with the available credit attached. This flow through mechanism is consistent with the current requirements under both the New Zealand and Australian existing legislation.

(2) Creditable taxes

The discussion document contains a significant change to the existing rules. Creditable taxes will, for the first time, also include non resident withholding tax (NRWT) paid in either jurisdiction. For example, if a royalty is paid by the New Zealand subsidiary to the Australian parent company NRWT must be deducted in New Zealand. Under the proposal, Australian companies which maintain an imputation account will be permitted to credit New Zealand withholding tax on interest, royalties, dividends, and non resident contractors withholding tax. However, approved issuer levies will not be creditable to the company's imputation account because it is a liability of the New Zealand resident borrower.

The converse will apply to a New Zealand company which maintains a franking account. Franking credits for dividends, interest, and royalty withholding tax will amount to an extension of the current Australian franking credit regime.

(3) Compliance issues

There will be additional compliance costs for New Zealand and Australian companies which elect to enter the pro rata allocation proposal. They will have to become familiar with the imputation rules of the other jurisdiction and comply with that country's administrative requirements. This could become a significant issue. For example, the recent Australian changes to the definition of "debt" and "equity" mean that instruments which from a New Zealand perspective are eligible for imputation credits may not be eligible for franking in Australia. An example of this type of asymmetrical treatment is redeemable preference shares which will often not be eligible for franking in Australia.

Additional compliance costs will arise from differences between each country's domestic law. For example, the provisions relating to shareholder continuity in New Zealand, exempting companies in Australia, benchmark dividends and anti-streaming rules, contain a number of subtle but significant differences. Finally, the dividend statements provided to shareholders will require amendments to incorporate the respective imputation and franking credit which were previously not disclosed. Accordingly, it is anticipated that any company which elects to adopt the pro rata allocation solution will only do so if the benefits of the additional tax saving outweigh the inevitable additional administrative and compliance costs stuff.

(4) *Foreign currency issues*

In the above hypothetical example, the new tracking account of the parent company (Aust Co) will have to be maintained in New Zealand dollars. Secondly, there are various implications at the shareholder level associated with the conversion of the available credit from its base currency into the other country's currency. The discussion document contains a detailed appendix which outlines three possible options to deal with the problems created by changes in the exchange rate. It is highly likely that the exchange rate on the day a dividend is declared, will be different from the prevailing exchange rate on the day the underlying company tax was paid. How should the inevitable difference be reconciled?

WILL THE REFORMS WORK?

a) Introduction

The pro rata allocation proposal is not the optimal solution (see below). Accordingly it is difficult to predict the extent to which an individual New Zealand and Australian shareholder will benefit. The impact of the proposal will depend on a case by case analysis of the following variables.

b) The dilutionary effect

The hypothetical example analysed above clearly demonstrates that only a proportion of the tax paid is available for distribution. Only 50% of any tax paid in New Zealand is available for distribution to the New Zealand shareholders. However, if the streaming option was implemented, all of the tax paid in New Zealand would be available as a credit against the individual New Zealand shareholder's personal liability.

There are two key drivers that will determine the benefit an investor will obtain from these reforms:

- the dividend distribution policy of the distributing company; and
- the percentage of income derived by that company from the investor's home jurisdiction

There will be additional tax leakage if the percentage of profits distributed exceeds the percentage of profits derived in a particular jurisdiction. As a general rule where the percentage of profits distributed is equal to the percentage of profits received from the other jurisdiction, shareholders should receive a fully imputed dividend. However, in situations where the percentage of profits distributed is significantly higher than the percentage of profits received from the other jurisdiction, shareholders in the other jurisdiction will only receive partially imputed dividends.

The application of this principle is graphically demonstrated in the hypothetical example analysed above. It is not possible for the Australian parent company to distribute a fully imputed dividend to its New Zealand shareholders because of the imbalance in the mix of income reflected in that dividend.

c) Complexity of the proposed Rules

Unless there are significant financial benefits to the individual shareholders, an Australian company is unlikely to adopt this method simply because it will improve the after tax return of its New Zealand shareholders. A major disincentive is the complexity of the proposed rules and the requirement for the Australian company to maintain an additional memorandum account which satisfies all of the New Zealand requirements of its imputation regime.

Furthermore, there is an additional complication arising from the relationship between the way in which relief from NRWT is provided by the respective countries. Australia exempts a fully franked dividend from Australian NRWT. However, New Zealand has adopted a complex method known as the foreign investor tax credit regime (FITC). Under this approach, the foreign shareholder receives a supplementary dividend that is equal to the NRWT which is payable. The advantage of this approach is that it increases the non resident shareholder's available tax credit in the country of residence.

It is not clear from the discussion document how the FITC regime will interact with the calculation of imputation credits which will become available to an Australian company that carries on business in New Zealand via a subsidiary.

One possible way of eliminating any complexity caused by the FITC regime, would be to negotiate a protocol to the New Zealand/Australian double tax agreement (DTA) which recognises the close relationship between the two countries. The protocol would provide for the elimination of withholding taxes on dividend flows between the two countries. An international precedent for this proposal is the recently concluded Australia/United States DTA.

The combined effect of the reduction in imputation credits associated with the pro rata mechanism, coupled with the complexity and related compliance costs associated with adopted the proposal, will limit its appeal. An Australian company that carries on business via a New Zealand subsidiary is not going to be encouraged to adopt these proposals if there are only a small number of New Zealand shareholders which could conceivably benefit. In that scenario, any benefit to the Australian company is marginal and the Australian parent company could well find that the compliance costs exceed any benefit.

