TRANS-TASMAN TAXATION OF EQUITY INVESTMENT

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Foreword

Since its foundation in 1983, the Institute of Policy Studies has supported several research projects about New Zealand's relations with Australia. In the face of Closer Economic Relations, issues of trans-Tasman taxation are clearly of major importance in facilitating any flow between the two countries.

Both New Zealand and Australia have experienced unprecedented tax reform under the Lange and Hawke Governments. There have been differences both of degree and of detail, and this book examines these reforms and looks at their implications for equity financing. It also places tax moves and proposals for reform in an international context, and suggests ways by which national reforms may impinge on international tax agreements and ways by which international events both restrict and drive tax reform.

Richard Vann is Professor of Law at the University of Sydney and specialises in international tax law. He is therefore eminently qualified to produce this comprehensive study of trans-Tasman taxation of equity investment. The book is produced as part of the Institute's Taxation Programme.

The conclusions of this study are those of Richard Vann. The only criterion for publication by the Institute is its assessment of the intrinsic merit of the research reported. The Institute seeks to sponsor work which is likely to be of value to those responsible for determining policy, whether directly or through creating a climate of public opinion which facilitates the making of difficult choices. It is confident that Richard Vann's study satisfies all these requirements.

Gary Hawke
Director

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1 Tax Planning and Tax Reform

The purpose of this paper is to explore the taxation of income flows in the business area with particular reference to the international tax treatment of equity investments (company shares) in Australia and New Zealand. The focus will be on tax policy as viewed from a tax planning perspective, that is, the likely responses of taxpayers to tax changes already made and in progress will be investigated to see whether the changes are likely to achieve their purpose and, if they do, whether the costs are too high. Although the paper is focused on one major area of income flows, it will be found that many parts of the tax system and of tax reform impinge on the discussion.

Tax planning is often equated with tax avoidance and regarded as an anti-social activity, while general business planning is regarded as a prudent, indeed necessary, part of doing business especially in the international arena. This has always struck me as rather odd. It is the case that many international and domestic business deals are done only on the basis of achieving a favourable income tax outcome, but equally they are done only if all the difficulties of foreign investment controls, corporate and securities law, accounting practice etc., can be successfully negotiated. Whether avoidance of the intention of the law has occurred in a particular case involves identification of that intention and in many areas that is not an easy exercise. Moreover, tax and business planning often involve overcoming what many people would regard as unwarranted barriers to particular business goals. Of course, the best response is for the government to evaluate the barrier in question and to remove it if it is undesirable, but that takes time and often in the international arena it is not in the control of a single government alone.

The value of treating Australia and New Zealand together in the analysis is two-fold. First, it assists in forming a clearer view of the purpose and effect of tax reform when two parallel but different reform processes are compared. Secondly, it enables discussion of the interaction of the two tax systems. This interaction is an increasing phenomenon and is of considerable economic importance to the two countries, yet it is a relatively unexplored topic.

On the other hand, attempting the analysis is a case of seeking to hit a rapidly moving target. In the period in which this paper has been written, Australia has introduced its imputation system and foreign tax credit system (both operative from 1 July 1987), and then made a major announcement in the form of the Treasurer's Economic Statement of 25 May 1988. This statement was intended to bring about major changes to the effect of imputation by bringing long-term savings institutions within the system, as well as proposing to change the foreign tax credit system

fundamentally from 1 July 1989 by replacing it with a combined accruals tax system for tax haven income and an exemption system for other foreign income (Keating 1988a). In turn the New Zealand Treasurer announced a controlled foreign company regime for foreign income of New Zealand residents on 18 June 1987 (Douglas 1987a), replaced it with a much more comprehensive system in the Consultative Document on International Tax Reform (Douglas 1987c), and then drew back more closely to the original proposal as a result of the consultative and legislative process (Consultative Committee 1988a, 1988c). In addition, detailed proposals for the imputation system have appeared as well as a proposed fundamental reform of long-term savings (Douglas 1987a, 1987d, 1988a; Consultative Committee 1988b, 1988c).

In order to keep the discussion within reasonable bounds and to highlight the contrast of theory and practicality in tax reform, I will use Australia as a model of pragmatic realism and New Zealand as a model of the impractical but theoretical ideal. The cutoff point for discussion of the Australian position will generally be the Treasurer's Statement of 25 May 1988, while for New Zealand it will be the Economic Statement of 17 December 1987 and the accompanying Consultative Documents (Keating 1988a, 1988c; Douglas 1987b, 1987c, 1987d). Subsequent developments will be touched on where they materially affect the discussion. No doubt the contrast produced is a caricature of the true position but it serves to highlight an important difference in tax reform in the two countries.

Although New Zealand's company and business tax reform has been more far-reaching than Australia's, particularly in seeking to treat all kinds of income on an equal footing, ironically it may be that the 17 December 1987 proposals in New Zealand in relation to imputation and international taxation produce different rather than less economic distortion, which is contrary to their purpose. The reason for this is the operation of the proposals in the context of interaction of different countries' tax systems. While the problems that arise from such interaction are in the final analysis insoluble, it should be possible for two such closely related nations as Australia and New Zealand at least to ask the question whether reduction of tax avoidance and investment distortions by better co-ordination is possible.

A Tax Reform in Australia and New Zealand

Both Australia and New Zealand have experienced unprecedented tax reform since the election of the Hawke and Lange Labo(u)r governments. There have been many similarities in the directions of tax reform, but there have also been fundamental differences. As a general comment it is probably true to say that the New Zealand tax reform to date and the further proposals considered in this paper have been both more experimental and more fundamental. This is partly due to the different nature of the countries involved. New Zealand is a small, homogeneous country with a unitary legislature that is dominated by the government. Australia is a larger and more diverse society with a much more complex governmental structure.There are federal, state

and territory governments with two houses of parliament at the federal level, one of which, the Senate, has not been controlled by the government of the day for over a decade.

These differences in some respects explain the differences in tax reform that have occurred. New Zealand is the ideal environment for experiments in taxation and seems to have returned to its role of a social laboratory for which it was noteworthy early this century. Tax reform in Australia is necessarily more complex and pragmatic. It is made complex by the governmental structure with key public goods such as education and health being delivered at the state level, though largely funded with federal money, and the federal government's need to negotiate with the Australian Democrats in the Senate to achieve passage of its tax reform legislation.

The process of tax reform has also been different. Australia has adopted what might be termed the 'big bang' approach exemplified by the National Tax Summit in June 1985 followed by the Treasurer's Statement on Reform of the Australian Tax System of 19 September 1985, from which most, but not all, of the structural reform in Australia takes its origin (Keating 1985). A second big bang - or a whimper depending on one's point of view - occurred on 25 May 1988 with the Treasurer's Economic Statement which included business tax reform. The consequence of this approach has been a degree of indigestion on the part of all the parties concerned - the politicians, the bureaucrats, private interest groups, professional advisers and individuals generally. It has also probably led to a higher level of opposition as virtually every group in the country has had something to complain about in the range of measures proposed. The benefit of the big bang approach to tax reform is that it allows the development of packages whereby the combination of tax measures can be viewed as a whole so that most groups will find not only something to complain about but also something they like.

In New Zealand, on the other hand, the approach to tax reform which has been adopted might be termed that of the 'bite-sized chunk' (though the bites seem to be getting bigger). Tax reform has proceeded in stages with a number of major statements to date dealing with various aspects of tax reform over a more extended period. This has eased the indigestion of all concerned and has allowed the development of a more structured process which tends to quieten opposition. Thus a number of the proposals have been announced in outline, followed up with a Consultative Document on which a Consultative Committee has commented, and then the legislation has been the subject of a Select Committee of the Parliament which has considered the Consultative Committee's report, the government responses and the details of implementation of the measures. The risk in the New Zealand approach is that the overall effect of tax reform might be lost sight of in the sense that the relationship of measures announced at different times might not have been fully considered. To some degree this occurred with imputation and international tax reform, but the connection and relationship of these two reforms was firmly re-established in the Economic Statement of 17 December 1987 (Douglas 1987b).

Overall it seems that the coherence of the different proposals has at most times been present in the minds of the architects of New Zealand tax reform.

The outcome of the tax reform process in each country is interesting for its comparisons and contrasts. Both Australia and New Zealand have adopted fringe benefits taxes which are similar in their basic features. There have also been reforms in the timing rules for finance transactions, imputation and international taxation. In these areas, however, there are significant differences of detail. With respect to the timing rules for finance transactions, New Zealand has adopted a much broader system. The similarities and contrasts in the international and imputation areas will be discussed in detail in this paper.

The major differences in tax reform are also noteworthy. New Zealand has not adopted a capital gains tax, although the tax is being considered, whilst Australia has not reformed its indirect taxes in any comparable way to the goods and services tax. The proposal for a retail sales tax (called a Broad Based Consumption Tax) in Option C of the Draft White Paper was a casualty of the Tax Summit process in 1985. Nonetheless there is a feeling amongst many observers in Australia that a form of value added tax is almost an inevitability in the 1990s. Australia was slower to tackle the problems arising from tax exempt bodies and the changes were much less dramatic than those flowing from the reform of superannuation in New Zealand (Douglas 1987b, 1988a). Indeed in the savings for retirement area the exemptions were considerably expanded and rationalised in 1984 and extensive further rationalisation occurred in 1987, only to be removed in part in 1988 (Keating 1988b). It is not intended to debate the pros and cons of special concessions for retirement saving and associated adjustments to social security arrangements, but the problems of tax exemptions will figure significantly in the discussion of the imputation system in particular and the opportunities for tax arbitrage under that system.

One major item on the tax reform agenda which neither Australia nor New Zealand has yet tackled and which in the light of their respective inflation rates should be of fundamental concern is adjustment of the income tax base for inflation. Similarly neither country has effectively tackled the problem of tax drift caused by inflation interacting with a progressive rate scale, though the levelling of the rate scale is partly a response to the problems of inflation.

Although all the reforms in each country are clearly interrelated, many of them would not seem of relevance to equity financing which will constitute the focus of this paper. However, apart from the fringe benefits tax, all of the areas of reform mentioned above will be at least mentioned. The taxation of equity in the international arena provides a convenient focus for demonstrating just how interdependent the various parts of the tax system are. It will become apparent that the introduction of a capital gains tax in New Zealand seems an inevitable outcome of the current reform process, as has been recognised by the Consultative Committee on Full Imputation and International Tax Reform (1988a). Moreover, given the current penchant of New Zealand for fundamental reform, it will not come as a surprise if an attempt is made

to levy capital gains tax on an accruals basis which is something that has not been attempted generally anywhere else in the world.

B Tax Reform and the International Dimension

I will suggest that more fundamental reform does not necessarily mean better reform. There are limits to how far theories of taxation can be implemented in practice. Pursuing tax reform in isolation in the sense of creating tax structures which have no parallel in other countries (of which the New Zealand proposals of December 1987 for international taxation of residents are an example) may be more damaging than adopting a system which may be less desirable in some theoretical framework but is more consonant with other tax systems around the world.

This is not a counsel of despair nor is it simple pragmatism. It has become increasingly recognised in recent times that international events both restrict and drive tax reform. To take but two examples, in 1978 the Meade Committee in the United Kingdom was in favour of a progressive expenditure tax, but recognised in its concluding chapters that such a system would create immense difficulties if adopted in one country alone rather than being adopted across countries. Similarly it is evident that the US tax reform of 1986 is driving tax reform around the world. For small countries like Australia and New Zealand the message may be that only the largest countries can go it alone in tax reform and even the largest countries are subject to very significant international constraints in tax reform as the international tax reforms in the US in 1986 demonstrate.

Indeed, the argument can be put even more strongly than this. Less than perfect tax reform may in fact better achieve the objectives of tax reform than would enactment of what is regarded as the most desirable tax structure. It will be argued in the following pages that the New Zealand imputation and international tax proposals of December 1987 may create as many investment distortions as they correct - and it is to be noted that the prime object of the reforms is the so-called levelling of the playing field and the reduction of distortions in investment decisions. Moreover, the reforms may run directly contrary to the goals of deregulation. The reforms will effectively prevent investment structures and flexibility in cases where tax considerations are not a reason for adopting a particular structure.

It will be evident from what has been said above that the relative sizes of Australia and New Zealand in the world economy impose constraints on tax reform. In turn, the relevant sizes of the economies of Australia and New Zealand may be thought to impose further constraints on New Zealand tax reform. Examples relevant to the latter issue will appear in this paper and I leave it to readers to judge the outcome.

Whatever the significance of size in this regard, some trends in the development of Australian and New Zealand markets need to be borne in mind when judging tax reform. Both countries are reliant on foreign investment in order to meet development needs. Conversely enterprises in each country necessarily must expand overseas if

they seek to grow. This trend has been particularly evident in Australia and New Zealand in recent times with overseas investments by enterprises based in each country increasing rapidly. It may seem ironic that each country requires significant levels of foreign investment while enterprises in each country need to engage in substantial investment overseas, but the two trends are by no means incompatible. An enterprise can only expand within each country to a certain point. On the one hand, competition legislation will prevent expansion in particular markets, while on the other hand it will often be less rational from both a national and enterprise viewpoint to become a conglomerate within the enterprise's country rather than to expand overseas in the enterprise's special area of economic activity.

