Commentary on:

TRANS TASMAN TAXATION

Paper presented by Dr R.L. Congreve — Page 3, Part II.

by

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In his written paper Dr Congreve has, quite properly, addressed himself primarily to the major questions which surround New Zealand enterprises wishing to trade in Australia. In the spirit of C.E.R. my commentary will address not only those questions, but also some of the tax ramifications of Australian entities wishing to trade in New Zealand.

In this regard I expect that a number of you have already had occasion to advise Australian companies and businessmen when they seek to enter the New Zealand market. As a practical point, for the professional advisor, you will no doubt have noticed that, in general, the Australian businessmen of Corporate Executive has had a high degree of exposure to tax planning techniques and the possibly peculiar Australian view of taxation in general. It is an attitude which differs quite markedly from that of his New Zealand counterpart. Any closer relationship between the business communities of the two countries will, I suggest, do more to foster the tax planning industry and environment in New Zealand than vice versa.

There are of course at least two different ways in which to trade between the two countries. The first is relatively straight forward and involves continuing to do business in one's home country, be it New Zealand or Australia but nonetheless to conclude agreements of various sorts with the business community in the other. One presumes that at some time in the future it will be possible for both Australians and New Zealanders to take part in the other way of trade, which is to actually be in business in each other's country. Presumably Messrs Muldoon and Keating, if they be the true protagonists, will resolve their differences in this regard. Turning specifically to Dr Congreve's paper and my task of making commentary upon it I would prefer to start at the end. As an accountant, I find his suggestion of an Australasian Tax Court too horrendous to contemplate and I also find extremely disturbing the suggestion that more effort should be made in unifying tax systems or principles between the two countries. The reason for this, of course, is that tax advisors in both jurisdictions are only too pleased to play-off the differences between the rules of one jurisdiction and those of the other to the benefit of their clients. This all notwithstanding the Double Tax Convention between the two countries.

Whether the investment is from Australia into New Zealand or from New Zealand into Australia, many of the basic tax questions are similar. In the specifics of course, the questions become more difficult and harder to answer but dealing with the relatively ordinary type of proposal with which one is faced, the questions may be summarised as:

1. The Structure - Representative Office, Branch or Subsidiary,
2. Regulatory authority requirements so far as they impinge upon either tax considerations or disclosure problems,
3. Executive remuneration and the taxation regime surrounding that,
4. Funding of the particular operation.

In view of my limited time-frame in this commentary I will make broad comments illustrated by a few specific examples of difficulties. With regard to difficulties which will become apparent with Australian legislation, I can only emphasise that it is not possible in tax to make any assumptions whatsoever about the Australian legislative or judicial reaction to a particular proposal. Local advice is essential and in this regard the Australian tax advisory scene differs somewhat from that of New Zealand.

It is worthwhile mentioning this difference because a number of you will no doubt be seeking Australian advice. In Australia, far more than in New Zealand, and this is particularly true in Sydney and Melbourne, the legal and accounting professions are in direct competition in the area of what I will describe as structural tax planning advice. Without wishing to give an unseemly puff to the Australian accounting profession in this regard, it is fair to say that a number of them are better at tax law than some members of the legal profession. Listen closely to your

Australian client as to where he takes his primary tax advice, establish your own relationships, no doubt mostly within the legal profession in the major cities and make rational use of what you judge at the time to be the best Australian tax advice. It is important also to understand that there are specialists in certain fields as indeed there are in New Zealand but the trend is more exaggerated in Australia.

In his paper Dr Congreve has mentioned the differing effect of Australian tax on a branch or subsidiary; the double tax treaty and the concept of industrial and commericial profits and the equally important concept of permanent establishment. I have here a slide which demonstrates no more than what Dr Congreve has said is the tax effect. The one point that I would note here, that Dr Congreve has not covered, is the somewhat grey area concerning the method in which export incentives are presently calculated based upon the consideration receivable less certain costs. Expressed simply in a sale to an Australian entity the F.O.B. price is taken as the base calculation point for export incentives. In a sale through a branch, of course, the New Zealand exporter is making his sale in Australia to his customer. There are however, all the direct costs related to the transportation and insurance of the goods to deduct from the selling price and the grey area exists over what other costs related to those goods once they have left the shore of New Zealand are in fact to be deducted. The argument is not simple, nor is it one which the New Zealand Revenue have yet come to grips with. Suffice it to say that care must be taken before making any assumptions concerning increasing export incentives by direct sale through a branch. The second slide covers the case of an Australian coming into New Zealand presuming that he will ever be able to do so again, with no account taken of the Australian export market development expenditure grants or allowances.

