24 October 2002

The Secretary
The International Taxation Project
Board of Taxation Secretariat
c/- The Treasury
Langton Crescent
PARKES ACT 2600
AUSTRALIA

Dear Sir/Madam

Submission – Review of International Taxation Arrangements

On behalf of our members we wish to submit on the discussion paper *Review of International Taxation Arrangements.* As we are only focusing on issues relevant to New Zealand resident companies wishing to invest in or through Australia, we have limited our comments to various issues raised in Chapter 3 of the paper "Promoting Australia as a location for internationally focussed companies".

About Institute of Chartered Accountants of New Zealand [ICANZ]

The Institute of Chartered Accountants of New Zealand is this country's only professional accounting body and represents nearly 27,000 members in New Zealand and overseas. Those members include chartered accountants, associate chartered accountants and accounting technicians.

The role of the Institute's Tax Division is to make submissions on behalf of its members on a wide variety of topics, particularly taxation and commercial legislation, to advance the cause of understandable and consistent business laws. This process helps to ensure that legislation and its application are continually assessed, which leads to more workable legislation for Institute members and all businesspeople.

Summary of Submission

In principle we support the direction of these proposals, particularly in the following areas:

- Providing conduit relief for Australian resident holding and joint venture companies
- Establishing foreign income account rules to facilitate flowthrough of foreign sourced income without additional taxation costs through Australia.
- Clarifying the residency test for companies

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We do not however agree with the proposal to tax gains derived from sales of non-resident interposed entities. We disagree that this contributes to the policy objectives of this review.

Although we have not made detailed submissions in respect of these matters, we also make the following comments:

- We note with concern the complexity of Australia's CFC rules and encourage any move to simplify these.
- We strongly support triangular tax and submit that this initiative is implemented notwithstanding the proposals in the consultative paper.

Our detailed submissions are set out in the attached document using the prescribed format. We note that as we are not involved in the detail of your legislation on a day-to-day basis, we have kept our comments at a fairly high level.

Yours faithfully

Signed by:

Chris Abbiss
Chair
National Tax Committee

Option 3.6 for consultation: to consider whether or not to proceed with the Review of Business Taxation proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets.

Summary

We are strongly opposed to this proposal. We consider that it is flawed from a policy perspective, would be difficult to comply with in a practical sense and would harm Australia's international competitiveness.

Current Law

Under the current law, a non-resident shareholder is only subject to capital gains on assets having the *necessary connection with Australia*. This includes any shares in an Australian resident private company or 10% or greater (including interests of associates) of the beneficial ownership of a public listed company. If the non-resident shareholder is itself owned by a second non-resident company, there is technically an ability to sell the non-resident shareholder without triggering a CGT event as that asset does not have the necessary connection with Australia.

What is the problem?

The paper raises this the problem that a non-resident (particularly one living in a country which does not tax capital gains) is able to achieve a gain from selling the interposed entity free from CGT despite the fact that the gain has principally been sourced from the sale of Australian assets.

We do not agree that this is a problem as:

The underlying assets still are held with the original cost base and accordingly will be subject to CGT if ultimately sold.
Australia still retains absolute rights to tax the capital gain when it is realized by the interposed entity.

From a policy perspective, this proposal would be very difficult to target and would involve necessary complexities. Issues include:

- Defining the threshold test for seeking to tax the sale of an interposed entity.

To what extent would the entity need to hold Australian assets in order for the measures to apply – 100% Australian assets, greater than 50% or any Australian assets? How would these be valued?

- Dealing with apportionment issues for non-Australian assets held directly or indirectly by an interposed entity.

  Apart from valuation issues where the interposed entity owned both Australian and non-Australian assets directly, there would be no policy basis for seeking to tax a non-resident on the sale of an interposed entity which held non-Australian assets even where those non-Australian assets were held through an Australian entity (this point is recognized in the discussion document).

- Dealing with tax treaty issues.

  Where an interposed entity is resident in a country, which has a favorable tax treaty with Australia, seeking to tax the sale of that entity could put Australia in breach of its treaty obligations.

- Risks of economic double taxation.

  Many countries impose some form of capital gains tax. If Australia seeks to impose CGT on the sale of an interposed entity then there is an increased risk that the vendor will be subject to double taxation. This is particularly likely in circumstances where, for compliance or other reasons, the Australian tax is imposed on an entity other than the interposed entity (e.g. by imposing the tax directly on the Australian assets). Many countries would deny a credit for Australian tax paid in these circumstances.