C Structure of the Paper

The analysis in the paper begins with a look at the imputation systems of Australia and New Zealand primarily in a domestic context. Although the focus of the paper is the international taxation of equity, the discussion of tax planning responses in the domestic context will point the way for responses in the international context, especially with regard to non-residents. The reasons why the imputation system has been chosen for the taxation of company profits will not be elaborated (see Benge and Robinson 1986, Vann 1986a) although some of the design features and possible alternatives will be explored.

The discussion then turns to the taxation of overseas equity investments by residents, in the context of the foreign tax credit and proposed accruals regime for foreign income in Australia and the changes to taxation of foreign income by New Zealand. Because of the significant differences in the treatment by each country, the essential nature of the particular systems will be analysed. It will be argued that both systems produce investment distortions, that both are subject to extensive avoidance possibilities and that it is doubtful whether either represents the most desirable treatment of foreign income of residents in a world of second best solutions. This has been recognised in decisions subsequent to the Consultative Document in New Zealand (see Consultative Committee 1988a) and will probably lead to significant modifications to the Australian proposals of 25 May 1988 (Keating 1988c).

The taxation of non-resident (foreign) equity investment is an issue that has attracted more attention in Australia than New Zealand. It was in fact not clear from the Consultative Document on Full Imputation (Douglas 1987d) how foreign equity investment was to be taxed as regards the dividend withholding tax and the branch profits tax, and the Consultative Document on International Tax Reform (Douglas 1987c) confines itself to foreign income of New Zealand residents only. The avoidance possibilities in this area abound, but there is a problem of eliminating the avoidance as both New Zealand and Australia are in need of foreign equity investment and raising the tax level on foreign investment may be counter-productive. The specific areas that will be addressed are the incentives created by the imputation

system for non-residents to engage in arbitrage activities with imputation credits, the operation of the dividend withholding tax, and problems arising from debt/equity characterisation issues, particularly thin capitalisation.

Transfer pricing forms one of the major ways that non-residents can avoid Australian or New Zealand tax but this activity is one that is common to residents and non-residents alike and accordingly will be discussed separately. Transfer pricing is also a good example of the limits of tax administration. Consideration of administrative problems in this area will thus give an insight into the likely success or otherwise of the administration of the new tax regimes for foreign income of residents.

Finally the paper analyses briefly the problems that arise in equity investment across the Tasman. This involves a discussion of the interaction of the Australian and New Zealand tax systems as they affect equity, together with the impact of the Australia New Zealand double tax treaty. One particular issue that will arise more and more is the trans-Tasman merger or takeover of companies. A matter that will be of significance to both countries will be whether the company which emerges from the process is located in Australia or New Zealand. At this stage it is not possible to predict the outcome as there are too many unknown features of the tax systems that will apply in each country in 1989. However, it does seem certain that there will be considerable tax obstacles to such activity and much tax planning energy will be directed to eliminating them. It is a matter of some importance for both countries to decide whether they should engage in tax competition or co-operation in this area; the indications for the moment are that competition will prevail, notwithstanding that co-operation in the trade area is increasing through Closer Economic Relations.

2 Imputation

Australia and New Zealand will both have full imputation systems which give full tax credits to shareholders for company tax paid. The legislation in Australia is found in Part IIIAA of the Income Tax Assessment Act 1936 (the ITAA). The details of the proposed system in New Zealand that are discussed here are generally those found in the Consultative Document on Imputation, apart from the proposed tax rates and some changes which are based on later decisions. Because the company tax rate in the case of Australia until 30 June 1989 effectively equals[1] the maximum marginal individual tax rate, dividends are tax free for maximum marginal rate taxpayers and for lower marginal rate taxpayers tax liability is reduced on other income. In New Zealand it was originally hinted in December 1987 that the company tax rate would exceed the individual rate (as in the US) and that the individual tax rate would be flat apart from the zero bracket (Douglas 1987b). Subsequently it was settled that the company tax rate would be 28% while the maximum individual rate would be 33% (Douglas 1988b). This means that imputation credits do not eliminate the total tax on dividends for individuals on the maximum marginal tax rate. In the discussion that follows, both possibilities will be considered in relation to New Zealand to evaluate the results where full imputation is applied with a company rate above and below the maximum individual tax rate.

Both the Australian and New Zealand systems are based on an accounting mechanism which ensures that credits given to shareholders are matched by tax paid at the company level. Where a dividend carries an imputation tax credit, the dividend and the attached tax credit are included in the income of the shareholder and the tax liability of the shareholder is reduced by the amount of the credit. The imputation credits are mainly available to resident individuals of the respective countries on dividends received from resident companies and are non-refundable where they exceed tax liability of the shareholder. This means that tax exempt and non-resident shareholders do not get the advantage of the tax credits. Where a dividend with an imputation credit attached is received by a resident company, the existing methods for relieving inter-corporate dividends from tax will continue to apply in each country and in turn the recipient company will be able through the accounting mechanism to pass on to its shareholders the imputation credit attached to the dividend received.

Australia originally proposed that it would use a compensatory tax modelled after the UK Advance Corporation Tax to ensure that shareholder tax credits were matched by tax at the company level, but this proposal was dropped in view of its likely effect of considerably raising the tax effectively levied on non-residents and tax exempts. It may be thought that there is no reason why such increases in tax should not occur,

but particularly in relation to non-residents there were transitional problems that would have caused a large outflow of capital when the exchange rate was already under pressure (Vann 1985b). The tax increases arise under the compensatory tax because profits that have not borne full company tax are subjected to a special tax on distribution which is not recouped to non-residents or tax exempts.

Under the accounting mechanism for imputation, where dividends are paid which do not have matching tax payments at the company level and therefore do not carry tax credits for shareholders, the dividends do not attract any tax on the company on distribution but they are still taxable to the shareholder. Hence the problem of the compensatory tax in this regard is avoided. Taxation of such dividends is a departure from the proposals of Benge and Robinson (1986) which were the main source of the accounting mechanism and which both countries' systems otherwise generally follow. Benge and Robinson proposed that such dividends should be exempt as they reflect exempt income at the company level and there is no reason why tax concessions enjoyed at the company level should be cancelled out on distribution (1986, pp 93-96). It was felt by the respective governments, however, that such a regime would give rise to tax avoidance activities and so it was not adopted.

This means that income derived through companies still is not treated the same as income derived through trusts and partnerships and so pressure still exists on the entity classification rules of each country to avoid characterisation as a company in certain circumstances.

The Australian imputation legislation utilises the device of a' franking account' as the accounting mechanism for keeping track of company tax payments (ITAA ss 160APA definition of franking account balance, 160APJ). The credits to the franking account are, however, not of company tax payments as such but effectively the after-tax taxable income of the company and dividends received by the company with imputation credits attached (ITAA ss 160APM-160APP). Dividends paid by the company with imputation credits attached are debited to the franking account in the amount of the dividend (ITAA s.160AQB). Because the account keeps track of after-tax taxable income it is necessary to convert company tax payments to after-tax payments and this is achieved by the formula:

$$\frac{1 - CR}{CR}$$

where CR is the company tax rate (ITAA s.160APA definition of adjusted amount).

By contrast the equivalent New Zealand account (to be called the Imputation Credit Account) records as credits company tax payments and imputation credits attached to dividends received. Debits are the amount of imputation credits attached to dividends paid by the company, and so if a dividend paid has a full imputation credit attached, the amount of the debit is calculated by converting the dividend (the after-tax income of the company) as follows:

$$\frac{CR}{1 - CR}$$

where CR is again the company tax rate (Douglas 1987d, p 32).

There is no difference in substance between these two methods of operating the necessary accounting mechanism, but in the discussion that follows, the different calculations should be kept in mind. In view of the difference, the terms 'franking account' and 'imputation credit account' will be used for the Australian and New Zealand accounting mechanisms respectively, but otherwise the Australian terminology developed for the imputation system will generally be used as New Zealand is in the course of developing its terminology. Because of the use of the accounting mechanisms to keep account of tax paid income for other purposes (besides granting imputation credits to individuals), the Australian system probably is the more sensible (as is in effect recognised by the Consultative Committee in New Zealand in relation to the reconciling of tax paid under its accruals regime for foreign income and the taxation of dividends received from foreign companies, 1988c paras 9.12.1-9.12.2).

New Zealand has moved closer to the Australian approach to what is a dividend for tax purposes, both generally and for the purposes of imputation, particularly as regards bonus shares and liquidation distributions. The definition of dividend in ITAA s.6(1) makes it clear that bonus shares fall within the scope of the definition (except bonus shares which are debited against an amount standing to the credit of a share premium account), and liquidation distributions are made dividends by s.47 in most cases. At present s.4 of the New Zealand Income Tax Act 1976 (NZITA) in broad terms defines a dividend for the purposes of the Act as any distribution which is equivalent to a distribution of company earnings. A bonus share is defined in NZITA s.3 as a capitalisation of the amounts standing to the credit of certain accounts. Since a bonus issue is a capitalisation and not a distribution of company earnings, a bonus share is not a dividend for the purposes of the Act.

Concurrently with the introduction of imputation in New Zealand, bonus issues, other than those made from share premiums, are to be taxed in the same way as dividends (Douglas 1987b, p 18). At present NZITA s.4 provides that distributions of certain capital profits, share premium reserves, and paid up capital where the company has not made a bonus issue within 10 years of being wound up are exempt from tax if they are made on the winding up of the company. The Consultative Document on Full Imputation (Douglas 1987d, p 13) provides that all distributions on liquidation other than paid up capital will be taxed. Paid up capital is defined as the aggregate of the amounts paid in by its shareholders, including any share premiums, in the subscription of shares and the amounts capitalised to paid up capital by way of taxable bonus issues. In the Consultative Committee's report (1988b paras 2.5.1-2.6.6) these rules were modified by giving the company an option of making a taxable or non-taxable bonus issue and exempting capital gains of the company from tax to the shareholder as a dividend in liquidation distributions.

As well as overcoming tax avoidance activities, the treatment of bonus shares and

liquidation distributions forms an important feature of both imputation systems. Particularly noteworthy is the treatment of bonus issues which confer the ability on companies to attach imputation credits to bonus shares out of retained profits, while still being able to make tax free bonus issues out of the share premium account (or, in the case of New Zealand, by election by the company). This avoids the potential cash flow difficulties for companies arising from a full imputation system whereby shareholders may require that dividends be paid in order to gain access to imputation credits while the company wishes to reinvest its profits. A bonus issue will carry imputation credits but will not place a cash flow burden on the company.

While the cash flow problem is solved by the bonus issue device, it may be doubted whether it will be much utilised for tax reasons alone, especially in New Zealand. If the shareholder is on the maximum marginal rate and the imputation credits do not exceed that tax rate, then the shareholder gets no direct benefit from the credit on a bonus issue as no cash is received and the company may as well retain the imputation credits for use with cash dividends or for 'sale' to other companies which desire them. In Australia there is an indirect benefit in the form of an increase of the cost base of the shares for capital gains purposes (ITAA s.160ZYHC), but this is of value only to shareholders who acquired their shares after 19 September 1985 because of the transitional rule under the capital gains tax whereby only assets acquired after that date are subject to the tax.

If the company tax rate in New Zealand were higher than the maximum individual rate as originally proposed, and imputation credits were granted at this higher rate, then this reasoning against bonus issues would not be as strong, as some offset of tax on other income would be available from the imputation credit attached to a bonus issue. While the company tax rate in New Zealand is below the maximum individual rate as has turned out to be the case, and there is no capital gains tax, there is no benefit from a taxable bonus issue as the shareholder will be required to pay tax on the taxable bonus issue even if it carries a full imputation credit. Nevertheless, there may be good commercial reasons for the making of a bonus issue (mainly because of the apparently irrational reaction by the market to bonus issues of increasing the overall market value of the company), and the imputation system will at least not unduly impede this process.

The ability of companies to attach imputation credits to bonus issues means that the imputation system is moved one step closer to the integration system which is regarded as the ideal for company taxation by many economists. The difference between imputation and integration is that the former attributes company tax to shareholders only so far as company profits are distributed, whereas the latter attributes company income and tax to shareholders whether or not profits are distributed. From the tax planner's perspective this move takes on a different complexion as it confers greater tax avoidance potential on the company because the company is given the power to stream imputation credits to particular types of

shareholders without the necessity of paying out cash. Both New Zealand and Australia have made it clear that they wish to prevent streaming of the credits, but it will be suggested below that neither country has been successful.

The problem of streaming credits is closely related to the question of whether imputation reduces the incentive for tax avoidance by companies. The argument that it does is that shareholders will be taxed on dividends which are not supported by imputation credits and so the company will be under pressure to pay dividends with credits attached. As credits can only be attached to dividends when company tax has been paid, companies will not have the same incentive as previously to reduce company tax. The argument depends on two premises that often turn out to be wrong. First, not all shareholders are taxed on distributions that do not have imputation credits attached (or at least their tax payments vary). Secondly, the ability to attach credits to dividends does not depend on company tax payments by the company paying the dividend but only upon company tax having been paid by some company. It can therefore be expected in Australia and New Zealand both that an active market in imputation credits will develop, and that companies will continue to seek to reduce company tax liabilities.