It is with some sadness that I know turn to Section 23q of the Australian Income Tax Assessment Act. Section 23q is like a troublesome mistress in that it has caused joy and heartache: moments of intense wonder that something so marvellous could exist and days of deep despondency when the difficulties and problems it creates appear to be insuperable. The despondency is caused only because, it appears from statements of the new government in Australia that Section 23q will die and be replaced by that great leveller: a foreign tax credit system. For those who are not familiar with Section 23q of the Australian Income Tax Assessment Act, it is a magnificent little animal and provides, broadly, that income sourced in a foreign country which is subject to an income tax in that foreign country shall be exempt from income tax in Australia. Let me give you some examples of the vagaries of 23q.

In the good old days before Australia outlawed cross-border leverage leasing, it was possible for Australian equity partners to achieve capital related deductions on assets utilised in New Zealand amongst other countries. However, problems clearly arise if the income from such lease transactions could be seen to be sourced in New Zealand and taxed in New Zealand. Section 243(2) (p.a.) of the New Zealand Income Tax Act deems, a New Zealand source to income arising from a number of such transactions. There would always be a question about the "real" source as compared to the deemed source particularly if New Zealand chose to tax the transaction. The effect, of course, would be that the income being sheltered from the effects of Australian taxation by virtue of the exemption granted by Section 23q, would cause the capital related deductions to be not available to the Australian partners as the income was not assessable income. I leave it to you to ponder on how and in what circumstances these problems were solved.

Another difficulty relating to Section 23q and New Zealand operations involves a loss-making Australian parent and a profit making New Zealand branch. Due to the operation of Australian loss provisions it is possible for Australian sourced losses to be eaten away and not be available for future use because of New Zealand profits of the same entity. This despite the taxing in New Zealand of those profits. Structural solutions to this particular problem abound. But I have observed poor pre-planning resulting in such Australian losses being lost forever.

On a lighter note the way to make friends and influence people as a tax advisor, is to ease the Company Directors' own personal tax problems: 23q has been, up to now, a device whereby this can be achieved easily. Any income such as Directors fees paid in New Zealand by a New Zealand entity for services rendered in New Zealand will not achieve treaty protection. The effect, of course, is that they are taxed in New Zealand and achieve Section 23q exemption in Australia for the Australian resident director. As part of an overall employment package it brings smiles to their faces.

If we move back now to a New Zealand enterprise wishing to trade in Australia and consider some of the funding difficulties, I bring to your attention the new Division 13 of the Income Tax Assessment Act. I have included as part of my written paper a New Zealand view of the new Division 13. I have done this because I consider that, at this stage, it is a part of the Australian Act to take very seriously. In brief the new Division 13 was brought into Australian law to counteract and correct the weaknesses exposed in the old Section 136. The old Australian Section 136 sought to give the Commissioner in Australia, in certain circumstances, the power to look toward the profits of an enterprise doing business in Australia and using certain specific criteria to determine a profit which he thought it should have made. Its weaknesses were glaring for years and were finally exposed in the Comalco case. The new Divison 13, rather than looking towards an enterprise's profit, looks towards the arm's length nature of individual transactions or series of transactions, where an International transaction, as defined, takes place. Entire seminars have been devoted to Division 13 in Australia; perhaps they should be here, but this is not the place to go into great detail. I will however, give an example of how Division 13 might affect a particular common transaction. The primary purpose of Divison 13 is to protect the Australian revenue and certain transactions are affected, which are not in the purview of the Double Tax Treaty. One of these concerns the loan from New Zealand to Australia of a sum of money from a parent to a subsidiary company.