VIII. FULL STREAMING

a) Introduction

Table 4 illustrates the operation of the streaming model from the perspective of an individual New Zealand shareholder. They key point to note is that no credits are wasted because all of the imputation credits are attached solely to the dividend distributed to individual New Zealand shareholders. The converse applies in the case of dividends paid to individual Australian resident shareholders who receive all of the available franking credits.

	Before reform	**Pro rata allocation**	**Full streaming**
Cash dividend	$700	$700	$700
Imputation credits	Nil	$225	$345
Franking credit	Nil	$300	$Nil
Gross income	$700	$925	$1,045
Tax due @ 39%	$273	$361	$408
Imputation credits	Nil	$225	$345
Franking credit	Nil	Nil	Nil
Tax payable	$273	$136	$(63)
Net dividend	$427	$564	$637
Effective tax rate	57.3%	43.6%	39%

Table 4

The streaming model is superior to the pro rata allocation alternative, because it provides the maximum benefit to both groups of shareholders and therefore achieves the underlying objective of ensuring that tax is not paid twice on the same income.

b) Why was this model rejected?

The discussion document summarises[7] the three primary reasons why both governments have rejected the streaming alternative.

1 The first reason is the perception that the streaming model provides tax benefits that are disproportionate to the individual shareholder’s interest in the company.

2 The second is perception that this alternative contains a fiscal risk because all of the available imputation credits could be used to reduce an individual shareholder’s New Zealand tax liability.

[7] Pages 16-17, paragraphs 3.25-3.27.

3 A concern that the adoption of the streaming model could be interpreted as a signal that streaming is now an acceptable strategy.

A careful examination of the history of New Zealand's international tax regime and the underlying objectives of the imputation regime strongly suggests that there is very little merit (if any) in the joint government's concerns.

c) Disproportionate benefits

1. The discussion document

The joint government's government concern is

> "Streaming would see all tax paid in New Zealand available to provide imputation credits solely to New Zealand shareholders. Such a model is contrary to Australia and New Zealand's imputation rules as it provides tax benefits to shareholders disproportionate to their shareholding."[8]

2. Maximum imputation ratio

This is not a substantial reason for rejecting the streaming model. Under this model Australian Co is restricted by the amount of imputation credit which it can attach to the dividend. Based on the current corporate tax rate of 33% the current ratio is 33/67. It is therefore not possible for the New Zealand shareholders to receive an imputation credit which exceeds the tax paid by the New Zealand operating subsidiary to the New Zealand revenue authority.

3. A minor distinction

The only difference between the pro rata and streaming models is that the parent company has a choice under the streaming model of allocating either a franking or imputation credit to its respective shareholders. The objective of the streaming model is to eliminate the incidence of double taxation on income sourced from the country in which the shareholder is a tax resident. This laudable objective is entirely consistent with the objectives of the New Zealand and Australian imputation regimes which were introduced to eliminate double taxation. The point which has been overlooked in the discussion document is that New Zealand corporate tax is distributed to New Zealand resident shareholders. There is no attempt to ensure that an individual New Zealand shareholder obtains a credit for Australian company tax in respect of income which was not previously taxed in New Zealand.

[8] Page 10, paragraph 3.25.

d) Fiscal risks

1. The discussion document

The fiscal concerns of the governments are difficult to understand.

> 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. This means that most of the imputation credits allocated could be used to reduce the shareholder's home country tax liabilities.[9]

2. An anomaly in the current law

Both governments are incorrect in their understanding of the streaming model because it will only offset a resident shareholder's domestic tax liability to the extent that underlying corporate tax was paid in that country. When viewed from this perspective it is difficult to see how the streaming model could ever pose a material threat to the New Zealand tax base. The streaming model merely alleviates the wastage of credits which occur under the current imputation regime. The streaming model merely rectifies a deficiency in the current law which is not putting the tax base at risk. By correcting an anomaly in the existing law will ensure that there is consistent treatment between a domestic investment and a triangular investment.

3. An international perspective

At the international level, this model merely streams the available tax credits to the domestic shareholders in the country in which the underlying corporate tax was paid. It does not stream foreign tax credits to shareholders at different rates. The existing anti streaming provisions in both domestic tax systems will still apply thereby preventing any attempt to stream the domestic tax credits.

e) Inconsistent with anti-streaming rules

1. The discussion document[10]

The third and final concern of both governments was that to allow streaming in the context of triangular taxation:

> "Might also signal that streaming of credits more generally is not acceptable. Both governments wish to avoid such a result, as it is still both country's policy that imputation credits should not be streamed and should be allocated across all shareholders."[11]

It is clear that the streaming model is not inconsistent with the imputation regime. The report of the original committee which considered the design

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[9] Page 16, paragraph 3.26.

[10] Page 16, paragraph 3.27.

[11] Report of the Consultative Committee on Full Imputation (April 1988) at page 53.

parameters of the current imputation regime noted that from an imputation policy perspective, there were no policy reasons to prevent the streaming of credits in the case of triangular taxation. For the reasons discussed earlier in this article, the committee rejected the streaming option because of their concern that it could underline the CFC and FIF regimes. The current anomaly merely reflects the historical imperative that major New Zealand corporates such as BIL, should not be in a position to stream imputation credits arising from New Zealand source income to domestic New Zealand shareholders. If that were to occur it could have provided BIL with an incentive to trap offshore income in a CFC, thereby avoiding the impact of those two regimes (which were also introduced at the time of imputation).