In evaluating the operation of the imputation systems in the respective countries, particularly in relation to tax avoidance by companies and streaming of credits, it is important to bear in mind other elements of the tax systems outside imputation proper. There are in fact major differences between Australia and New Zealand outside imputation. New Zealand does not levy a general capital gains tax whereas Australia does for assets acquired after 19 September 1985. The lack of a general capital gains tax in New Zealand has two important effects. It means that shareholders can often realise the benefit of company profits through a sale of shares rather than a receipt of dividends where the dividends would not have imputation credits attached to them. Companies thus have an incentive to reduce company tax in many cases and to allow shareholders to realise the benefit of the increased profits that result by a sale of shares. Further, the absence of a capital gains tax often provides a convenient avenue for companies to achieve the tax avoidance prompted by this omission from the tax base.

On the other hand, the existence of tax exempts which cannot utilise non-refundable imputation credits produces an incentive for these types of taxpayers to sell imputation credits to shareholders who can utilise them. Tax exempts also provide a means for companies to engage in tax avoidance activities by interposing an exempt entity in a transaction at the point where tax liability but not the full economic benefit of the transaction occurs. Prior to 25 May 1988, this was much more of a problem for Australia which, unlike New Zealand, had not taken action to do away with tax exempts but, on the contrary, had increased the number of exempt bodies and the opportunities to utilise them (especially approved deposit funds and exempt annuity business of life companies). The Economic Statement of that date which introduced tax on these bodies in fact reversed the incentives involved but did not solve the problem as will be explained below.

Both Australia and New Zealand have similar problems of controlling the imputation credit sale and streaming activities of the other major group which is denied the credits, namely, non-residents. Although the position of non-residents will be referred to in passing in the general discussion of imputation, the major discussion of the problems arising from non-resident shareholders will be postponed until the section on the taxation of non-resident equity investment.

A Australia

Although it originally appeared that the franking account would be kept on a simple payment basis with respect to the company tax (Keating 1986), it proved necessary to create a much more detailed credit and debit process in order to reflect the various types of events that occur in the assessment and payment of company tax. (The credits and debits are referred to as franking credits and franking debits.) For example, each of the three instalments of company tax usually payable during the year gives rise to a franking credit as does the issue of a company tax assessment for the full tax liability for a particular year of income (ITAA ss 160APM, 160APN). There is thus an element of double counting with respect to the franking credits as the instalments are effectively credited twice. In the company tax assessment the instalments are applied to reduce the tax payable and to give a balance of company tax to be paid for the year. This process in turn gives rise to a franking debit equal to the amount of the instalments so that the double counting of the instalments is reversed (ITAA s.160APY). Similarly, the foreign tax credit in Australia operates under a separate process from the company tax assessment and separate franking credits and franking debits arise in the process (ITAA ss 160APT, 160AQA).

As a result of this crediting and debiting process, the franking account will have a positive or negative balance at any given time (referred to as a franking surplus or franking deficit, ITAA s.160APJ). Where there is a franking surplus when a dividend is paid by the company, generally that surplus must be used to 'frank' (that is, attach imputation credits to) the dividend. A company can, however, frank a dividend beyond the amount of the franking surplus and even when there is a franking deficit at the time of payment of the dividend under s.160AQF (generally referred to as over-franking). If at the end of the franking year (the annual period that operates for imputation purposes which usually corresponds to the year of income for company tax purposes) there is a franking deficit, then franking deficit tax is payable at the company tax rate of an amount sufficient to generate a franking credit that will restore the franking account balance to zero (ITAA s.160AQJ).

This franking deficit tax is treated as a pre-payment of company tax and is credited against company tax liability in the next year of income, reducing company tax payments (ITAA s.160AQK). The purpose of franking deficit tax is to ensure that imputation credits attached to dividends are in fact supported by company tax

payments, as a franking deficit can arise ultimately only if dividends paid have been over-franked. To discourage over-franking of dividends, a penalty tax applies in addition to franking deficit tax if there has been more than minimal over-franking (ITAA s.160ARX). This tax is non-deductible against income and cannot be offset against future company tax. The franking deficit tax can be compared in function to the Advance Corporation Tax in the UK, but unlike that tax, it performs only a residual function in the Australian imputation system where the company has not followed the rules of the imputation game.

Generally speaking, companies can frank dividends from zero to 100% (ITAA s.160AQF). A dividend is unfranked when there is no imputation credit attached and is (fully) franked when the full rate of company tax is imputed to the dividend. (In Australia, this means that prior to the cut in the company tax rate to 39%, a dividend is fully franked when it carries $49 of imputation credits per each $51 of dividend; with the reduction in the company tax rate, the maximum imputation credit will be $39 for each $61 of dividend.) A dividend in between these extremes is usually referred to as partially franked.

The franking procedure simply requires that companies make a formal and irrevocable declaration that a dividend is franked to a particular extent before the dividend is paid (ITAA s.160AQF). This freedom is partly circumscribed by the rules referred to above about over-franking, but on their own such rules would have little impact on the sale and streaming of imputation credits to particular categories of shareholders (Dixon and Vann 1987). Before the details of the rules designed to prevent sale and streaming of the credits are described, the incentives for streaming will be identified, both before and after the Economic Statement of 25 May 1988.

1. Incentives for the Sale and Streaming of Imputation Credits

Tax arbitrage involves deals, generally between taxable and non-taxable entities, whereby both parties arrange to reduce their combined tax liabilities and split the profits between them. The major loser from such transactions is the revenue because of the tax advantages shared by the parties. The scope for such tax arbitrage was increased by the imputation system because some persons are entitled to the benefit of imputation credits, namely resident individuals and companies, while other persons are not, especially tax exempt bodies and non-residents.

The following table indicates the different value of a $51 cash dividend (fully franked and unfranked) to different categories of shareholders. In the case of a non-resident it is assumed that a tax treaty limits dividend withholding to 15%. The table relates to tax rates prior to the May Economic Statement.

Table 2.1 **The Different Value of a $51 Cash Dividend to Different Categories of Shareholders (Prior to May Economic Statement)**

	Pre-tax value of franked dividend	Post-tax value of franked dividend	Pre-tax value of unfranked dividend	Post-tax value of unfranked dividend
Resident Individual				
- No Tax Liability	51	51	51	51
- 24% Tax Bracket	100	76	51	38.76
- 29% Tax Bracket	100	71	51	36.21
- 40% Tax Bracket	100	60	51	30.60
- 49% Tax Bracket	100	51	51	26.01
Resident Company	100	51	51	51
Tax Exempt Entity	51	51	51	51
Non-residents	51	51	51	43.35

The following table indicates the different value of a $61 cash dividend (fully franked and unfranked) to different categories of shareholders after the Economic Statement (including the new tax of 15% applied to tax previously exempt bodies in the superannuation area).

Table 2.2 **The Different Value of a $61 Cash Dividend to Different Shareholders (Prior to the Economic Statement)**

	Pre-tax value of franked dividend	Post-tax value of franked dividend	Pre-tax value of unfranked dividend	Post-tax value of unfranked dividend
Resident Individual				
- No Tax Liability	61	61	61	61
- 24% Tax Bracket	100	76	61	46.36
- 29% Tax Bracket	100	71	61	43.31
- 40% Tax Bracket	100	60	61	36.6
- 49% Tax Bracket	100	51	61	31.11
Resident Company	100	61	61	61
Tax Exempt Entity	61	61	61	61
Entity taxed at 15%	100	85	61	51.85
Non-residents	61	61	61	51.85

There is both a variation in the pre-tax and post-tax values of the same franked dividend for various categories of taxpayers. In the case of unfranked dividends, the only variations are in the post-tax value to various shareholders because of their taxable status in the hands of recipients. From the view point of tax arbitrage, the most important variations are between the pre-tax values of franked dividends to non-residents and tax exempt bodies and to resident individuals and companies, and the post-tax values to individuals subject to various marginal rates of tax.

The tax arbitrage opportunities in post-tax terms lie principally in the area of unfranked dividends and for franked dividends in income splitting between individuals if and where dividends can be transferred to taxpayers with the lower marginal rates of tax (but with sufficient tax liabilities on other income to absorb the tax credit). The scope for arbitrage in pre-tax terms is, however, likely to be much more significant, at least in terms of the extent of funds invested in company shares.

If tax exempt investors such as superannuation funds (prior to 25 May 1988) and non-resident investors were able to arrange transactions to replace dividends by other income, such as interest or capital gains not subject to the separate company tax, there is substantial scope to increase both their pre- and post-tax incomes. Incentives for arbitrage are also increased because while all interest income is subject to tax on a nominal basis, capital gains are either not subject to tax on assets acquired prior to 20 September 1985, or only gains in real terms are taxed when realised because of the indexation factor for assets subject to capital gains tax (ITAA ss 160L(1), 160ZJ). The devices through which arbitrage can be achieved are various and are analysed below.

a) Tax Exempts, Life Companies and Superannuation Schemes

In Australia prior to the Economic Statement, tax exempts, life companies and superannuation schemes were likely to be major sellers of imputation credits. Australia has committed itself to a policy of encouraging private saving for old age through an elaborate system of superannuation and allied schemes whereby the savings were effectively given expenditure tax treatment. That is, contributions to superannuation funds were (and are) tax deductible to employers within very generous limits, the benefit of the contributions was (and is) not taxable to employees, contributions to and accumulations in the funds were (but no longer are) exempt from tax, and payments out of the funds were (and are) taxable to the recipients. In fact the taxation arrangements were more complex and less pure in their expenditure tax treatment than this outline suggests, but it is adequate for present purposes. The important point for now is the tax exemption previously enjoyed by employer contributions and the earnings on the fund's investments. The non-refundability of imputation credits means that they were effectively wasted when received by superannuation funds.

This in fact was one of the major reasons why the credits were made non-refundable, the other having to do with the treatment of non-residents and the prospect of pressure being brought to bear on Australia in tax treaty negotiations to extend the

credits to residents of other countries (Vann 1985). The general non-refundability, however, was more of a smoke screen for the policy decision involved, as it is quite possible to have refundable credits and then deny refunds to particular groups or entities (which is the UK approach). Indeed an imputation system that requires imputation credits to shareholders to be matched by company tax payments would seem to require or at least suggest refundable credits, whereas non-refundability is more justified where the credits do not require supporting company tax payments, as in Canada. The real reason why the credits were denied to tax exempt institutions was that the cost to revenue would have been too great if the refunds were allowed, and non-refundability was effectively the position of tax exempt institutions in relation to company tax payments under the classical system so that the absolute position of the tax exempts was not changed by imputation.

Such is the level of investment funds that have built up in tax exempt funds in recent times that it is not unrealistic to imagine that many millions of dollars of wasted imputation credits would quickly build up in the funds. A sale price of the credits of even 10c in the dollar would thus have been a very attractive proposition to the funds.

The changes made to the tax arrangements for superannuation on 25 May 1988 were many and varied (Keating 1988b), but here only those relevant to imputation are highlighted. Superannuation and similar funds are from 1 July 1988 taxable on employer contributions and fund income at 15% and are allowed to use imputation credits to offset their tax liability. The tax on payments from funds is to be reduced by 15%, so that apart from the imputation effect, the main change is a bring forward of tax. The imputation effect is, however, substantial as demonstrated below.

Life insurance companies prior to 25 May 1988 also were likely to build up a large reservoir of wasted or unusable imputation credits. So far as life companies are involved in retirement income arrangements, their investment income is taxed in a similar manner to superannuation funds and so they will be in a similar position in regard to imputation credits.

With respect to traditional (and not so traditional) life policies, life companies were taxed on a very rough proxy basis for policyholders. The proxy was rough because there were many differences between the tax rules applied to life companies in the area of income earned on behalf of policyholders, and individuals. The life companies were assessed on their interest and rents but were effectively not taxed on dividends because they are allowed a tax rebate under ITAA s.46 on dividends received from Australian companies. Realised gains on portfolio investments are also taxable without allowance of capital gains tax indexation. Moreover, life companies receive a special deduction related to their liabilities which reduces their taxable income (less significantly in recent times than previously). To complete the picture for life companies it should be stated that payments out on maturity of the policy are generally exempt from tax in the policyholders' hands.

The imputation treatment of life companies prior to 25 May 1988 was interesting and somewhat inconsistent. They were denied by ITAA ss 160APP, 160APQ and

160AQCA a franking credit with respect to franked dividends attributable to their insurance funds (the funds held on behalf of policyholders), but they were allowed franking credits for tax payments made by the companies including payments attributable to income (other than franked dividends received) on policyholders' funds (ITAA ss 160APM and 160APN). Because there was considerable tax paid in the latter category, the companies built up enormous franking surpluses, much more than could ever be used for franking dividends paid to shareholders where the companies have shareholders and are not mutual insurance companies. This difference in treatment of franked dividends received and tax paid seems to have been the result of pure legislative oversight with respect to the latter.