If that loan is at nil interest or less than market interest, the Second Commissioner of Taxation has suggested that in certain circumstances Divison 13 might be invoked. Let us imagine that that loan is made from a New Zealand parent to an Australian subsidiary which acts as a holding company for a number of Australian operational companies. That Australian holding company receives dividend income only from those operational companies. Such income is, under Australian law, fully rebatable. In this circumstance the Second Commissioner has suggested that if he deems interest to be payable to the New Zealand parent he will achieve a 10% tax on that (the limitation being due to the double taxation treaty) and the corresponding deduction which Division 13 makes him give to the deemed payer, will be set-off against the rebatable dividend income. In other words, no effective Australian deduction is available. The Australian revenue will be better off, the New Zealand taxpayer would have suffered 10% tax on interest income which he has not derived and, in my view, will not be eligible for a foreign tax credit in New Zealand as no income is assessable here.

Once again structural solutions are perfectly possible but have to be decided upon in advance. Of course, when contemplating such questions in New Zealand we are still governed in our domestic law by Section 22 which is remarkably similar to Section 136 of the Australian Act as it used to be whether a New Zealand court will be quite as strict in its interpretation of our Section 22 as the Australian court was of its 136 is another matter.

At this stage I think some mention should be made of source and source rules. A number of problems have arisen both in Australia and New Zealand, but particularly in Australia, concerning "source" and foreign tax credits. The essential element of both jurisdictions giving a credit for foreign taxes paid and indeed that contained in the Double Tax Treaty is that the income concerned should have a source in the country whose taxpayer seeks to have the foreign tax credited against his domestic tax liability. Care must be taken in both jurisdictions in looking at statutorily imposed "source", that is deemed source; where such a source may not exist in general law for the particular income. The problem is self evident. The New Zealand Commissioner, may by virtue of statutory provisions, deem income of a particular character to have a source in New Zealand and to be taxable accordingly in the hands of a non-resident. But the Australian Commissioner could deem that same income by virtue of different statutory rules or by virtue of the operation of general law only to have a source in Australia. The Australian Commissioner may decide in such circumstances not to give the relevant tax credit. And while we are talking about foreign tax credits it is also worthwhile noting that both jurisdictions will give a foreign tax credit only so far as the domestic tax would have run against the particular income concerned. Problems have in the past occurred and may do so again where a question arises to the priority of incentive tax credits as compared to foreign tax credits.

Although New Zealand has fairly recently amended it's statutory provisions relating to priority of tax credits (Section 293(2A)) to allow for a foreign tax credit to be granted against New Zealand tax payable prior to the application of certain export incentive oriented provisions, it is nonetheless a limited correction of a problem. The reason being that section 156F in relation to export market development expenditure, apparently takes priority over the foreign tax credits resulting in certain circumstances in a loss of the foreign tax credit against New Zealand income tax, for all time.

No commentary on Australasian taxation within C.E.R. would be complete without a mention of sales tax. Sales tax is a much more important animal in Australia than it is in New Zealand. This applies both to professional advisors and to sales tax payers or more accurately sales tax collectors. The rates, while not being necessarily as high as those applicable in New Zealand, are rising and the range of goods upon which the sales tax is levied is getting wider - subject to Senate approval of course - and the entire subject matter is one that should be taken seriously by a New Zealander wishing to trade in Australia. Naturally, no rationalisation of approach or even rates has been made between the two countries. Perhaps the greatest danger facing the New Zealand enterprise wishing to trade in Australia is one of simply leaving the problem too long before enquiries are made. If the goods in question are not taxable in New Zealand, then it is understandable that the question is not raised in time. Sales tax in Australia is levied more or less on the same basis as it is levied in New Zealand. That basis is that it operates as a wholesale tax usually levied on the last wholesale sale of goods, but this situation varies in a number of circumstances, the actual method of trading and structure for income tax purposes may not be totally appropriate for sales tax purposes. It is important that the relevant advice is taken before matters have progressed too far for remedial action.