2. New Zealand's anti avoidance rule

There are a number of significant provisions in New Zealand domestic law which would prevent the inappropriate use of the streaming model thereby alleviating this concern.

a) The current imputation regime has numerous provisions which are designed to prevent streaming. The first is a restriction against attaching imputation credits to dividends which exceed the maximum imputation ratio (i.e. 33/67). This rule ensures that a company cannot distribute a dividend that exceeds the rate of company tax.

b) The benchmark dividend rule. This test ensure that all distributions contain the same imputation ratio (subject to a ratio change declaration).

c) A continuity of shareholding test. A company cannot carry forward and imputation credit balance where there is a greater than 34% change in shareholding. In other words, a company must maintain at least a 66% continuity of shareholding.

d) Specific rules that prohibit the trading of shares where a purpose (not being an incidental purpose) of the arrangement is to provide a tax advantage to any shareholder. Those provisions are designed to prevent shareholders from buying and selling shares to facilitate the passing of imputation credits to shareholders who are best able to utilise them.

3. Australian anti avoidance rules

a) The Australian legislation contains a number of similar provisions. The maximum franking ratio in Australia is 30/70.

b) The forty-five day holding period requires a shareholder who wishes to qualify for any franking benefits to have held those shares at risk for at least forty-five days prior to the receipt of a franking benefit.

c) Specific rules that are designed to prevent a company from introducing different classes of shares which in substance are identical. This rule is designed to prevent the streaming of franking credits to different legal categories of shareholder.

d) A benchmark dividend rule which provides that any subsequent dividend paid within a six month period must not depart from that ratio by more than 20%.

4. For all of these reasons it is difficult to see why the adoption of the streaming model would give rise to any genuine tax based maintenance issues. The existing rules in both jurisdictions are adequate to prevent the disproportionate allocation of credits.

DOUBLE TAX TREATY ISSUES

a) The model convention

There is clearly a joint New Zealand Australian political commitment to improving the position. To what extent (if any) will the ultimate legislative solution reflect New Zealand existing double tax treaty network.
The OECD model tax convention does not provide any authoritative guidance on mutual recognition of imputation credits. Whether or not the negotiating party should provide imputation credits to non resident shareholders of the other treaty country is left to the negotiation process.

The commentary on article 10 (Taxation of Dividends) suggests there is no consensus on this topic. Despite the absence of any clear guidance some European countries have granted bilateral relief to non resident shareholders. In the Asia Pacific region there is the Malaysian-Singapore experience.

However none of these treaty solutions go anywhere as far, either the pro rata allocation model, or the full streaming option.

b) International precedents

1) The United Kingdom imputation system

According to Harris[12] all dividends paid by United Kingdom companies are prima facie taxable in the hands of all shareholders including non residents. Prior to April 1999**,** imputation credits were available to non residents under numerous United Kingdom double tax treaties. The treaty partner shareholders

[12] Peter A Harris "Corporate Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems" IBFD Publications BU (1996) pp787-788.

were entitled to a refund of imputation credits attached to dividends less NRWT at 15% of the grossed up dividend. In some cases the imputation credit was only available to portfolio shareholders and in other instances it was limited to individual shareholders.

In the case of the New Zealand United Kingdom double tax agreement, Article 11 provides that the United Kingdom can impose tax at the rate of 15% on the gross dividend (including the "imputation" credit, i.e. ACT which was the position up until the repeal of ACT in April 1999.). An individual resident New Zealand shareholder is also entitled to a cash refund.

2) Malaysia and Singapore

Harris[13] contains a useful summary of the Malaysia-Singapore double taxation agreement. In his discussion of the Malaysian imputation system, Harris notes that:

> "Where Malaysian companies distribute income derived from Singapore, they may declare themselves resident in Singapore for the purposes of such distribution. Accordingly, Malaysian companies are subject to Singapore's equivalent of s108 of ITA 1967 with respect to such distributions and Singapore shareholders are entitled to Singapore dividend tax credits."

In his discussion of Singapore's imputation system, Harris notes that:

> "The Malaysian treaty is again worthy of special mention. Under that treaty, where Singapore companies distribute income derived from Malaysia, they may declare themselves resident in Malaysia for the purpose of such distribution. Accordingly, Singapore companies are subject to Malaysia's equivalent of s44 of ITWA with respect to such distributions and Malaysian shareholders are entitled to Malaysian dividend tax credits."

3) Bilateral Issues

Another issue which businesses, policymakers, and politicians must take into account is whether there are any bilateral DTA constraints which would enable other treaty countries to also enjoy the benefits of any trans-Tasman solution. This is an important question because the risk of having to provide similar benefits to the residents of other countries could undermine the latest initiative to devise a trans-Tasman solution.

[13] Ibid p 682, pp 748-749.

c) Non-discrimination clauses

1. Introduction

Irrespective of whatever emerges as the final solution, a potential barrier would be any existing bilateral DTA article which would enable a third party treaty country to enjoy the benefits of the ultimate legislative solution. This could conceivably occur due to non-discrimination and/or most favoured nation clauses in existing DTA.

2. Article 24 of the OECD convention

The non-discrimination clause in the OECD model is contained in article 24. New Zealand has reserved its position on the non-discrimination article.[14] However New Zealand has agreed to include a non-discrimination article in the following DTAs. Generally speaking, it is based on article 24 of the OECD model.

- China (article 24)
- Denmark (article 22A)
- Finland (article 23A)
- India (article 24)
- Ireland (article 25)
- United Kingdom (article 23)
- United States (article 23)

3. Paragraph 1 of article 24

Article 24(1) provides that residents of the other country shall not be subjected in New Zealand to any taxation which is more burdensome than the taxation requirements to which New Zealand residents in the same circumstances are subjected to.

If article 24(1) is read literally, then it could never apply to either solution. In the case of a resident of, for example China or India, it would only apply if those residents were also a tax resident of New Zealand. Article 24(1) does not require New Zealand to apply the trans-Tasman solution to tax residents of other treaty countries.