The life companies prior to 25 May 1988 thus had two sources of imputation credits that they might wish to sell. Those credits arising from activities producing exempt income had to be utilised on a current basis as the credits are lost once franked dividends are received by the life company (that is, the life company would have to deal with the shares on which franked dividends would be paid before the dividends were paid). Those arising from the enormous franking surpluses due to payment of company tax would not have to be used on a current basis because they are be able to be carried forward from one year to the next (ITAA s.160APL), but efforts will be made to use them up reasonably promptly as legislation to deny franking credits in this case can be anticipated.

The changes to the taxation of life companies and their policyholders made by the Economic Statement of 25 May 1988 (Keating 1988a) are again substantial but can be summarised briefly for present purposes. Income attributable to policyholders' funds will in future be taxed to the companies at a 39% rate without the benefit of a s.46 rebate on dividends and without the special deductions previously available to life companies. Imputation credits attached to dividends received by the life company on policyholders' funds will be available for offset against this tax liability and the proceeds of life policies will generally remain exempt in policyholders' hands. This means that life companies will benefit immediately from the receipt of franked dividends rather than having to sell the credits to realise the benefit of them.

b) Tax Preferences and Dividend Policies of Australian Companies

It follows that there will be sellers of imputation credits in Australia, namely non-residents, tax exempts and, prior to 25 May 1988, superannuation funds and life companies. The other question to ask is whether there will be buyers for the wasted credits. That depends in part on the market's perception of unfranked dividends and in part on the desire of resident individual shareholders for the credits. These are matters which cannot be predicted with certainty at this point but it does seem reasonable to assume from the analysis above that there will be incentives for buying credits.

Prior to 25 May 1988, by way of some rather large generalisations, it can be said of Australian listed companies that effective tax rates measured as the percentage of

Australian tax paid of pre-tax paid profits varied largely and were nearly all below the statutory tax rate. Those companies with low effective Australian tax rates achieved them by various routes. First, Australia had some quite explicit tax concessions for business such as accelerated depreciation, an investment allowance, exemption of and accelerated and augmented research and development deductions. There has been a recent thorough-going attempt to remove most of these in Australia (Keating 1988a) just as there has been in New Zealand, but it will take some years for the changes to bite because of the transitional arrangements involved. Secondly, the treatment of interest deductions especially in the context of geared takeovers is thought by some to reduce significantly the company tax base, and prior to the market crash such takeovers were commonplace. Thirdly, an increasing amount of income of Australian companies is foreign source and either untaxed or subject to a foreign tax credit in Australia, with the result that Australian tax on the company's profits is less than the statutory rate.

Australian listed companies have tended on average to pay cash dividends of about half of their after-tax profits and to make bonus issues periodically rather than as an annual event. Given effective tax rates, this means inevitably that a number of large companies will (in the absence of action to reduce cash dividend levels, to purchase imputation credits or to stream imputation credits to some shareholders only) find themselves with no option but to pay unfranked or partially franked dividends. A reduction of cash dividend levels does not seem feasible in view of the important groups of shareholders (tax exempts and non-residents) which do not get the off-setting benefit of an imputation credit. At this stage companies have been reluctant to rush headlong into purchase of credits, and so the outcome has been the payment of unfranked dividends by some companies and a dividend selection plan in at least one case to stream franked and unfranked dividends to different shareholders.

In the case of an individual shareholder, if the taxpayer is on the maximum individual tax rate, then the receipt of franked dividends directly in lieu of other income is only of use to the extent to which the cash dividend exceeds the after-tax income which it replaces. It seems that streaming and purchase activities with respect to imputation credits will strike a 'price' for the credit of less than its nominal value so that individuals will usually be better off with franked dividend income. Geared purchases of shares by individuals will amplify the value of the credits especially as earnings per share and interest rates become more closely aligned (earnings per share having increased after the market crash and interest rates having fallen). The gearing of credits, however, will probably be more effectively achieved in large investment trusts and partnerships because of the imputation treatment of these entities described below and the more efficient borrowing achieved in collective form.

The effect of the changes announced on 25 May 1988 is to change the scenario outlined above in a number of ways. First, the statutory and effective rates of company tax are likely to become over time more closely aligned with the removal of tax concessions and the cutting of the company tax rate. Secondly, the new treatment of

superannuation funds and life companies means that they will not be in the market as sellers. Thus it seems that the arbitrage problem is largely removed. However, superannuation funds and life companies are still not neutral in their imputation choice - they now have been turned into effective buyers of imputation credits, and individuals remain buyers under the new regime. Indeed, the Economic Statement (Keating 1988b) assumes that superannuation funds will change their portfolios and that they will be able to purchase imputation credits for less than their face value. This seems the only plausible explanation for the statement that portfolio changes will eliminate the tax on such funds and will prevent the lowering of the rate of return on investment income by the tax liability of the funds (if the imputation credits were priced at their face value then the purchase price of shares would increase and the removal of tax liability with imputation credits would not be able to restore rates of return to their former levels).

It thus seems likely that streaming and sale activities will grow in Australia as companies and shareholders become more accustomed to the imputation system. In turn this will place more pressure on the control mechanisms designed to limit these practices. The difficulties in preventing the many possible avoidance techniques must raise the question whether the attempt is worth the effort, or at least how a balance can be struck between making avoidance difficult without restricting ordinary transactions. Moreover, as will become apparent in the discussion of the international area, especially across the Tasman, the techniques described may achieve the worthwhile purpose of overcoming unwarranted barriers to investment posed by the international tax system.

The main difference caused by the Economic Statement is that the market in imputation credits has changed from a buyers' to a sellers' market. Prior to the Statement the sellers (Australian institutions and non-residents) outnumbered the buyers (Australian companies and individuals), whereas buyers (Australian institutions, individuals and to a lesser extent Australian companies) probably now outnumber sellers (non-residents). This is likely to affect the purchase price of credits. For example, if the sale price before the change was one third of the face value of the credit (16.33% of the grossed up dividend, that is, one third of 49%) and the sale price increases to two thirds of the face value of the credit (26% of the grossed up dividend, that is, two thirds of 39%), there is a 62.5% increase in the value of the credit to the non-resident (rather than a doubling - the change in the company tax rate produces this effect). A sale price of this order will make the transaction attractive to non-residents. Whether there is a floor price for credits greater than zero below which it will not be worthwhile to sell credits depends on the alternative assumptions made in relation to the nature of the sale price. If, for instance, the sale price appears as an amount of interest income of the non-resident, then account must be taken of the interest withholding tax.

For example, assume that a non-resident company sells its shares in an Australian subsidiary to a resident company for $1,000 and takes a put and call option over the

shares to lock in the repurchase of the shares at that price. The purchase price is not paid and the purchaser agrees to pay interest of 8.7% on the purchase price so long as the shares pay a fully franked dividend of 6.1% (if this dividend is not paid the purchaser can put the shares to the non-resident for $1,000). This amounts to the sale of the credits for two thirds of their face value and the non-resident is better off by $17.30 per year. That is, the non-resident gives up a fully franked dividend of $61 and receives $87 interest less $8.70 interest withholding tax at a 10% rate (or $78.30). On this basis the non-resident would show a profit as long as the interest rate exceeded 6.77% (6.77% less interest withholding tax of 0.67% gives a net return of 6.1%). For its part the purchaser receives $100 in value each year because of the imputation credit of $39 attached to the dividend of $61.

2. Control of the Streaming and Sale of Imputation Credits

The Australian government has clearly indicated in its public statements and in the legislation itself that the streaming and sale of credits will be strongly discouraged. Even apart from this determination, it is necessary to have some guide for the treatment of distributions where a company has the ability to pay two different types of dividends. Such rules could take any one of four forms: it could be required that franked dividends be paid before unfranked dividends; or vice versa; or that franked and unfranked dividends be paid in the same proportion as fully taxed and untaxed profits; or that companies be given complete freedom in the type of dividends paid (in effect no rule).

In the event the rule adopted is that franked dividends be paid before unfranked dividends. This is a simpler proposition to state than to implement, and the rules adopted are both complex and defective. The mechanism used to accomplish the desired ordering is labelled a "required franking amount". It is calculated by means of three formulae to determine the minimum amount to which a dividend should be franked (ITAA s.160AQE). Because the franking of dividends is a formal but voluntary act on the part of the company, it was not considered possible to prohibit the payment of dividends which do not meet the rules. Instead, compliance is encouraged by the use of a sanction in the form of a franking debit to the franking account, imposed to the extent that the franking of the dividend falls short of the required franking amount (ITAA s.160APX). This penalty franking debit has the effect that the amount of the debit is wasted as a potential imputation credit to the shareholder.

The reliance on a required franking amount and corresponding franking deficit tax to police the ordering system sets in train a number of complications. The starting point of the calculation is the franking surplus of the company at the time of payment of the dividend. Various adjustments are then made to this amount to give the amount of the franking surplus that must be used to calculate the required franking amount.

One problem is that the franking surplus may be subsequently reduced by events that are not predictable by the company, such as a refund of previously paid company

tax. Unless the company has some means to anticipate the later franking debit that will result, it will be required by the rules as to the required franking amount to frank a dividend paid before the refund of company tax to an amount that will ultimately produce a franking deficit and perhaps lead to the payment of franking deficit tax. To overcome this problem, the company is given power to lodge a notice with the Australian Tax Office anticipating the later debit and then immediately debit the franking account by the expected future debit (ITAA s.160AQD). This procedure is but one example of the many complexities that inevitably flow from the attempt to control franking of dividends by companies when the control operates on a prospective basis, that is, the control is applied at the time of payment of the dividend and not at the end of the income year.

The rule that franked dividends should be paid before unfranked dividends puts some minor restraint on streaming and sale of credits. In order to understand the full range of rules required to deal with the practice, it is helpful to review the kinds of devices that are likely to be used by companies. The basis of the devices is to achieve the differential payment of dividends (or substitutes) so that one shareholder receives a franked dividend and another shareholder an unfranked dividend or other type of income.

a) Classes of Shares

One simple device to stream franked and unfranked dividends to different types of shareholders is to have different classes of shares and to pay dividends on the shares at different times, with the dividend with imputation credits attached paid to the first class to exhaust the franking surplus of the company so that an unfranked dividend can then be paid on the other class of shares. The unfranked dividend would be greater in amount than the franked dividend but less than the franked dividend plus the imputation credit so as to achieve a sharing of the benefit of the arrangement. Such an arrangement would not breach the required franking amount rules stated above. Because one shareholder in this arrangement is likely to have been brought into the company especially for the purpose (and at a price to the new shareholder), that shareholder will probably require assurances of the level of the dividend that will be paid.

The Australian legislation seeks to prevent the streaming of dividends in this manner by providing that any committed future dividends are to be included in the calculation of the required franking amount for dividends paid before them, and the franking surplus is effectively prorated across the current and committed future dividends to determine the required franking amount of the current dividends. In the absence of further measures, this rule of itself does not stop the success of the arrangement for, as already pointed out, there is nothing to prevent overfranking of dividends and the current dividends can be fully franked. To prevent companies from resorting to this tactic, the legislation makes the required franking amount in relation to the committed future dividend, when it comes to be paid, the same as the current

dividend (that is, it must be fully franked) and so the device is defeated. The supposition that one or other of the dividends must be fixed in amount will not, however, always hold and so there is still scope to use simple timing of dividends to some effect.

A further variant of this device involves the straddling of two franking years. The concept of a committed future dividend operates only within one franking year and so if the company is committed to pay an unfranked dividend on the first day of the next franking year it will not be a committed future dividend and the franking surplus will not be required to be prorated across the franked dividend and the unfranked dividend.

Alternatively and to similar effect, at least in a private company setting, it is possible to have shares all of the same class, but for the company to have power to pay differential dividends on the shares. This device is countered by measures which provide that all dividends paid on a class of shares will be franked to the same extent as the first dividend paid on that class of shares in the franking year (ITAA s.160AQG). Unlike the previous rule, this one does not operate through the required franking amount formulae but exceptionally deems the amount of franking regardless of the company's declaration as to franking. Again in this case the rule operates within a franking year, making it possible to straddle franking years to avoid the rule, though straddling will be more inconvenient as only one group of shareholders will be able to receive a (franked or unfranked) dividend each year.

The discussion above has proceeded on the assumption that a party brought into the company will receive unfranked dividends, but it is more likely to be the case that the introduced shareholder will want franked dividends (such as an introduced company which is seeking to purchase imputation credits in excess of the seller's needs). One way which could achieve the introduction is to have the new shareholder subscribe for redeemable preference shares at a premium, receive a large fully franked dividend immediately of the order of the premium less the purchase price of the imputation credits, and then redeem the shares at par. In this event, the committed future dividend rules above will have no adverse effect as the fixed dividend is paid immediately and in any event the paying company will have sufficient credits to fully frank later dividends. The transaction will still be in difficulty by reason that it may involve a dividend stripping operation and both the imputation credits and the s.46 rebate may be denied to the company receiving the dividend (ITAA ss 46A, 160APP(5)).