  In the event it is the interposed entity that is taxed, this would need to be factored into the cost base to ensure that double taxation did not occur on eventual sale of the entity. While this would be straightforward in a wholly owned situation, it would be more problematic where the disposal is of less than 100%.

Taking into account the above issues alone, it seems likely that the implementation of this proposal in any form would require complex legislation. Inevitably this will increase compliance costs for foreign investors into Australia. At a time when many countries are seeking to reduce compliance costs as well as make themselves more attractive to foreign investors this would seem to be a significantly retrograde step.

What evidence is there of the problem?

While there is anecdotal evidence that interposed companies have been established as part of global structuring of groups, we are unaware of substantive evidence that sales of interposed companies (as opposed to the underlying company) commonly occur. In practice we note this is often not an attractive option to buyers, particularly where less than 100% of the underlying company is held or an Australian resident is acquiring it

However, we also reiterate the point that the underlying deferred tax liability is still held by the interposed company and remains to the credit of the Australian tax base. In addition it is difficult to see how the above complexities could fairly be addressed.

We therefore submit that this proposal should not be proceeded with.

Option 3.10 for consultation: to consider options to provide conduit relief for Australian regional holding and JV companies, including considering the benefits and costs of introducing a general conduit holding company regime, providing an exemption for the sale of non-portfolio interests in a foreign company with an underlying active business and providing conduit restructure relief.

Summary

From a policy perspective in a residency or sourced based regime, it is not correct to seek to tax non-residents on income which is not sourced in Australia. We therefore support the moves to consider ways to alleviate this issue.

From the perspective of encouraging investment through or in Australia, we prefer the proposals to either establish a conduit holding company regime or as a lower compliance cost option to exempt capital gains from the sale of a non-portfolio interest in a non-resident company with an underlying active business.

However, we consider that a conduit restructure relief mechanism would be a useful backstop particularly where there are substantial foreign interests with unrealized capital gains that are not going to be realized during the period of investment in the Australian entity.

Current Law

Under current law, a regional holding company established in Australia (or one arising from a foreign company acquiring an Australian multinational) may pay CGT when selling its regional (foreign) subsidiaries. If the holding company is then sold, that sale by the non-resident parent is also subject to CGT. Had the non-resident parent invested in the foreign subsidiaries directly, they would not have paid CGT in Australia.

What is the Problem?

Multinationals are very sensitive to the application of domestic tax in respect of foreign sourced income. This results in either considerable time or effort being spent on alleviating the impost or the relocation of the regional base. While sometimes this is only in legal form as opposed to actual location, where other alternatives are available to multi-nationals without domestic tax being imposed, this encourages the relocation to be comprehensive.

For New Zealand companies, the potential taxation of conduit income represents a distinct deterrent.

What evidence is there of the problem?

Our members regularly are required to advise on both the consequences of such investment and alternative structures that can be used to eliminate the exposure. This will often include avoiding the establishment of a base in Australia unless significant commercial opportunities otherwise justify. In addition, substantial effort is made to avoid having an Australian company interposed either in respect of outbound NZ investment or inbound.

What Solutions should be considered?

Conduit Holding Company Scheme

We support the progression of a conduit holding company scheme as discussed in Option 3.10. Further, we consider it should at least be available to all non-portfolio investors. It was proposed that it may be simpler to restrict it to companies wholly or nearly wholly owned by non-residents. We note that this would mean relief is not available to non-resident majority investors in public listed companies. This would not fulfill the objectives of encouraging foreign investment through the capital markets.

While we acknowledge there would be substantial compliance costs, we note that:

- For wholly owned companies, a mechanism that offers exemption with an equivalent adjustment to the cost base of the holding company (which can be reversed on distribution) has merit, and

- For partly owned foreign companies, a similar proposal; this would require a tracking account to be kept to ensure on distribution that the additional credit would be allocated to the non-resident.

- Measuring the non-resident shareholdings at times of disposals of foreign subsidiaries would not be overly onerous as compared the benefits to the non-resident investors.

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Capital Gains Tax Exemption for sales of non-portfolio interests in a non-resident company with an underlying active business

In concept we support the proposal to exempt such gains, on the basis that the proposals to establish a foreign income account as discussed under Option 3.11 (below) also proceed. While we understand the rationale for exempting only active business interests from a domestic perspective, we do not think the same rationale applies to non-residents. Therefore while this regime may offer some relief, depending on the ability to design legislation that is workable, we prefer the use of a more comprehensive conduit holding company regime.