4. Paragraph 3 of Article 24

In the present context article 24(3) provides that the taxation of a permanent establishment which an enterprise of, for example, China has in New Zealand shall not be less favourably taxed in New Zealand than the taxation levied on enterprises of New Zealand carrying on the same activities.

The commentary makes it abundantly clear that this paragraph is not designed to extend the benefits of an imputation system to non resident shareholders.

[14] Note 2 of the commentary on Article 24.

> "This provision and the discrimination which it puts an end to, relates to the taxation *only of* enterprises and *not* the persons owning or controlling their capital."[15] (Emphasis added)

5. Paragraph 5 of Article 24

This rule provides that enterprises of New Zealand, the capital of which is wholly or partly owned or controlled by residents of, for example, India, shall not be subjected in New Zealand to any taxation or any requirement which is more burdensome than the taxation and connected requirements to which other similar enterprises of New Zealand are subjected.

If article 24(5) is read literally then it is unlikely to create any difficulties, because it only applies to discrimination directed against the New Zealand company. It does not apply to any discrimination directed against the non resident shareholders of the New Zealand company. A provision in New Zealand domestic law which denies imputation credit relief to a non resident is a shareholder issue, and is not related to the New Zealand resident company. The commentary to article 24(5) states that this paragraph only protects the enterprise and not the owners or controllers of its capital.

> "This paragraph forbids a contracting state to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other contracting state. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not to the person's owning or controlling its capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same state and not to subject foreign capital, in the hands of … shareholders, to identical treatment to that applied to domestic capital.[16]

6. The Position in Australia

The only non discrimination article in Australia's DTA network is contained in the Australia-USA treaty. In 1985 Richard J Vann analysed the implications of article 23(1) in the context of the initial Australian proposal to introduce an imputation system based on the United Kingdom advanced corporation tax model. He concluded that article 23 would not create any significant difficulties, because it only applies to discrimination directed at the entity and not against its shareholders.[17]

[15] Note 2 at paragraph 4 of the commentary on Article 24, p C(24)2.

[16] Note 2 at paragraph 57, p C(24)20.

[17] Taxation in Australia pp 468-479 at p 471.

d) Most favoured nation articles

1. Introduction

Both countries have agreed to renegotiate selected aspects of the existing double taxation agreement if either country subsequently grants another country a more favourable treatment of, inter alia, the taxation of dividends. These undertakings are commonly known as "a most favoured nation" clause.

2. The OECD model convention

Most favoured nation clauses are not often considered because there is no "most favoured nation" clause in the OECD model convention or in the accompanying commentary a DTA reflects a bilateral negotiation and the idea that the benefit of a subsequent negotiation should be automatically granted to an earlier treaty partner is a concept that does not sit easily with the principle of bilateral negotiations. For this reason, most countries do not concede "most favoured nation" clauses in their DTA negotiations.

3. New Zealand's "most favoured" nation clauses

In the context of dividends, New Zealand has conceded a "most favoured undertaking" in the following DTAs:

- Finland
- Italy
- Netherlands
- Norway
- Republic of South Korea
- Switzerland
- United States of America

4. The NZ -US Treaty

In terms of capital inflows, this is the most important. In the context of triangular taxation the NZ-US "most favoured nation" clause only applies when the reduction in NRWT is contained in a future double tax convention. The clause would only be triggered if the mechanism was incorporated as an amendment to the 1995 NZ-Australia DTA, which is unlikely to occur.

PROFIT REPATRIATION STRATEGIES

a) Introduction

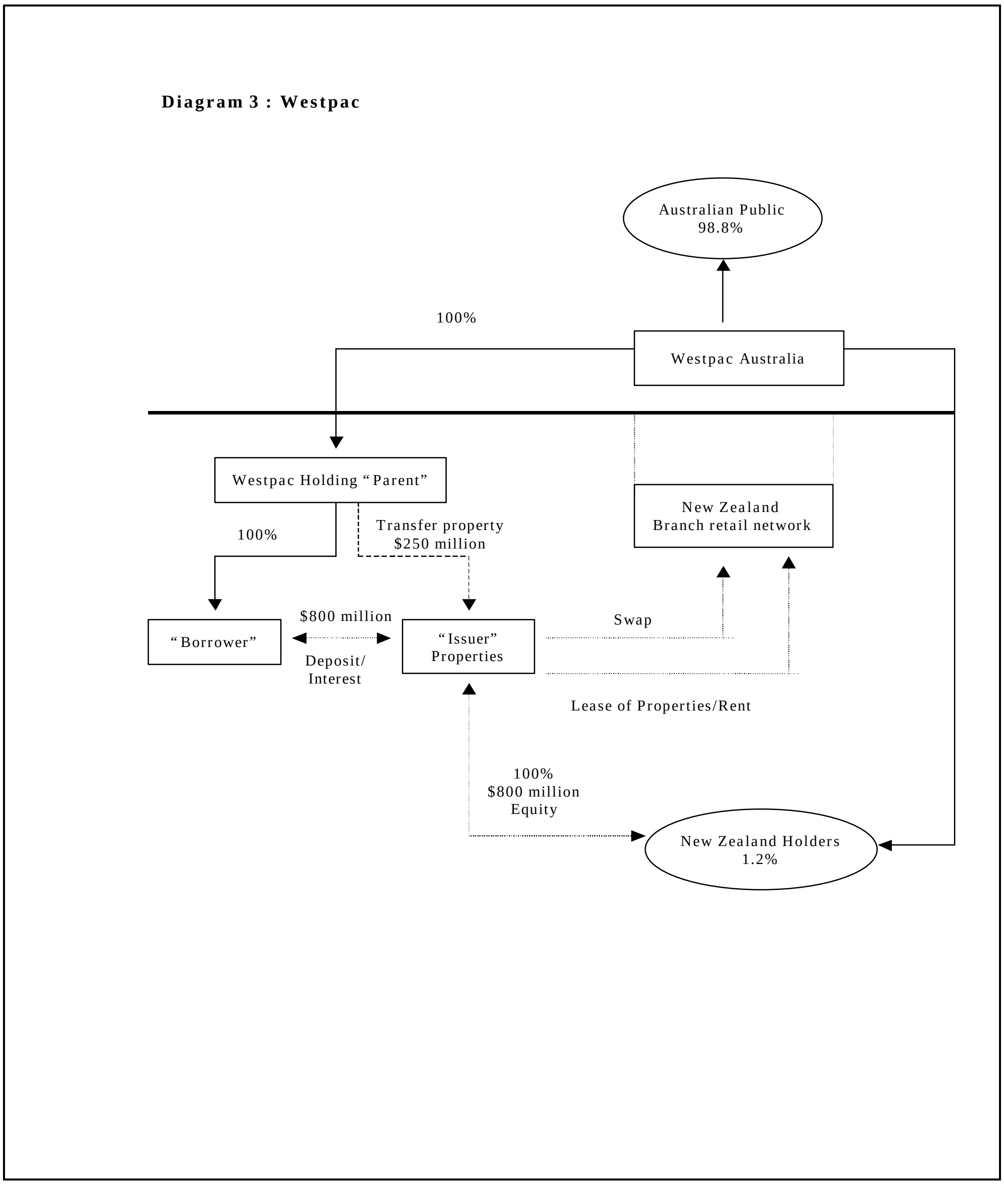
b) Floating a separate New Zealand subsidiary