Hence, in the area of the use of classes of shares and similar devices to stream or sell credits, the legislation has some success in preventing obvious avoidance devices but is not perfect.

b) Trusts and Partnerships

If it were possible for imputation purposes to direct different types of income to different members of a partnership or different beneficiaries of a trust, then an easy method of streaming and selling imputation credits would be available. Generally,

Australia allows imputation credits to be passed through partnerships and trusts, but probably prorates credits in accordance with the partners or beneficiaries share of the income of the partnership or trust regardless of type of income and so meets the avoidance possibilities (ITAA Part IIIAA, Division 7, though the legislation is by no means perfectly clear on this point). Although there may be difficulties in achieving differential treatment of partners or beneficiaries for imputation purposes, these entities will still have their uses in amplifying the credits. The pass-through of the credits is on a gross basis, that is, the full credits are available despite the reduction of the taxable income generated in the entity by reason of expenses (in the case of a partnership, pass-through occurs even when the partnership is in loss, though not in the case of a trust). Thus they offer a convenient method of collective gearing of a share investment designed to produce imputation credits for the investors.

c) Credit Traps in Company Groups and Stapled Shares

The use of classes of shares seeks to treat different shareholders of the same company differently. Perhaps a simpler way of achieving this result is to isolate imputation credits in one company in a company group and untaxed profits in another company in the group.

A basic form of this concept would to be to have a non-operating holding company for a group which never receives franked dividends from other companies in the group, but itself pays dividends on the basis of unfranked dividends received and of revaluations of shares in subsidiaries (borrowing from its subsidiaries to fund the dividends in this case). The dividends paid by the holding company would then always be unfranked. Access to the imputation credits confined in companies lower in the group can then be granted by the allotment of shares (bonus or otherwise) out of the lower company to shareholders in the holding company. If the holding company is listed but the lower company is not listed and there are restrictions on the transfer of the lower company shares, these shares are then effectively unsaleable. As the final step, shareholders in both companies would have an election to receive franked dividends from the lower company or dividends of a greater amount from the holding company.

A dividend selection scheme along these lines has been adopted by Elders IXL Limited with an exchange price of the credits of effectively one third of their face value. To make the link between the shares on the holding and the lower company more formal, it would be possible to have so-called 'stapled shares', where neither share can be sold without the other. Apart from issues as to dividend stripping referred to above, there seems to be nothing in a tax sense against adopting this type of structure, though there may be commercial obstacles arising from listing rules or company law. As well as using separate companies to isolate imputation credits, it is possible in a group structure to predetermine the level of imputation credits by appropriate inter-company transactions. This can be of use where a sale of credits is sought to be effected but the precise level of the credits that will be available is in

doubt. Suppose that a holding company capitalises a single purpose subsidiary with $10m and the subsidiary lends the $10m to an operating sister subsidiary at 15% interest. This sets the income of the single purpose subsidiary at $1.5m and company tax at $0.75m (assuming a 50% tax rate). The single purpose subsidiary can then pay fully franked dividends of $0.75m year by year to a specially introduced shareholder. It does not matter that the taxable income of the operating subsidiary (apart from the payment of interest to the single purpose company) oscillates above and below $1.5m. The effect of this structure is to convert a potential franking deficit in the operating company (and liability to franking deficit tax and penalties), if it were to seek to pay $0.75m franked dividends year by year, into a carryforward tax loss in the operating subsidiary that can be utilised immediately by the parent.

d) Sale and Buy Back of Shares

An important question in the operation of an imputation system is the nature of the ownership of shares that is required to obtain the credits. In Australia it seems that being the shareholder on the share register of the company is sufficient even though the shares are the subject of options for sale to another.

This fact suggests that a tax exempt institution could use the complementary nature of its tax position with most companies and individuals to considerable effect. Companies are generally not taxable on dividends received because of the rebate under ITAA s.46 and gain a franking credit if dividends received are franked (ITAA s.160APP). They receive a tax deduction for interest incurred on the purchase of income producing assets but are taxable on interest received and on gains on assets purchased after 19 September 1985. Tax exempt bodies do not get any benefit from imputation credits but are not taxable on interest or capital gains. If a tax exempt body sells its shares to a company and leaves the purchase price outstanding at interest with a call option to repurchase the share for an amount equal to the sale price, then it receives non taxable interest while protecting its potential capital gain. The company for its part would receive in the usual course a deduction for the payment of interest and would receive tax free dividends together with attached imputation credits. The sale price of the credits would be reflected in the interest rate paid (say one and a half times the expected dividend flows). The position of the company in the event that the expected dividends do not materialise can be protected by a put option whereby it can require that the arrangement be cancelled by a sale of the shares back to the tax exempt body.

There is nothing explicit in the imputation legislation to prevent this apparently desirable result for all concerned. Difficulties of defining ownership in this case can be resolved by denying credits where shares are the subject to options but such a rule would constrict normal option transactions and possibly cause the complete loss of imputation credits where two tax paying companies are involved. Moreover, ways can be found to achieve similar results without the need for an option to be granted over existing shares. Thus the power to make a swamping allotment of shares or the

holding of convertible notes can confer effective control over the fortunes of imputation credits without affecting directly the shares which in the normal course are expected to receive dividends and attached imputation credits. Such devices will not be suitable in every context but will have their uses, especially for non-residents.

B New Zealand

For the purposes of discussion two tax rate scenarios will be discussed. The first is the scenario which seemed likely after the Economic Statement of 17 December 1987 (Douglas 1987b) that the New Zealand corporate tax rate would be higher than the individual flat rate of tax proposed (say 33¹/3% company tax and 25% individual flat rate tax: Douglas 1987b did not give explicit tax rates, though it indicated that some such rates were likely). It is also assumed for this scenario that imputation credits are given at the rate of 331/3% so that individuals will always receive more imputation-credits on dividends than the tax liability on them if the dividends are fully franked in the Australian terminology. These assumptions did not turn out to be correct and as some important consequences depend on it, the actual outcome of a company tax rate below the maximum marginal individual tax rate with full imputation will be considered where appropriate (the rates are 28% company tax and 33% maximum individual tax rate: Douglas 1988b).

So far as appears from the Consultative Document on Full Imputation, the New Zealand system will be similar to Australia. One difference is, as already noticed, that the Imputation Credit Account will be kept on a tax payment basis rather than as after-tax taxable income, but this is largely a formal matter. It seems to be envisaged that the franking credits and debits will be made purely on a tax paid basis, but it remains to be seen whether this will prove possible in practice or whether, as in Australia, separate entries will have to be made for every step in the assessment process that impinges on final company tax payments. The New Zealand system for tax assessments seems to be less formalised and compartmentalised than Australia and so credits and debits might be feasible on a simple tax paid basis.

1. Incentives for the Sale and Streaming of Imputation Credits

The following tables rework the corresponding tables for Australia and indicate the different values of a cash dividend (fully franked and unfranked) to different categories of shareholders. In the case of non-residents the calculations are done on the basis that dividend withholding tax continues to apply to all dividends whether franked or unfranked (referred to as Full DWT) and on the basis that only unfranked dividends are subject to the tax as in Australia (referred to as Partial DWT) and calculated at the usual tax treaty rate of 15%. The Consultative Document on Full Imputation is simply unclear on this point, though it has subsequently been made clear that the withholding tax remains whatever the level of franking of the dividends (Douglas 1987b, 1988b).

Table 2.3 **Cash Dividend of $66.66 with the Company Tax Rate of 33¹/3 and Flat Individual Tax Rate of 25%**

	Pre-tax value of franked dividend	Post-tax value of franked dividend	Pre-tax value of unfranked dividend	Post-tax value of unfranked dividend
Resident Individual				
- No Tax Liability	66.66	66.66	66.66	66.66
- 25% Tax Bracket	100	75	66.66	50
Resident Company	100	66.66	66.66	66.66
Tax Exempt Entity	66.66	66.66	66.66	66.66
Non-residents - Full DWT	66.66	56.66	66.66	56.66
- Partial DWT	66.66	66.66	66.66	56.66

Table 2.4 **Cash Dividend of $72 of a Company Rate of 28% and a Maximum Individual Rate of 33% with Full Dividend Withholding Tax for all Dividends**

	Pre-tax value of franked dividend	Post-tax value of franked dividend	Pre-tax value of unfranked dividend	Post-tax value of unfranked dividend
Resident Individual				
- No Tax Liability	72	72	72	72
- 33% Tax Bracket	100	67	72	48.24
Resident Company	100	72	72	72
Tax Exempt Entity	72	72	72	72
Non-residents - Full DWT	72	61.2	72	61.2

As in Australia there is both a variation in the pre-tax and post-tax values of the same franked dividend for various categories of taxpayers, though the variations are not as great because of the lower tax rates. In the case of unfranked dividends, again the only variations are in the post-tax value to various shareholders because of their taxable status in the hands of recipients. From the view point of tax arbitrage, the position has similarities to Australia when the imputation system is viewed in isolation.

The tax arbitrage opportunities in post-tax terms for franked dividends in income splitting between individuals, however, differs from Australia. For Table 2.3 it exists if and where dividends can be transferred to taxpayers with the highest (and only positive) rate of tax. For unfranked dividends the transfer should be from high to low rate taxpayers. For Table 2.4 it exists where dividends can be transferred to taxpayers with lower rates of tax below the company rate (provided in the case of franked dividends they have sufficient tax liabilities to absorb the imputation credits). Moreover, when one looks at the combination of imputation and the rest of the tax

system as it will be in New Zealand, in the context of the different market conditions, the picture that emerges is quite different from Australia.

a) Tax Exempts, Life Companies and Superannuation Schemes

There will be fewer tax exempts in New Zealand compared to Australia with the announcement (Douglas 1987b, 1988a) that tax benefits attaching to life companies, superannuation funds and charities will be removed. There will no doubt be some tax exempts left such as local councils and these may lend their status for the purpose of reducing tax liabilities of companies (for which there will still be incentives as explained above), but these types of tax exempts are unlikely to have significant wasted imputation credits that they will wish to sell. Hence on the domestic scene, there will not be any significant long-term problem so far as the sale of credits is concerned by tax exempts.

The intention of the changes is to equate the taxation of life companies and superannuation schemes as closely as possible to other taxpayers and other income from savings. Some important features in relation to the new tax arrangements for life companies and superannuation funds should be noted. Although there is no general capital gains tax in New Zealand, life companies are taxable on portfolio gains and losses on insurance funds, unlike individuals (NZITA s.204). The position of superannuation funds as to taxability on gains and losses is similar (NZITA s.225). If these bodies are taxable on portfolio gains, then there will be a tax disincentive for individuals to invest through them in the absence of a capital gains tax on individuals.

The taxation of dividends received by these institutions also is an issue. In Australia life companies are entitled to a rebate of tax on dividends received so that if dividends without imputation credits are received they still attract no tax at the level of the recipient company. On the other hand, trusts which receive unfranked dividends are taxable on them in the sense that they enter the net income of the trust estate and receive no tax rebate (the tax is paid by the beneficiary and/or the trustee depending on the circumstances). Thus where superannuation trust funds are not exempt, unfranked dividends are taxable and the tax is payable by the fund trustee. In New Zealand it seems that dividends will be taxable to superannuation schemes and, in general, life companies.

The important issue for present purposes is the treatment of imputation credits, whether attached to dividends received or generated by the payment of tax. It seems that tax payments and dividends received by life companies will not attract credits to the ICA. It will be recalled that in Australia the position seems to be that life company tax payments do generate credits to the franking account while dividends received with respect to insurance funds do not. To be consistent it is necessary to prevent credits for both situations in relation to insurance funds and New Zealand should ensure that this occurs in its legislation as otherwise life companies will have imputation credits to sell.

For superannuation schemes, dividends received will be taxed to the trustee which

will be able to claim the imputation credit to offset the tax liability. As a superannuation scheme will not be able to maintain an ICA, tax payments by the trustee will not generate any further tax credits. It therefore seems unlikely that superannuation funds will have unusable imputation credits for sale.

Overall the likely outcome seems to be that there will not be any significant level of unusable or wasted imputation credits in the case of superannuation funds and life companies. Hence the major sellers of imputation credits in New Zealand will be non-residents, the problems of domestic sellers having largely been eliminated by changes elsewhere in the tax system.

b) Tax Preferences and Dividend Policies of New Zealand Companies

The effect of tax preferences with respect to streaming is that they create a class of buyer for imputation credits in the imputation system where the benefit of tax preferences is eliminated on the distribution of profits. Both the Australian and New Zealand imputation systems have this effect in the sense that the use of tax preferences by a company will eventually generate unfranked dividends that are taxable to individual shareholders without the benefit of an imputation credit.

In New Zealand there were, with one important exception, fewer tax preferences than in Australia prior to 25 May 1988 (when the most important tax preferences were removed), and accordingly there was less likely to be demand for the purchase of imputation credits by companies. The exception relates to capital gains, and accordingly companies with a large proportion of their profits made up of capital gains may need to buy imputation credits to keep shareholders happy. A number of important New Zealand companies would seem to be in this category.

Many New Zealand companies have established a dividend policy over the years (no doubt encouraged by the tax regime that has applied) of making bonus issues rather than paying cash dividends. Apart from the tax effects of this strategy, the policy has enabled companies starting with a relatively small capital base to expand rapidly by reinvestment of profits. Profits for the dividends have often been generated by revaluation of assets rather than cash flows, and the companies concerned have had low effective tax rates because of their preference for appreciating assets rather than cash flows.