Having said this, however, and having made my other comments regarding the care to be taken by both Australians and New Zealanders I have tried to find a simple idea to correspond with Robin's suggestion of an Australasian Tax Court. My own expression is borrowed from the most bloody minded member of the EEC. "Vive la difference"

I. DIVISION 13 OF THE INCOME TAX ASSESSMENT ACT 1936

1. History

The originating enactment of Division 13 ("Div.13") was section 31 of the Income (No.2) Act 1915 (U.K.) which became in turn, section 23 of the Income tax Assessment Act 1915 - 1921, section 28 of the Income Tax Assessment Act 1922, and then the former section 136 of the Income Tax Assessment Act 1936 ("the ITAA"). The new Div.13 (section 136AA to section 136AG of the ITAA) was substituted for the former section 136 by the 1982 Amendment Act. The provisions of the new Div.13 apply to income derived and expenditure incurred after 27 May 1981. The former section 136 applies to income and deductions incurred prior to that date provided that the Commissioner is of the opinion that they are appropriately related to that period.

Div.13 aims to eliminate the removal of profits from the Australian tax regime, whether by transfer pricing or other means of international tax avoidance, where there are either separate entities involved or one entity who conducts business in another country through a branch or permanent establishment.

2. The Former Section 136

The former section 136 gave the Commissioner a discretion to adopt, as taxable income of the taxpayer, such an amount of the total receipts of the business as he determined, once it appeared to him that there was an income deficiency when compared to the taxable income that may have been expected to arise from that business.

Three conditions had to be satisfied before an assessment under the former section 136 could be made:

(a) the business had to be carried on in Australia;

(b) there had to be non-resident control as provided by the section; and,

(c) it had to appear to the Commissioner that the business produced either no taxable income, or less than the amount of taxable income which may have been expected to arise from the business.

Problems with this provision, as outlined in the Explanatory Memorandum to the legislation which abolished it, were:

"(a) the section, in general, applied to non-residents who engage in international profit shifting and does not set out to deal with Australian residents engaging in such activities;

(b) the limitation to business income may preclude application of the section to rents, interest, or other transactions not clearly linked to a business;

(c) the section may only apply to companies and not to other entities such as individuals and trusts;

(d) the section is inadequate to impute the derivation of income in a transaction which would produce income if it were one between independent parties, such as an interest-free loan to an off-shore associate;

(e) the section's link with total receipts could be unduly restrictive - it could mean that even where total receipts have been reduced by a tax avoidance arrangement, the Commissioner would be unable to look beyond the reduced amount in determining taxable income."

The operation of the section could also be avoided by either interposing another resident company between the company carrying on the Australian business and the non-resident, or arranging for residents to hold preference shares which constituted a majority of the shares, while the controlling shares were held by non-residents.

The requirement that the business which was carried on in Australia had to be "controlled principally by non-residents" was held by the Courts to look to de facto or actual control and not to the capacity to control. That is, if the Directors of a resident company controlled that company's business from within Australia and if there was no evidence of interference with the management of the business by the non-residential shareholders, the company would not be held to be controlled principally by non-residents. This also limited the application of Div.13.

3. The Present Division 13

The new Div.13 allows the Commissioner to reallocate income arising from an "international agreement" where no, or insufficient, consideration passes under the agreement, where he is satisfied that the parties were not dealing at arm's length and that the consideration given was not an arm's length consideration. The Commissioner can impute or create income where necessary to give effect to the arm's length principle.

The provisions are limited to international transactions and will not affect purely domestic transactions with no international element. The provisions also do not affect transactions concerning a business carried on by non-residents in Australia at or through a permanent establishment unless either non-resident without a permanent establishment, or a resident with a foreign permanent establishment, is also involved. Transactions between residents would only be caught where at least one resident carries on business outside Australia and the transaction concerns the non-resident business. Thus the threshold test of non-resident control of a business has been removed so that specific 'control' situations are not required.

The question asked by the Commissioner prior to invoking Div.13 is no longer whether the taxable income of the business is insufficient, but whether there are arm's length dealings in relation to a particular supply or acquisition of goods or services and then whether the consideration paid or received is less than an arm's length consideration.

In summary, the transactions which are aimed at reducing the liability to Australian income tax must have the following before the Commissioner may exercise his discretion to invoke Div.13:

(a) an international agreement;

(b) non-arm's length dealing;

(c) non-arm's length consideration.

Once he has invoked Div.13 and prior to the issue of an assessment, he must determine the sources of the income, reallocate the income and make consequential adjustments if he considers the adjustments necessary.