How does the problem/solution relate to other options in the consultation paper?

The proposals rely on the establishment of a Foreign Income Account as proposed in Option 3.11.

What priority should be given to resolving the problem?

We believe the priority should be high, although we recognise the complexities involved.

Option 3.11 for consultation: To consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation and whether to allow the tax free flow of foreign income account amounts

Summary

Subject to the decisions in Option 2.1, we strongly support the proposal to introduce new foreign income account rules, which would ensure that there is no bias for directing investment away from Australia.

As an alternative, we support the proposal in Option 2.1 to allow the streaming of dividends as it offers a simple option for removing the bias for both resident and non-resident shareholders. However, we acknowledge that where the resident/non-resident shareholder mix is not reflective of the investments held, this will not address the full problem.

Current Law

Under current law, limited conduit flow through is allowed through the use of foreign dividend accounts which allows a withholding tax exemption for unfranked dividends paid out of non-portfolio dividends received from listed countries (and from unlisted countries to the extent that foreign tax credits are available).

What is the problem?

Currently, this relief is only available for foreign sourced dividend income. It does not include branch profits and is of limited value where the foreign entity is owned through an Australian resident joint venture company.

As the exposures are to both income tax and CGT, there are considerable deterrents for establishing a Joint Venture company in Australia.

What evidence is there of the problem?

In dealing with clients investing into Australia, our members are regularly advising on structuring issues. The overwhelming view is that if possible, companies should not direct offshore activity through an Australian subsidiary and where this has occurred inadvertently, efforts are taken to modify this.

As NZ is a net capital importer, our members are regularly advising subsidiaries of multinationals. There is a growing trend to ensure that NZ is held directly by the parent companies, rather than be held through Australia.

What solutions should be considered?

We strongly support the expansion of the current rules to a foreign income account which allows relief for all foreign sourced income.

As holding companies will often hold more than one company in a chain, we also encourage that relief be provided to ensure that the credits can flow through a chain of domestic companies to effectively give relief in these circumstances.

How does the problem/solution relate to other options in the consultation paper?

This proposal clearly buttresses the conduit holding company proposals.

What priority should be given to this proposal?

We strongly support this being given a high priority. Precedence is available though the foreign dividend account rules currently in place.

Option 3.12 for consultation: to consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business.

Summary

We support a move to either an exclusive use of place incorporation for determining residency or greater emphasis on place of incorporation. Moving to a more objective test will serve to reduce uncertainty and therefore compliance costs.

Current Law

Under current law, a company incorporated outside Australia is tax resident in Australia if it carries on business here *and* either has its central management and control in Australia or has its voting power controlled by Australian resident shareholders.

What is the problem?

The problem is the difficulty in determining whether the company carries on business in Australia. While the Australian Taxation Office has stated that it applies the test separately, case law supports the fact the two-part statutory test would be met if the business carried on in Australia consisted of or included the company's central management and control.

As noted in the paper, the way companies operate these days may easily trigger the residency tests. For New Zealand companies, this is particular pertinent as commonly they have Australian resident directors. It is exacerbated further by the different approaches taken by the NZ and Australian authorities in respect of the definition of central management and control.

What evidence is there of the problem?

Considerable time and effort is expended to avoid problems in this area. This can involve, directors meeting in person in one jurisdiction or another to ensure that they do not trigger residency inadvertently. This is a significant cost where they could easily have met through video or teleconference.

In addition, members advise us of executives changing location at considerable personal cost and company inconvenience to ensure residency is not inadvertently triggered.

Again, this encourages Australia being removed as a regional holding company both in form as in fact.

What solutions should be considered?

We strongly support the clarification of the residence test as proposed in Option 3.12 so that merely exercising central management and control in Australia does not constitute the carrying on of business.

Further we would encourage this proposal being extended so that a company will solely be resident by virtue of incorporation. We consider the constraints of the imputation regime will assist in deterring companies from exploiting this change in appropriately.

How does the problem/solution relate to other options in the consultation paper?

The reform of the residence test supports the proposals commented on above which are designed to remove disincentives for multinationals having a regional headquarters in Australia. While it would be necessary for improved conduit relief to encourage this fully, this will at least ensure that the presence of senior regional executives will not create further conduit tax problems for multinationals.

What priority should be given to resolving this problem?

This represents a reasonably simple reform, but one which will provide substantial benefits for multinational companies. We submit the priority should be high.