1. Introduction

An obvious solution to the triangular taxation problem is for an Australian parent company 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 Australian parent company). The most significant example of this strategy is the recent $800 million successful capital raising undertaken by Westpac in late 1999.

Following the successful Westpac $800 million float, the ANZ Banking Group announced a similar proposal but it has yet to proceed.

<u>The Westpac $800 Million Share Issue</u>
As part of the capital raising exercise, Westpac obtained a binding product ruling from the Inland Revenue Department which inter alia stated 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 are summarised in Product Ruling BR PDR 99/13. They can be described in the following diagram:



The diagram has used the notation discussed in the ruling.

The commercial rationale for the float was the fact that Westpac carried on business as a branch which meant that New Zealand branch was unable to raise separate equity in New Zealand. Furthermore, 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 issuing company owns the properties that will be leased to the various Westpac branches and subsidiaries that conduct business in New Zealand. The issuer will derive gross taxable rental income.

The proceeds of the float were lent by the issuer to another member of the New Zealand group which produced gross interest income.

A third source of taxable income arises from the swap entered into between the issuer and the retail branch network. Under that agreement the issuer will receive a yield based on the dividend paid by Westpac Australia to its Australian shareholders. The corresponding cash flow paid by the issuer will be funded from, inter alia, the interest earned from the loan, and the rental income.

These transactions are designed to ensure that the issuer derives sufficient gross income and pays sufficient New Zealand company tax to distribute a fully imputed dividend to it New Zealand shareholders. That dividend will equal the equivalent dividend paid by the parent company to its Australian shareholders.

Key Taxation Issues to be Resolved

The key taxation issue is whether payment of dividends constitute 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 dividends in New Zealand dollars to allow New Zealand holders to use imputation credits, both sections could potentially apply to the class of shares issued by New Co.

The ANZ share issue

Shortly after Westpac announced its proposed share capital raising proposal, ANZ embarked on a similar scheme. The following diagram is based on the information contained in product ruling BR PDR OO/14.[18]