4. <u>International Agreement</u>

An "international agreement" is a necessary requirement for Div.13 to operate. An agreement is an international agreement if:

(a) a non-resident supplied or acquired property under the agreement otherwise than in connection with a business carried on in Australia by the non-resident at or through a permanent establishment of the non-resident in Australia; or,

(b) a resident carrying on a business outside Australia supplied or acquired property under the agreement, being property supplied or acquired in connection with that business.

As stated previously, transactions concerning a business carried on in Australia by a non-resident at or through a permanent establishment are excluded, unless the transaction involves either another non-resident with no permanent establishment or a resident with a foreign permanent establishment.

"Agreement" is defined to include all types of formal and informal arrangements and understandings. "Property", "services", "supply" and "acquire" are also widely defined. "Permanent establishment" includes a place where any property of the taxpayer is manufactured or processed, either by the taxpayer or by another person.

5. <u>Arm's Length Transaction</u>

Before the Commissioner can reallocate the taxpayer's assessable income, he must be satisfied that two or more parties to the international agreement were not dealing at arm's length with each other.

To reach his conclusion, he must have regard to "any connection between any two or more of the parties to the relevant agreement or any other relevant circumstance".

This gives him an extremely wide discretion but generally parties will not be arm's length if either one party controls the other, or both are under common control. However, it would appear that "any connection" would include independent parties who have certain understandings with each other in relation to their dealings.

If, for example, a company in Australia bought a raw material from an independent supplier overseas, paying an inflated price because it sold the finished product at a correspondingly inflated price to an Australian affiliate of the overseas supplier, non-arm's length dealings would exist. The purchase by the interposed company would therefore be open to attack under Div.13.

6. Arm's Length Consideration

The price received or paid for the supply and requisition of property or services under the matrimonial agreement must be equal to an "arm's length consideration" which is defined to mean the consideration which might reasonably be expected to have been received and given had the dealings occurred between independent parties dealing at arm's length.

The arm's length principle is internationally accepted with regard to transfer pricing. It is also the method adopted by the O.E.C.D. in its Model Double Tax Convention.

The four methods of ascertaining arm's length prices (viz.

comparable uncontrolled price, resale price, cost price, any other method) could each give a different value, any one of which could be represented to be an arm's length price. However, once account is taken of the particular circumstances of the industry in question and the company's circumstances, the variety of methods and range of prices would narrow down to one appropriate method giving the most appropriate price. The fourth method would be implemented where it was not practicable or possible because of any reason (including insufficient information) for the Commissioner to determine what might be termed an "objective arm's length consideration".

7. Commissioner's Determination to Apply Provision

Once the Commissioner is satisfied that:

(a) there is an international agreement;

(b) the dealings are not at arm's length; and,

(c) the consideration passing is not an arm's length amount,

he must determine whether or not to invoke the provisions of Div.13. Once he decides to invoke Div.13, the arm's length consideration is substituted for the consideration which was decided on by the parties and is treated as the actual consideration for all purposes of the ITAA.

If, for example, an overseas company lent interest-free to its Australian subsidiary, the overseas lender would not derive the interest, subject to withholding tax of 10%. If such interest was imputed to the lender, the consequential adjustment provisions would probably require that a deduction be allowed to the borrower, saving the Australian subsidiary tax at the rate of 46%. As the non-payment of interest would also mean that there would ultimately be a flow of dividends subject to dividend withholding tax, invoking the Division would not benefit the Australian Revenue. Thus the provisions would not be invoked by the Commissioner.

8. Territorial Source of Income

Once Div.13 is invokved, questions may arise as to the source of the income. The Commissioner must have regard to the nature and extent of any relevant business carried on by the taxpayer, the place or places at which it is carried on and the degree to which it operates in different countries.

Where a non-resident carries on business in Australia through a branch or other permanent establishment, the profit shifting is achieved by means of book transactions within the one legal entity and not between two or more parties.