While bonus issues were not taxable to individual shareholders and the shares could be sold without the levy of capital gains tax, this policy kept shareholders happy as their profits were essentially tax free. Tax paid by the company no doubt reduced the gain to the individual shareholder on sale, but while the classical system prevailed shareholders could gain no benefit from company tax payments in relation to dividends received so that sale of shares would usually be the preferred method for the shareholder to realise the gain. The incentive under the classical system was for the company to reduce its tax liability as much as possible so that in this respect the shareholder was also assisted by the company.

The tax position of bonus shares has changed and such issues are now taxable, if

not paid out of a share premium account or the subject of an election that they be untaxed, but taxable bonus issues are subject to the imputation system (that is, may carry imputation credits). It will be recalled that the election was introduced subsequent to the December 1987 Economic Statement as a result of the consultative process (Consultative Committee 1988b). The possibility of a tax free sale of shares still continues in the absence of a general capital gains tax. As the commercial imperatives that have required low cash dividend payments by companies will continue, bonus issues will probably remain important in New Zealand. It has already been noted that there may be an element of irrationality in the market response to bonus issues. Even putting that aside, as bonus issues are such an established part of New Zealand company dividend policy, investors would probably react adversely if companies ceased to utilise them in response to the changes wrought to their taxation with the introduction of imputation.

There are two obvious responses to the imputation system by companies which wish to continue to make bonus issues. First, they can attach imputation credits to bonus issues but this will usually entail the purchase of imputation credits since many of the companies concerned will in the past at least have been paying little company tax. Secondly, non-taxable bonus issues can be made out of share premium accounts or by election. Since the companies concerned will not wish to make too great a call on shareholders for funds, the creation of share premium accounts by rights issues to shareholders will not be an important source of credits to the share premium account. Takeovers involving share for share exchanges will usually give rise to substantial credits to the share premium account, so this form of company expansion may have been encouraged by the new tax system were it not for the subsequent decision to allow companies to elect to make non-taxable bonus issues, rather than confining such issues to the share premium account.

If the imputation credit is greater or lesser than the individual tax rate, the choice between bonus issues with imputation credits attached and bonus issues out of share premium account will not be a matter of complete indifference to shareholders. If the maximum individual rate is above the company rate, as has turned out to be the case, individual shareholders on the maximum rate will prefer non-taxable bonus issues. If the maximum individual tax rate were below the company rate, as seemed likely after the 1987 reforms were announced (Douglas 1987b), the incentive for the individual would be to receive dividends with imputation credits attached. It is thus difficult to judge whether there will be significant demand for the purchase of imputation credits in the absence of a capital gains tax in New Zealand, but this position may change if such a tax is introduced. If the attempt to eliminate tax preferences out of the tax system continues to be pursued with the rigour seen in recent times, then there will not be significant buyers in the market for imputation credits. The elimination of preferences most importantly must include the introduction of a capital gains tax on an accruals basis to be consistent with other changes to the tax system recent and proposed. Whether such changes to the New Zealand tax system go beyond practical

reform (especially in view of international considerations) is a matter considered hereafter.

2. Control of the Streaming and Sale of Imputation Credits

The New Zealand imputation system has adopted a different approach to the problem of streaming and sale of credits. Unlike Australia there will not be a general rule that franked dividends must be paid before unfranked dividends. Rather it seems that the company will be able at its option to frank dividends up to the full company tax rate. Originally it was proposed that this be subject to the constraint that the credits allocated to a dividend could not exceed the balance of the ICA at the time (Douglas 1987d, pp 31-37). On this rule there could not be overfranking of dividends relative to the current franking surplus as there can in Australia (putting aside the complications of committed future dividends in Australia). The proposed rule was dropped as impractical by the Consultative Committee (1988b paras 2.3.1-2.3.8) on the basis that it would effectively require the approval of the Revenue for every dividend paid by a company.

The constraint, if adopted, was also likely to have an effect on the payment dates for dividends which would move to just after the dates for provisional tax payments or the date of receipt of franked dividends (as the ICA will be in credit at those points of time). This change of dates may have had untoward cash flow effects on shareholders in the transitional period as companies adjusted to new dividend payment dates. Further, in the transitional period there may have been an incentive to miss dividend payments until the ICA began to build up sufficient credits to frank dividends to a reasonable extent. These kinds of effects are absent from the Australian system which allows companies to put their franking accounts into deficit by overfranking dividends. It is therefore not surprising that the Consultative Committee recommended that this rule be dropped.

The ICA under the Consultative Document (Douglas 1987d) would only have had the potential to go into deficit during the income year in one case, namely, where there was a refund of company tax. At any rate this was the assumption in the Consultative Document on Full Imputation and depended on whether New Zealand could construct an accounting mechanism based purely on a tax payment basis. Once again the change in direction in the Consultative Committee has overcome this problem.

In order to discourage companies from overpaying provisional tax and putting themselves in a position to receive a later refund which would mean that imputation credits previously allocated by the company are no longer supported by company tax payments, refunds will be limited to the surplus of the ICA at the end of the income year to which the refund relates (the surplus indicates payment of company tax by the company or the receipt of franked dividends). The balance of the refund which is not paid to the company at that time will be used to reduce payments of later provisional tax (company tax instalments).

The critical difference from the Australian system is that, instead of judging finally

at the time of payment of a dividend whether the degree of franking is appropriate, New Zealand will adopt a look back system. That is, at the end of the income year there will be a look back to ensure that certain conditions have been satisfied by the company with respect to the allocation of imputation credits. If the conditions have not been satisfied then franking debits will arise and if they throw up a franking deficit, tax will be payable to restore the balance of the ICA to zero. This tax payment then goes to reduce later provisional tax payments.

The New Zealand system both allows greater freedom to the company in its allocation of credits during the year (especially since the dropping of the constraint in relation to not putting the ICA into deficit) and then imposes greater responsibility on the company to get its allocations right by the end of the year. Because of the retrospective nature of the end of year adjustment, it was rightly proposed in the Consultative Document that there be no penalty tax in addition to the deficit tax. This would have been in contrast to Australia although there are good arguments that the penalty is unwarranted in Australia since no significant time disadvantage is suffered by the revenue when dividends are overfranked. Even so, as will become apparent, the New Zealand system is more penal than the Australian system because of its retrospective reconciliation of the ICA. Unfortunately, to compound the matter, the Consultative Committee followed the Australian lead and adopted the penalty tax (1988b paras 2.3.4, 2.3.8).

a) Classes of Shares

The originally proposed conditions that a company must satisfy at the end of the income year in relation to the allocation of imputation credits both related to the problems posed by classes of shares. They were (Douglas 1987d, p 35):

(1) the ratio of the credit per share to the aggregate taxable value of the dividends and bonus shares paid or issued per share during a financial year must be the same for all classes of share in that financial year. The aggregate taxable value of the dividends and bonus shares paid in respect of any class of share means the sum of the taxable dividends (whether interim or final) and taxable bonus shares paid or issued to holders of that class of share during the year; and

(2) on any day that imputation credits are allocated to any holders of a class of share, the credit allocated per share must be the same for all shares of that class on issue on that day.

If the rules were not observed by year end then further notional allocations of credits were to be made to ensure their observance and the ICA debited accordingly. Thus, assume that a company has 100 A class shares and 100 B class shares on issue and dividends of $72 have been paid on each class, with the A class dividends fully franked (that is, $28 of imputation credits attached to them based on a 28% tax rate) and the B class dividends unfranked. Under the original proposal there would be a

debit to the ICA at the end of the year of $28 through a notional allocation of credits to the B class shares to equalise them with the credits on the A class shares. It seems that the B class shares would not in fact receive these credits and they would not be available for later utilisation by the company. If the dividend on the B class shares had been $144 unfranked, the year end debit would be $56. In other words, the important equivalence across classes of shares was not the amount of the dividends but the degree to which they were franked.

The first of these rules is the most severe to comply with. It would certainly prevent the kinds of sale and streaming of credits that are still possible in Australia with classes of shares despite the rules dealing with the matter, but it also has the potential to cause unfairness when events which are unforeseen occur.

For example, if a company with more than one class of share on issue wrongly anticipates events later in an income year, it may be placed in a position where the rules simply cannot be complied with. If a fully franked dividend is paid early in the year on ordinary shares and receipt of franked dividends or company tax payments are reasonably expected later in the year to cover a fully franked preference share dividend, but the expectations are not met in the event, the company may not have a sufficient balance in the ICA to fully frank the preference dividend. As the company will probably not be able for commercial reasons to pass the preference dividend, the result will be the arising of a debit to the ICA at year end and payment of tax which does not give rise to imputation credits for shareholders. This is to be compared with the situation in Australia where it is usually possible to predict at the time of payment of a dividend whether a deficit will arise and, so long as dividends are franked to the required franking amount, there is no loss of franking credits even if franking deficit tax (but not penalty tax) becomes payable at year end.

The Consultative Committee responded to these problems by proposing that all dividends paid by a company in a year be franked to the same extent and that a safety valve be created whereby the company can make a statutory declaration to the Revenue that no streaming is involved and then frank a later dividend to a different extent (1988b paras 2.4.5, 2.4.10). Sufficient information would be given to the Revenue to evaluate whether a check on the declaration should be made. In addition the Committee proposed that the rule regarding dividends paid on the same day should be dropped on the basis that it is too hard to define a class of share in an effective way for tax purposes (1988b paras 2.4.3, 2.4.10, 1988c para.9.3.2).

Otherwise, the second rule for classes of shares would have caused a number of effects which may be regarded as undesirable distortions of behaviour brought about by the tax system. It would encourage companies to have only one class of shares. There has been a tendency for simplification of capital structures of companies during this century (which may itself have been tax induced) and the imputation rules as to classes of shares would have reinforced this trend. Where a company has more than one class of shares, the conservative approach would have been either to adopt common dividend payment days for all classes of shares and to frank the classes

equally on the payment days (though the extent of franking could vary from one dividend payment day to another) or, where it was not possible to use common dividend payment days for all shares, to have chosen a suitably low franking figure and to use that figure uniformly for all dividends paid during the year.

Shares issued part way through a year posed particular problems under the original proposals even if of the same class as existing shares. The shares would best have been issued towards the end of the income year so that no dividends were paid on them during the year. Presumably in this case the shares would not be regarded as in breach of the rules quoted above. It was not clear how those rules applied generally where no dividends were paid on particular shares during a year, as it would not be possible to calculate a meaningful ratio of imputation credits to dividends (the ratio is zero to zero). If shares were issued during an income year and dividends were paid before and after the issue in the year, then if different dividend payments through the year were franked to differing extents it would have been impossible for the dividends on the new shares and the old shares to be franked to the same ratio at the end of the year where they were of the same class. This problem has been dealt with by the change to the rules proposed by the Consultative Committee to the effect that all dividends on all shares paid during a year should generally be franked to the same extent rather than requiring that a constant franking ratio be maintained for all shares even if dividends paid at particular times were franked to different extents.

For example, under the original proposals and assuming a 33⅓% company tax rate, suppose that there are 300 $1 shares on issue and a taxable bonus issue out of revenue reserves is made as a fully franked dividend on a 2 for 3 basis. The bonus issue would carry imputation credits of $100 for $200 of dividends and the share capital of the company would now be 500 $1 shares. If a cash dividend of $133.32 with $33.34 imputation credits attached were paid after the bonus issue, this would amount to a half franked dividend. The original shares would have received dividends of ($200 + [$133.32 x 3/5]) or $280 and imputation credits of ($100 + [$33.34 x 3/5]) or $120 to give a franking ratio of ($120/$280) or 0.4286. The bonus shares would have received dividends of ($133.32 x 2/5) or $53.32 and imputation credits of ($33.34 x 2/5) or $13.34 to give a franking ratio of ($13.34/$53.32) or 0.25.

Thus at the end of the year it would have been necessary to allocate notionally to the dividends on the bonus shares a further imputation credit of $9.51 to bring the ratio up to 0.4286 ($22.85/$53.32) and a debit to the ICA of this amount would then have been necessary. It should be noted that this result would have been inevitable wherever a taxable bonus issue was followed later in the same year by a dividend on the class of shares on which the bonus issue was made and which was franked to a different extent to the bonus issue itself. Hence the recommendation was made above that bonus issues should be made near the end of the income year and not followed by any further dividends in that year. This timing would not be very suitable in a commercial sense since bonus issues generally are made when the annual report is released early in the year and final dividends for the preceding year (in a commercial

sense) declared. Hence the alteration to the rules arising from the Consultative Committee Report on Full Imputation (1988b) is to be welcomed.

The fact that the rules with respect to classes of shares are very stringent and may cause problems does not mean that they are not subject to avoidance. For example, suppose that a company has a substantial balance in its share premium account and has two classes of shares (which are formally different but not in substance), one held by taxpaying residents and one held by tax exempt bodies or non-residents. The company makes two bonus issues, a 3 for 4 bonus issue out of share premium account on the class of shares held by the tax exempt and non-resident shareholders, and a 2 for 3 fully franked bonus issue out of revenue profits on the class of shares held by the resident taxpayers.