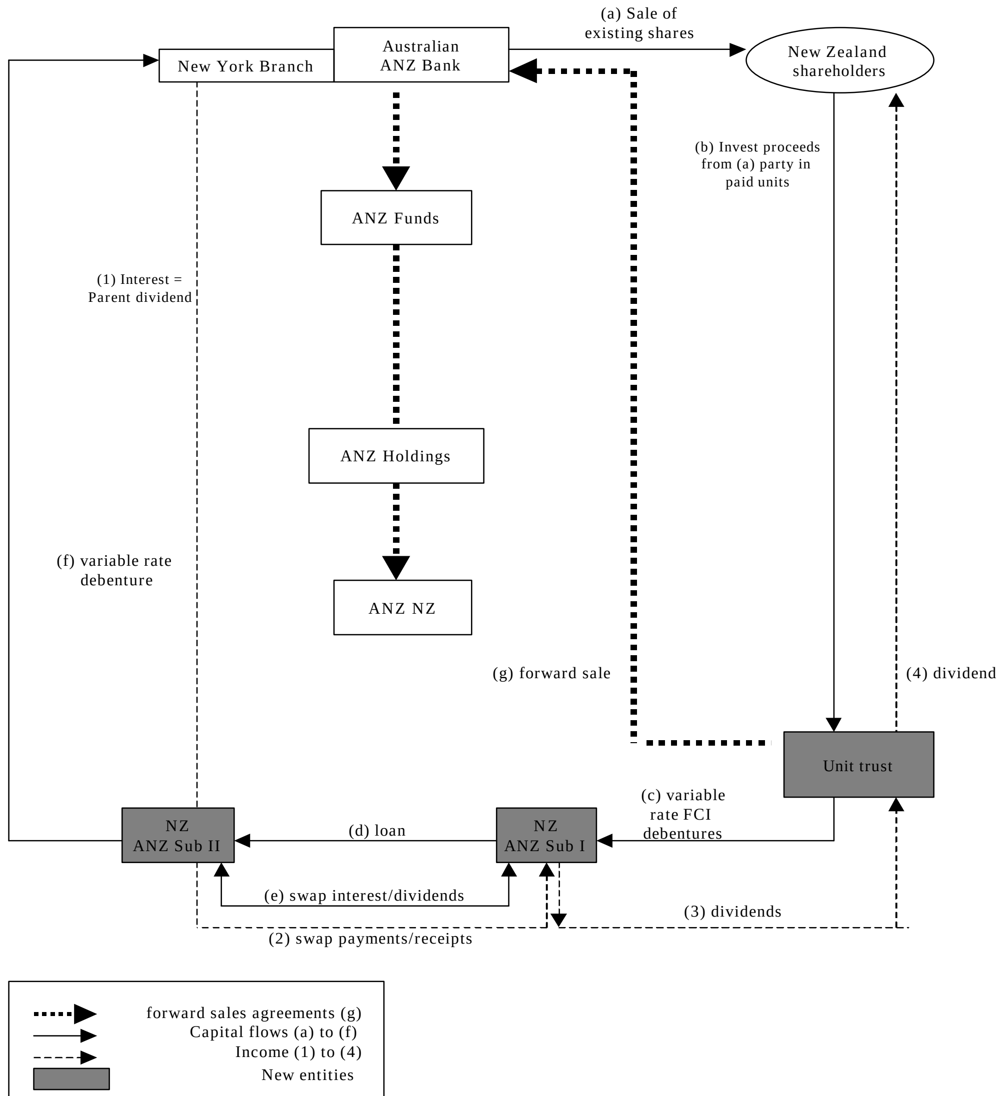


Diagram 4

[18] TIB Vol 13 (No 2) (February 2001) pp 12-21.

The commercial rationale was also to enable the New Zealand operations to raise additional Tier One capital. The structure was designed to enable the ANZ Group to pay fully imputed dividends to its inter alia New Zealand shareholders. Conceptually the arrangement has a similar tax effect to the Westpac solution. However, there are significant operational differences between the two proposals. Under the ANZ binding ruling, the additional capital will be raised via a special purpose trust (SPT).

For New Zealand tax purposes the trust will be deemed to constitute a unit trust and accordingly, distributions are deemed to be dividends for New Zealand tax purposes. Proceeds received by the SPT Trust from the issuing of units to New Zealand holders, will be used to subscribe for a variable rate FC 1 debenture which will be issued by a new ANZ entity described as ANZ sub one. That entity will in turn loan the proceeds at the prevailing bank bill rate plus a margin to a second new entity described as ANZ sub two. The final stage in the initial cash flow will involve ANZ sub two using the proceeds to purchase a variable rate debenture issued by the New York branch of the ultimate parent company, ANZ Australia.

Periodic cash flows will follow the initial "capital transactions" which will ultimately result in the payment of a fully imputed dividend by the SPT Trust to the New Zealand holders. The transactions between the SPT Trust, ANZ sub one, and ANZ sub two will create taxable income and corresponding imputation credits in New Zealand which will be attached to the deemed dividend paid by the SPT Trust to the New Zealand holders.

The complexity in the above diagram in part reflects the forward sale agreements between the original entities and the SPT Trust. The legal and commercial effect of the interrelated series of forward sale agreements was to ensure that the capital raised via the SPT was ultimately locked into the New Zealand operations.

The swap agreement between ANZ sub one and ANZ sub two appears to achieve the same result as the Westpac swap, which is to ensure that the dividend paid by the ultimate Australian parent company to its Australian shareholders mirrors the dividend payment by the SPT to its New Zealand holders.

Once again the same two key taxation issues arise namely the potential application of the anti avoidance provisions contained in sections GC 22 and GC 23.

3. Anti Credit Streaming Rules

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 explain why the IRD believe neither of these two provisions applied. The following analysis is one possible interpretation.

4. Section GC 22(1)(a)

In order for there to be an arrangement for inter alia the issue of shares, all of the four separate criteria contained in section GC22(1)(a) must be satisfied.

For the purposes of section GC22(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.[19] The ANZ and Westpac structures are clearly designed to benefit New Zealand resident shareholders, but does that mean they are automatically a party? If they are a party, are they a party to an arrangement? The term arrangement is defined in OB1 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. The passive shareholders were 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. Clearly they knew nothing about the structure until it was announced in the newspapers etc.

5. Section GC 22(1)(b)

Subparagraph (b) contemplates a comparison of benefits, to ascertain whether one 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.

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

c) Equity Instruments

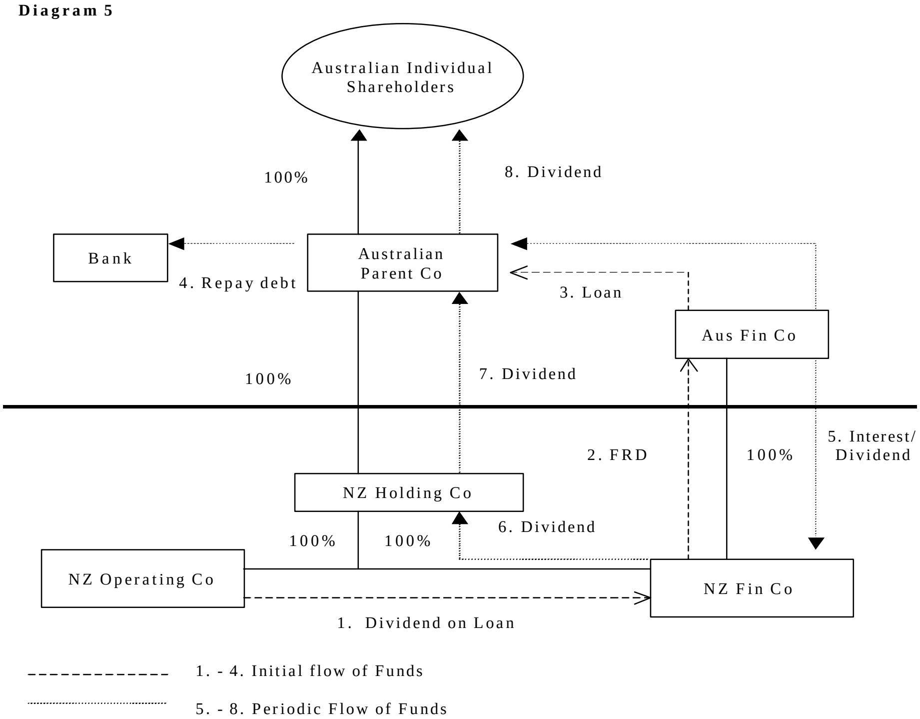
Secondly a Westpac and ANZ solution will not be a suitable vehicle for the tax effective transfer to the Australian group of surplus New Zealand funds arising from