Where the transactions involve the one legal entity, before the Commissioner can invoke Div.13, it must be shown that:

(1) a resident taxpayer carries on business through a P.E. in another country or a non-resident carries on business through a P.E. in Australia;

(2) the ordinary reallocation provisions cannot apply because two or more parties are not involved;

(3) a question has arisen as to the source of income or deductions;

(4) the question if determined according to the contents of the tax return would produce a "tax result" more favourable than if the Commissioner exercised his power of reallocation; and,

(5) finally, the Commissioner must hold the opinion that the derivation of income or incurring of deductions is wholly or partly attributable to the activities of the taxpayer at the P.E.

Before the taxable income of the permanent establishment or branch is reduced by the operation of Div.13, consideration must be given to what might have reasonably been expected to occur if the permanent establishment was a distinct and separate entity dealing at arm's length.

9. Compensating Adjustments

Once the Commissioner has exercised his power to reallocate income to one party, there may be a need to consequentially adjust the assessable income of the other party. For example, if a non-resident lends to a resident at an excessive interest rate, there would be a reduction in the resident borrower's interest deduction so that only the arm's length interest rate would be deductible for the purposes. The interest income of the non-resident should be reduced by a similar amount, and consequently the Australian interest withholding tax which would have been imposed on the original amount.

Before the Commissioner can make a compensating adjustment, he must be of the opinion that:

(1) (a) income is included in assessable income of a taxpayer which could not have been included if the parties were independent and dealing at arm's length; and

(b) that a deduction would be allowable if the parties were dealing independently at arms length; and

(2) it is fair and reasonable that the income should not be included or the deduction should be allowed.

Once he is satisfied of the above, he would be obligated to make the adjustment only if, in his opinion, it was fair and reasonable to do so.

10. Double Tax Treaties

Where Australia has a Double Tax Treaty with the non-resident party's country, the provisions of the relevant Treaty will take precedence over the operation of Div.13. As there are provisions in the Treaties which provide for the reconstruction of accounts where necessary, on an arm's length basis, both Division 13 and the Double Tax Treaties would have a similar effect in relation to the area of international tax avoidance.

In some instances, where the treaties them,selves give precedence to the domestic law, Division 13 will always operate if the taxpayer is an Australian resident (see Arts 1(3) and 9(3) of the U.S./Australian Treaty).

11. Penalties

The former section 136 and the Double Tax Treaties carry no penalty consequences.

The new Div.13 provides for a statutory penalty which also applies to the application of the corresponding tax treaty provisions. It is calculated at the rate of 10% on the difference between the taxable income as returned and the taxable income as adjusted pursuant to Div.13, from the due date of the lodgment of the taxpayer's return to the date when an assessment is made under Div.13 or a related treaty provision.

The penalty provisions were enacted to dissuade companies from using transfer pricing practices and/or lodging their returns calculated on the basis of non-arm's length pricing.

II. EFFECT OF DIVISION 13 ON TRANSFER PRICING

Transfer Pricing is the practice whereby a resident company sells to an affiliate in a "lower tax country" goods at a low price so as to reduce the resident company's profit from the sale. The affiliate company would then sell the goods to the eventual purchaser at a higher price. The affiliate company in the lower tax situation thus makes the greater profit from the transaction. The technique can also be used for transactions involving royalty payments, loans with or without interest, provision of services and the leasing of equipment or other property. The overall effect is that taxable profits are diverted into a lower tax country thus lessening tax revenue received in the resident's country. The former section 136 would have asked, "Is the taxable income of the resident company insufficient?" The new section 136 looks to the presence or absence of an international agreement, non-arm's length dealing in relation to a particular supply or acquisition of goods or services and non-arm's length consideration leading to a detrimental effect on the Australian Revenue.

Once the Commissioner invokes Div.13, the price paid or received by the Australian resident would be amended to become an arm's length consideration and tax on the resulting profits would be levied accordingly. The Australian resident would also have to pay the 10% penalty on that additional tax.

The reallocation of income could thus, in effect, produce a form of double taxation where the tax authorities in one country will tax the amount they have reallocated, but the compensating adjustment by the tax authority in the other country (resulting in a lesser tax burden) may not be made.

There could also be uncertainty in business transactions where the transfer pricing is carried out for non-tax considerations, as to whether or not the transaction will be subject to examination by the tax authorities and assessments altered accordingly.

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