By this means tax arbitrage is achieved between the two groups. This device depends for its success on the fact that for tax purposes the bonus issue out of the share premium account is not a dividend and so is not subject to the imputation rules set out above for classes of shares. It does not matter that the bonus issue out of revenue reserves is a fully franked dividend for imputation purposes and the other bonus issue the equivalent to an unfranked dividend. Non-residents would be particularly pleased by this device as it avoids dividend withholding tax into the bargain. In Australia such a structure would be more difficult to make effective because of the different capital gains tax rules that would apply to the respective bonus issues, which again highlights the problem of not having a capital gains tax in New Zealand.

Another possible avenue for avoidance is to straddle income years with dividends on different classes of shares (or simply different shares under a differential dividend article in the articles of association of a company). Straddling has been shown above to be effective for certain purposes in Australia, but in New Zealand it will be necessary to adopt a 'rhythm method' with respect to the payment of the dividends, with dividends paid on one class or share in one year and dividends paid on the other class or other share in the next year, whereas it is possible in Australia to achieve the straddle over one year end. The difficulty in New Zealand is created by the rule as to an equal franking ratio for shares in the same year, since a payment of dividends on different classes of shares or different shares franked to a different extent in the same year will create problems at the year end reconciliation of the ICA.

New Zealand proposed similar rules to Australia with respect to differential dividends paid on a single class of shares in the same year. This case was dealt with by the second rule quoted above and would seem to block off arbitrage activities in this case. However, it would probably be possible to create shares that are formally different classes of shares but in substance the same, and then the devices outlined above could be brought into play. Hence the Consultative Committee proposed that this rule be dropped (1988b paras 2.4.3, 2.4.10, 1988c para.9.3.2).

The treatment of dividend stripping is not resolved by the Consultative Document on Full Imputation but is likely to be a considerable problem in New Zealand. The Consultative Document simply states that the incentives for dividend stripping will

remain under imputation and that the existing dividend stripping provisions will be reviewed with the aim of improving their effectiveness (Douglas 1987d, pp 52-53). The current provisions on dividend stripping are unlikely to cover the case where the stripper is not a share trader and has bought in shares for the purposes of buying imputation credits rather than generating losses on sale of the shares. The scheme would involve subscription for shares of a particular class at a premium, and receipt of a payment of a large fully franked dividend on the shares which was equal to the premium less the purchase price of the credits. Thereafter the shares would carry only limited rights to a return of par value on a winding up or redemption. If the company paying the dividend has more than enough surplus in its ICA to fully frank dividends paid to its own shareholders and is selling its excess credits, the rules outlined above will not be an impediment. Australia has recently considerably strengthened its dividend stripping provisions in the context of the introduction of the capital gains tax and imputation (ITAA s.46A(12A)), and the provisions may provide a model for New Zealand (especially if a capital gains tax is introduced).

In summary, the New Zealand rules in this area are stricter than the Australian rules and as a result will restrict corporate financial policy more severely than perhaps is justified. At the same time they are potentially open to avoidance devices almost as much as the Australian rules. The Consultative Document on Imputation makes vague threats against avoiding the rules but whether such threats can be carried into action remains to be seen.

b) Trusts and Partnerships

New Zealand will adopt different rules from Australia to deal with trusts and partnerships. In the case of trusts, the rules originally proposed seemed intended simply to discourage their use (Douglas 1987d, pp 43-47). The tax consequences were all to take place at the level of the trust and distributions from the trust in respect of dividend income were to be tax free. It is not made clear whether imputation credits were to be able to offset other tax liabilities of the trust where the trust tax rate was lower than the company tax rate. In the case of corporate trustees, it was made clear that dividend income derived and tax paid in their trustee capacity will not give rise to imputation credits in the trustee companies' ICA which is unexceptionable (Douglas 1987d, p 39). However, the rate of tax to be paid on the trust income was to be the corporate rate rather than the trustee rate, which seems to be contrary to the general philosophy of trust taxation (Douglas 1987d, p 44). This means that there would not be any offset of imputation credits against tax on other income of the trust and it would be less advantageous to receive dividends through a corporate trustee than directly.

The Consultative Committee proposed that imputation credits should be able to be passed through trusts as though the trust were a company (1988c paras 4.4.1-4.4.5). This means that the same allocation rules will be applicable for imputation credits as for companies rather than the results that may follow from trust taxation rules

generally. This is similar to the Australian approach in relation to trusts taxed as companies under ITAA Part III Divisions 6B and 6C, and different to the Australian treatment of other trusts (compare ITAA ss 160APB, 160AQV-160ARDH). Whether it is wise to apply a conglomerate of rules borrowed from elsewhere to trusts may be doubted, especially where similar types of trust are not treated consistently for tax purposes as seems to be the case both in Australia and New Zealand.

In the case of partnerships, imputation credits will flow through in a similar way as in Australia (Douglas 1987d, p 44; Consultative Committee 1988b para.4.5.1). It is not made clear whether the partners will be able by specific allocation of types of income to direct the credits to particular partners. If this is the case, then possibilities of sale and streaming of the credits are opened up. It is suggested that imputation credits be allocated by the amount of income rather than the type of income allocated to the partners.

c) Credit Traps in Company Groups and Stapled Shares

The position of company groups is not expressly considered in the Consultative Document on Full Imputation and so it is not surprising that the kinds of opportunities for sale and streaming of credits and of by-passing the rules on classes of shares that occur in Australia may also be possible in New Zealand. The use of stapled shares and similar devices is to be prevented (Douglas 1987d, p 36). A stapled share scheme operates by issuing to a shareholder in a holding company a share in a subsidiary and giving the shareholder the election of which share on which to receive a dividend in the expectation that dividends on one company's shares will be franked and on the other company's shares unfranked. The Consultative Committee proposes that this result be achieved by treating stapled stock as if it were the stock of the principal company (1988b para.2.4.6), and access trusts will not be possible in view of the rules as to trusts outlined above (because the same rules will apply to trusts as apply to companies).

Accordingly it may be more difficult in New Zealand than Australia to give genuine shareholders of a company an effective choice of the type of dividend they are to receive by utilising different companies. Much depends, however, on the drafting of the legislation. The Elders IXL dividend selection plan referred to above in the discussion of Australia works by allotting a one cent share in a subsidiary to a shareholder electing to take part in the scheme, and paying dividends on the one cent share while the shareholder holds shares in the listed holding company. There is no need to staple the shares in a formal sense (that is, to ensure that they are traded together) as the one cent share has no market and is worthless unless the shareholder holds shares in the listed company. It seems that this situation has been covered by the legislation drafted for New Zealand (Consultative Committee 1988c Annex, pp 175-176). On the other hand if the New Zealand rules in the dividend stripping area prove to be less effective than Australia's, then the potential for selling credits held in trap companies will be easier to realise in New Zealand. Because the allocation

rules for imputation credits in New Zealand are so strict and involve a look back process at the end of the year, it may be that the use of companies in groups to achieve similar results will be the greater.

Both Australia and New Zealand have rejected any formal mechanism for grouping of imputation credits among companies with substantial common ownership, although they do permit grouping in other areas such as company tax losses. This can create a problem where a subsidiary has made a loss for financial reporting purposes but has imputation credits available (for example, from franked dividends received). The problem is not one of tax law but of company law arising from the rule that a company can pay a dividend only out of financial reporting profits, and hence there will be difficulty in passing imputation credits up to a holding company for consolidation of the credits on a group basis. No doubt means will be found to overcome this problem and they should not be characterised as tax avoidance since they are seeking to deal with a problem of company law.

d) Sale and Buy Back of Shares

The rules as to the ownership of shares required to attract the dividend received exemption in New Zealand are as vague as the rules for the rebate in Australia, and the Consultative Document on Full Imputation does not elaborate on them in the imputation context. Hence in the absence of specific rules, sales of shares accompanied by options for repurchase would probably be able to be used to sell imputation credits. The lack of a capital gains tax in New Zealand would also make this type of transaction more flexible than in Australia, where there are a number of capital gains tax obstacles to be surmounted with respect to such options.

The sellers of credits are likely to be non-residents and not tax exempts as in Australia, and the problem of interest withholding tax will therefore be raised if the purchase price is left outstanding as a loan. However, as New Zealand is to continue to levy dividend withholding tax on franked dividends then the non-resident will be considerably attracted to the sale transaction because the withholding tax rate may be lowered relative to dividends as well as the return to the non-resident being increased by the 'sale price' of the credits. In any event the standard methods for the avoidance of interest withholding tax in New Zealand may be available to alleviate this problem.

The Consultative Committee was alive to this problem and proposed that anti-avoidance and disclosure rules should be introduced to deal with short-term transfers of interests in shares (1988b para.2.4.8). The mechanism employed is to prevent the credit being passed to the short-term purchaser of the shares and then also to debit the ICA of the company again for the same amount as the credit where a company or shareholder taxation advantage arrangement has been entered into (1988c Annex pp 177-180). The effect is to produce a double loss of imputation credits to the company and a failure by the purchaser to obtain the benefit of any imputation credits. Once again therefore New Zealand has made it much more difficult for the streaming or sale of credits to occur.

3 Foreign Income of Residents

The generally accepted grounds for taxation in an international context are residence and source. The country of residence is best thought of as the place with which an individual has the closest personal contacts or, in the case of an entity, with which the ultimate individual owners of the entity have their closest personal contacts. The country of source is the country with which income has its closest economic connection. Under current international norms expressed, for example, in the OECD and UN Model Tax Treaties (1977, 1980 respectively), the source country is regarded as having the primary right to tax most types of income and the residence country the residual right to tax, and it is assumed that the source country will leave some room for a residual tax by the residence country.

It is usual to distinguish three types of systems for dealing with the taxation of the foreign income of residents, the systems being directed to the problems of double taxation of income in the international context and to the appropriate balance between the taxation of foreign income and domestic income of residents. They are the foreign income exemption system, the foreign tax credit system and the foreign tax deduction system. It is not intended here to rehearse the arguments for and against the different systems (see, for example, Bird 1987), but rather to look to the method of implementing each system, in the context of the simple model of a company that is often used to analyse the defects of the classical system of company taxation, that is, the company has only individual shareholders and the share price moves precisely in line with retentions of company profits[2]. The company is thus regarded as being a perfect conduit for income in the sense that the shareholder enjoys dividends and capital gains exactly equal to after-tax profit. It will also be assumed that the income of the company is all foreign income, that the income tax base applied to company income is comprehensive (particularly including capital gains) and that all shareholders are resident in one country which is the country of residence of the company.

The implementation of the foreign income exemption system requires that the company not be taxed on branch income and that the shareholder be exempt from tax on dividends received and from tax on capital gains made on the sale of the shares. A pure exemption system is really source taxation alone rather than residence and source taxation combined. Less pure versions of exemption include a restricted exemption which is only available on certain conditions, particularly that foreign tax has been paid on the income, and the exemption with progression system whereby the foreign income is not directly taxed but is taken into account in determining the tax rate payable on domestic income (see, for example, OECD 1977 Article 23A).

The foreign tax credit system requires that the company be granted credit for

foreign taxes against its tax liability on foreign income and if the conduit theory of company taxation is being adopted then the shareholders should have attributed to them foreign and domestic tax and receive credit for the foreign and domestic tax against tax liability on corporate income, with dividends and capital gains exempt. If taxation of shareholder dividends and capital gains is used instead of pure conduit taxation, then the shareholder should receive credit for foreign and domestic taxes paid by the company against the shareholder's liability to tax with respect to both dividends and capital gains.

In practice the nearest equivalent to the pure form of this system is found in countries with full imputation systems with respect to company taxation, foreign tax credit systems with respect to foreign income and capital gains tax on shares whose values represent retentions. These countries generally do not effectively carry through the foreign tax credit to the shareholder on dividends received (as imputation is only extended in respect of domestic tax) and invariably do not carry through to the shareholder foreign or domestic tax with respect to capital gains tax on the shareholder arising from retentions.

The foreign tax deduction system requires that the company be granted a tax deduction for foreign taxes in determining domestic tax liability. If a conduit approach to taxation is being used (with dividends and capital gains again exempt) then this deduction should be carried through to the shareholder by granting a credit against the shareholder's tax liability on company income only for domestic tax payments by the company less foreign tax. Alternatively the credit should be against the shareholder's tax liability on dividends and capital gains if the shareholder is taxed on that basis. Because the dividends and capital gains received by the shareholder will be the less by reason of the foreign tax, the deduction for foreign taxes is automatically carried through to the shareholder by taxing dividends and capital gains with grossing up and credit for domestic company tax only.

The reason why the conduit form of the latter two systems is not generally adopted in any country is probably that it has not been found administratively possible to operate corporate tax integration or, what amounts to the same thing in the simple model being used, imputation with respect to capital gains arising from retentions. So far as capital gains arising from retentions are concerned, most systems with a capital gains tax operate as a foreign tax deduction system on retentions as the foreign tax credit given to the company is not carried through to the shareholder. (They also may operate as a domestic tax deduction system for retentions if the market gives a zero price to imputation credits stored in companies.) Combined with the situation where there is no grant of imputation credits for foreign tax payments (although a foreign tax credit is available at the company level), this means that the pattern of imputation-capital gains tax-foreign tax credit also operates effectively as a foreign tax deduction system in relation to dividends.