- One off tax free New Zealand sourced capital gains
- Debt pushed down into New Zealand.

The following structure is designed to reduce the net tax cost to the Australian parent via the creation of an annual benefit of 6.5% calculated by reference to the annual interest cost. This benefit can be increased via the use of excess imputation credits.

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

Diagram 5



- NZ Operating Co loans surplus funds to sister company NZ FinCo,
- NZ FinCo loans the surplus funds using a floating rate debenture (“FRD”) to a special purpose finance company which is a member of the Australian group, Aus FinCo,
- Aus FinCo would then lend the funds at interest to its present parent company to retire existing third party debt.

The following table shows the overall tax saving to the Australian group. It is important to note that on this occasion the net cost is borne by the ATO.

Table 5

		FRD 10%	
Principal Sum		100m	
Australian interest @ 10%		(10m)	
A Gross Australian Tax Saving @ 30%		3m	
After Tax Cost		7m	
B Australian NRWT @ 10%			(1m)
NZ Gross Interest/Dividend		10m	
C NZ Net FDWP (less NRWT)			(2.3m)
D NZ Net Tax on Interest (less NRWT)			Nil
NZ Cash Available for Dividend			6.7m
NZ NRWT @15% Including Supplementary Dividend		nil	
NZ Cash Plus FDWP Credit for NRWT purposes	9.0m		
NZ NRWT @ 15%		1.350m	
Less NZ FDWP Credit	(2.3m)		
E Refund of Excess FDWP		0.950m	
Cash Dividend to Aus Parent		7.650m	
Tax (Cost) Benefit to Group **(A-B-C-D+E)**		7.650m	

d) Australian Capital Gains Tax

1. Introduction

One of the major differences between the two trans-Tasman tax systems is the absence in New Zealand of capital gains tax (“CGT”). Australian introduced a comprehensive CGT 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.

2. FCT v Lamesa[20]

Consider the case of a New Zealand Parent Company who wishes to purchase a commercial property in Australia. The New Zealand Parent believes the value of the building will double during the next 4 years. Can it structure the acquisition and anticipated disposal in a way which reduces its prima facie exposure to Australian CGT.

Insert Diagram 6

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 (Australian Holding Company first tier) called Australian Resources Limited (ARL). ARL acquired another Australian company (second tier Australian company) called Australian Resources Mining Pty Ltd (ARM). ARM made a successful on the market takeover (Target Co – third tier) of an Australian resource company known as Arimco NL (Arimco) which had as one of it's wholly owned subsidiaries – Target Sub – fourth 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 issuing 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 (Australian Holding Company – first tier) in two tranches. Lamesa accepted that the profit was part of its assessable income under the Australian 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. The facts in Lamesa clearly disclosed that the taxpayer (Dutch Holding Co) did not carry on business in Australia via a permanent establishment.

3. Article 13 of Australia Netherlands DTA

The Australia-Netherlands DTA is similar to the New Zealand-Australian 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 established a permanent establishment in the country of source. In Lamesa, the ATO accepted that the Dutch company (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. It does not allow Australia to tax any gain arising from the sale of shares in a company whose assets include shares in a property owning company. That is what

[20] 36 ATR 589

occurred in *Lamesa*. Neither the goldmining licenses, or the company which held them (Airmco Mining) were sold by Lamesa.

4. The judgment in Lamesa

The disposal mechanism consisted of *Lamesa* arranging for the Australian holding company 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 was 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 Australian holding company.

The ATO 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 held by Airmco Mining should be lifted for tax purposes, thereby treating the mining leases as constituting the asset of ARL. Under this interpretation Australia would have the primary taxing rights because the assets of the group were comprised “principally of direct interests in or over land” in Australian within the meaning of Article 13.

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 Australian Holding Company) comprised of the 100% shareholding in ARM (the second tier company), and not the mining licences owned by Arimco Mining (the fourth 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 first tier company. This was clearly a real possibility, because Lamesa had sold down its shareholding in two public floatation’s.

> *“But it is equally possible as a matter of policy that the legislature chose to limit the assimilation in Art 13 of shares to reality only to one tier of companies so as to avoid the kinds of melancholy complication 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[21].”

In view of the similarity of the relevant articles in the New Zealand-Netherlands DTA, and the New Zealand Australian DTA Lamesa structures can be used on both sides of the Tasman.

CONCLUSIONS

The problem of triangular taxation is not an historical accident. At the time both countries introduced their respective imputation regimes it would have been quite possible to have incorporated into current law the streaming model. The New Zealand government deliberately created the current problem because it was concerned about undermining the CFC and FIF regimes which commenced shortly after imputation.

Prior to the release of the joint Discussion Document triangular taxation encouraged trans-Tasman companies to maximise the payment of home country tax at the expense of the other country’s revenue base. Hybrid instruments such as FCI debentures, and treaty shopping techniques provided tax solutions to what is perceived to be an unfair trans-Tasman tax system.

The ultimate solution is to incorporate a special purpose subsidiary in the other country which is designed to pay a full imputed dividend to the individual shareholder resident in that country. Westpac Bank have successfully implemented a structure which achieves that objective.

Will the pro rata allocation model stop or reduce the incentives for trans-Tasman companies to devise “imputation efficient” tax structures. The answers appears to be no. Pro rata allocation contains no significant tangible tax benefits for individual Australian resident shareholders. Accordingly there is little incentive for Australian corporates to implement a proposal which benefits a small minority of resident individual New Zealand shareholders.

From the perspective of the New Zealand individual shareholder the benefit of pro rata allocation is dependent on the dividend distribution policy of the Australian company, and the mix of the underlying sources of income reflected I the dividend.

The only positive thing which can be said about this proposal is that it represents an improvement over the current taxation regime. To that extent,

[21] Note page 598 Line 10 and Line 20

New Zealand resident individual shareholders will welcome the introduction of the pro rata allocation model. However, it does result in a significant waste or misallocation of imputation and franking credits. The only long term feasible solution is for both countries to introduce full streaming.

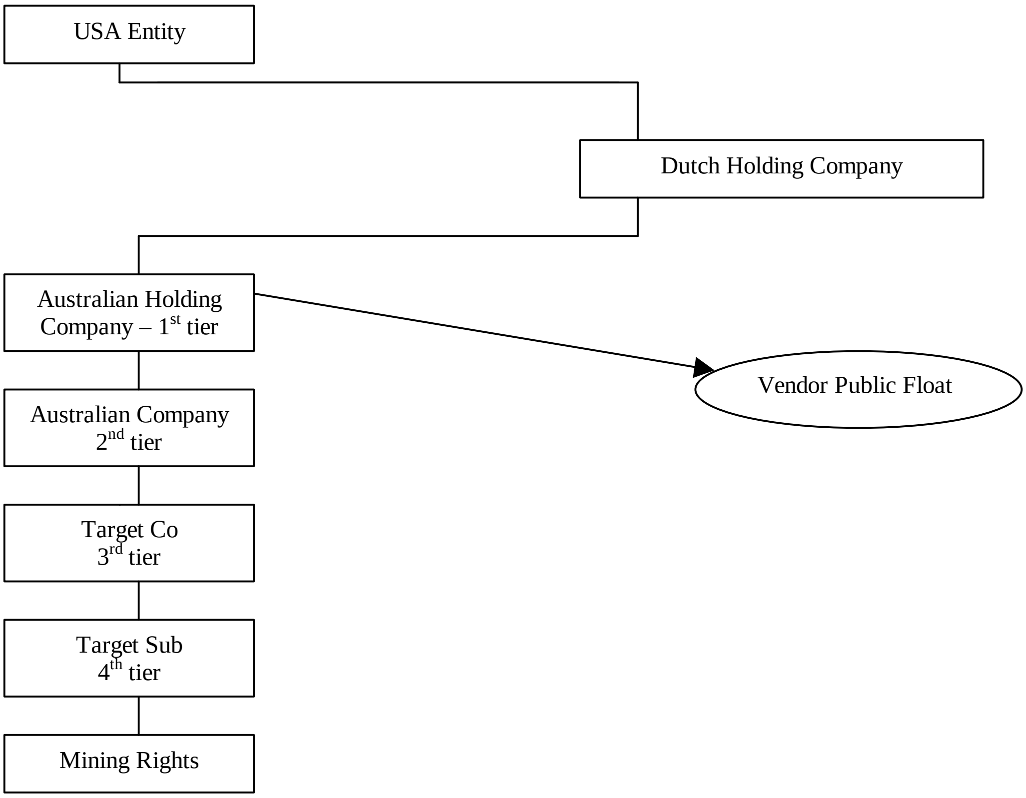
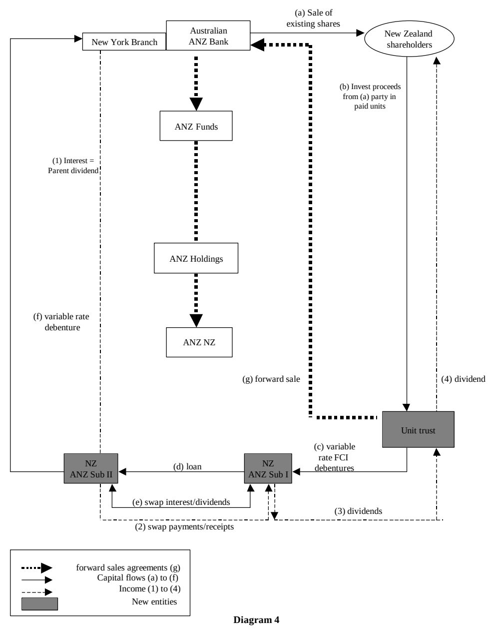


Diagram 6

ANZ BR PDR 00/14[22]

[22] TIB Vol 13 No 2 (February 2001) pp 12-21.



(a) Sale of existing shares
New York Branch
Australian ANZ Bank
New Zealand shareholders
(b) Invest proceeds from (a) party in paid units
ANZ Funds
(1) Interest = Parent dividend
ANZ Holdings
(f) variable rate debenture
ANZ NZ
(g) forward sale
(4) dividend
Unit trust
(c) variable rate FCI debentures
NZ ANZ Sub II
(d) loan
NZ ANZ Sub I
(e) swap interest/dividends
(3) dividends
(2) swap payments/receipts
forward sales agreements (g)
Capital flows (a) to (f)
Income (1) to (4)
New entities

Diagram 4