Moreover, so long as imputation credits are available only for domestic tax payments and capital gains tax is applied to company shares, this result holds for all

possible systems of providing relief for foreign tax at the company level - whether exemption, credit or deduction. A numerical example based on the Australian case may help to clarify this important point. Suppose that all the shares in an Australian company are owned by one individual, that the company derives $100 of taxable foreign income and has no Australian income, and that foreign tax of alternatively $20 or $60 is paid on the income. The second table below is the outcome under the various systems with the Australian company tax rate and maximum individual tax rate which is applicable to the shareholder assumed to be 40%.

As a benchmark for the second and third tables below, the foreign tax deduction system where $100 foreign income is derived by an Australian individual whose marginal tax rate is 40% and is subject to foreign tax alternatively of $20 and $60 would give a net return of $48 and $24 respectively calculated as follows.

Table 3.1 Example of Foreign Tax Deduction Systems on Australians

	Deduction	
Foreign tax rate (%)	20	60
Income	100	100
Foreign tax	20	60
Taxable income	80	40
Australian tax	32	16
Total tax	52	76
Net return	48	24

The following table assumes a full distribution of after tax profits by the company which operates through a foreign branch.

Table3.2 Example of Full Distribution of After-Tax Profits by a Company that Operates through a Foreign Branch

	Exemption		Credit		Deduction	
Foreign tax rate (%)	20%	60%	20%	60%	20%	60%
Income	100	100	100	100	100	100
Foreign tax	20	60	20	60	20	60
Taxable income	0	0	100	100	80	40
Company tax	0	0	20	0	32	16
Dividend	80	40	60	40	48	24
Imputation credit	0	0	20	0	32	16
Shareholder income	80	40	80	40	80	40
Shareholder tax	32	16	12	16	0	0
Total tax	52	76	52	76	52	76
Net return	48	24	48	24	48	24

If the income is earned in a foreign company which does not distribute any dividend, the share price increases in line with the retention, and if the shares are sold, then the outcome is still the same. This is so whether there is an Australian holding company or the shares are held directly by an Australian individual (assuming that the market prices the shares dollar for dollar in respect of imputation credits inherent in the shares but not foreign tax credits). This is demonstrated by the following table in which it has been assumed that it is possible to have a foreign company which is wholly owned by Australian residents: this is in fact possible under current law as explained below, but is contrary to the ideal residence rule suggested above for companies that they are resident where their shareholders are resident.

Table 3.3 Example of Effects of Income Earning in a Foreign Company with Shares Owned by Australian Residents or Held via Australian Company

	Shares in foreign company held directly and sold by shareholder		Shares in foreign company held via Australian company			
			Sale by parent		Sale by shareholder	
Foreign tax rate (%)	20	60	20	60	20	60
Income	100	100	100	100	100	100
Foreign tax	20	60	20	60	20	60
Taxable income	0	0	80	40	0	0
Company tax	0	0	32	16	0	0
Retention	80	40	48	24	80	40
Imputation credit	0	0	32	16	0	0
Shareholder gain	80	40	80	40	80	40
Shareholder tax	32	16	32	16	32	16
Total tax	52	76	52	76	52	76
Net return	48	24	48	24	48	24

The outcome of this reasoning is that the tax system may not be operating as it appears to be when one combines the taxation of foreign income with the system of company taxation and the treatment of capital gains even in the context of a simplified model. It thus is worth examining the past, present and proposed tax systems in Australia and New Zealand in the context of this model to attempt to characterise their operation as being closest to the exemption, credit or deduction systems with respect to foreign taxes.

Australia before 19 September 1985 operated a classical company tax system, an exemption for foreign branch income (ITAA s.23(q) prior to its repeal in 1986), an effective exemption for foreign dividend income received by Australian companies (the intercorporate dividend rebate under ITAA s.46 applied to dividends received from foreign companies), and no general capital gains tax. This meant that dividend income received by Australian individuals from an Australian company out of foreign source income was effectively subject to the deduction system. On the other hand, capital gains of Australian individuals arising from retentions of foreign income by Australian companies were subject to the exemption system because the capital gains were tax free to the individual shareholders and the retentions in the company were net of foreign tax only.

Currently Australia operates an imputation system, a foreign tax credit system that is not carried through to the shareholder, and a capital gains tax. This is the equivalent at the shareholder level to a deduction system for both dividends and capital gains arising from retentions, as is demonstrated by the tables above. From 1989, pursuant to the Consultative Document on Foreign Income (Keating 1988c), Australia will operate an exemption system for income derived by Australian companies from comparable tax countries and full current taxation of tax haven income with a foreign tax credit, while maintaining the imputation system and capital gains tax in their current form.

This will likewise operate as a deduction system at the shareholder level because the effect of the capital gains tax and the imputation system is to make irrelevant to the final outcome whether an exemption, credit or deduction system is operated at the Australian company level (as the last of the tables above makes clear).

New Zealand prior to reform had a classical company tax system, a foreign tax credit for branch income (NZITA s.293), an exemption for foreign dividend income (NZITA s.63), and no capital gains tax. At the shareholder level this was effectively an exemption system for retentions attributable to foreign dividends as the only tax in this case was the foreign tax, with the company being relieved of tax on the dividends and the shareholder on the capital gains. For retentions attributable to branch income it is difficult to characterise the system.

So far as the individual shareholder had a tax rate comparable to the company tax rate, the system operated at the shareholder level as a credit system, since the tax effects all took effect at the company level (company tax subject to a foreign tax credit on the branch income) with no tax effect at the shareholder level because of the lack of a capital gains tax. Where the shareholder's tax rate differed substantially from the company rate it is difficult to characterise the system in any meaningful way.

Where dividends were received by an individual shareholder, the New Zealand system operated as a deduction system for foreign tax on income arising from foreign dividends. There was no tax on the company on dividends received by it which were net of foreign taxes, but there was tax on the shareholder on dividends received by the shareholder which would be equivalent in amount to the foreign income less foreign

tax. For dividends received by shareholders that were attributable to branch income of the New Zealand company, again it is difficult to characterise the system. The shareholder would be left with an amount net of the New Zealand company tax rate (composed of the foreign tax and the New Zealand company tax less a foreign tax credit) and net of the individual shareholder tax on the balance.

In the future New Zealand will have an imputation system, a foreign tax credit system for branch income, and no general capital gains tax (the position of foreign dividend income is put aside for the present). This amounts to a deduction system with respect to dividends paid out of foreign source income to the shareholder (in this respect it mirrors the analysis of the Australian system above and the result would be the same no matter how the foreign income were dealt with at the company level). For capital gains arising out of retentions, this combination will operate as an exemption system assuming that full value is attributed to imputation credits stored in the company, because only the shareholder will effectively bear the foreign tax - any New Zealand tax at the company level will give rise to imputation credits stored in the company.

It will be apparent that, in terms of the simple model being used, the Australian system is the more consistent both before and after tax reform. The discordances in the New Zealand system are produced before tax reform by the different treatment of foreign dividend and branch income and after tax reform by the lack of a capital gains tax. It will become apparent in the course of this paper that the lack of general capital gains tax in New Zealand produces a number of oddities at the theoretical level and it is no surprise therefore that the Consultative Committee recommended the introduction of the tax (1988a paras 8.1.1-8.1.5). Of course, at the practical level a capital gains tax may create as well as remove distortions and will inevitably make the tax system more complex but, in view of recent reforms enacted or contemplated in New Zealand, complexity is already present in a high degree.

The important case of a resident shareholder receiving dividends from a foreign company has been generally passed over in the discussion because it is excluded by the premises that all individual shareholders are resident in Australia/New Zealand and that the ideal company residence rule is based on the residence of the ultimate individual shareholders in the company (though the latter premise has been relaxed in a few instances to encompass the discussion of foreign companies and dividends received from such companies by resident companies). This case will be returned to below and it will be seen that New Zealand has dealt more consistently than Australia with resident individual shareholders of foreign companies as compared to resident company shareholders of such companies.

The major point for the moment is that, even in the context of the simple model, in neither country does the tax system always effectively operate in accordance with the formal method for dealing with foreign income (exemption, credit or deduction). This fact can easily be overlooked as analysis is often limited only to the company level and does not combine with this the effects of shareholder taxation.

However, if the model is allowed to approximate more closely the actual tax system with respect to residence and source rules, the analysis becomes more complex. In fact tax systems do not generally adopt the residence rule suggested above for entities (that the country of residence is the country with which the owners of the entity have their closest personal contacts), but rather look generally to the place of incorporation of a company or the place of management and control of the company (there are similar problems of source rules not matching the ideal but these are overlooked for the moment). Thus it is possible to create a company which is ultimately owned by the residents of one country but is regarded as a resident of another country by the country of residence of its owners. Until relatively recent times the traditional tests of place of incorporation and place of central management and control probably coincided with the place of residence of the owners of entities, and for listed companies this is still generally true today. Increasingly in present times it is not true of many companies.

If the residence country of the owners of the company does not tax foreign income of non-residents as is usual, then the income of such a company is likely to be taxed, if at all, by the country of residence of the owners on a remittance or realisation basis (that is, when dividends are paid or the shares in the company are sold). If it is possible to realise or remit income in a way that does not attract the operation of the tax system of the residence country of the owners of the entity, then the effect is the same as the exemption system. It often proves possible to achieve such tax free remittance or realisation in many countries by loans to shareholders which are not treated as dividends or tax free sales of the shares due to the lack of or failure of operation of a capital gains tax. Thus the problems that face the country of residence of the owners of the entity are raised by its rules first as to the residence of the entity and secondly as to remittance and realisation.

The usual major response overseas has been to adopt controlled foreign company legislation which addresses the difficulties by taxing certain income of non-resident entities to substantial owners of the entity on a current basis, whether or not it is remitted or realised. By taxing the owners rather than the entity, the main problem of definition of residence of the entity is bypassed in favour of meeting the subsidiary problem of the remittance and realisation rules. This approach is bound to bring problems and unfairness in its train since it involves the taxation of retentions to shareholders on a current basis, that is, corporate tax integration in the international sphere when it has not proved possible to introduce this system in the domestic context. While the unfairness is minimised by control rules that limit the regime generally to foreign companies with few shareholders who have a substantial degree of influence over them, the generalisation of this integration approach to all foreign income of foreign companies in which residents have shares needs to be considered with caution, precisely because of the difficulties of integration (Vann 1986a, pp 24-43).

Another response that has been developed by the US is to adopt rules to prevent

treaty shopping, both in its treaties and legislation. Both Australia and New Zealand in their recently negotiated treaties with the US have such rules (Article 16 in each case). This response denies the benefits that would otherwise flow from being characterised as a resident of a treaty country.

The better response in theory is to change the generally accepted residence rules for entities to correspond with the residence of the owners of the entity. This was recognised in Australia by the Asprey Committee more than a decade ago (Taxation Review Committee 1975, pp 254-255). However, the current rules are so entrenched in international practice that this can only be a long-term goal. In the meantime it is necessary to seek a proxy solution and the controlled foreign company route offers the best solution as it seeks to balance the likely unfairness of the full accrual (or conduit) approach with limitation of the system to cases where abuse is likely to occur.

It may be asked why such arguably inappropriate residence rules have become accepted worldwide. As to the place of incorporation, it offers certainty and simplicity, but also is the easiest to manipulate. The great champion of this test is the US which will not accord priority to any other residence rule in treaty negotiations, so that US treaties do not have a tie breaker for dual resident companies where the other country adopts some other test for residence[3]. (If each country adopts the place of incorporation as the sole residence test then dual resident companies are not possible.) The adoption of the place of incorporation is natural in the US context of the use of citizenship for individuals as the prime test for worldwide taxation of income. Incorporation in the US is analogous to the birth of an individual in the US. Apart from this kind of argument for the rule, the other possible justification is one heard in the context of the debate over the classical system of company taxation - the consequences that follow from being treated as a resident for tax purposes are the *quid pro quo* for the privilege of incorporation.

The central management and control test had its origins in UK case law at the turn of this century. The test parallelled the development of company law theory when it was being established that the board of directors was dominant over the general meeting and was the company in some sense. Hence the residence of the directors indirectly determined the residence of the company, rather than the residence of the owners (the general meeting). One problem with the test is its uncertainty of application. It also is open to manipulation and permits a company to be a dual resident if the management and control is divided between two countries. The test in some ways is akin to a source rule in that the place of central management and control is likely to be the place with the closest economic connection with a company's income. The UK announced in its 1988 Budget that it was abandoning the test in favour of the place of incorporation rule, but the test survives in nearly all of the UK's former colonies.

Australia (ITAA s.6(1) definition of resident para.(b)) adopts each of these tests, but both the carrying on of business and also the central management and control of business in Australia is necessary in the case of the latter (whether it is possible to

have central management and control in Australia without carrying on business there is doubtful). Australia also has a third residence test of carrying on business in Australia combined with voting power being controlled by shareholders who are residents of Australia. The requirement of carrying on business in Australia again has connections with source ideas (the economic activity producing the company's income).

The third Australian test is easily avoided as it depends on the residence of the shareholder on the share register, and trustees or nominees can be used to ensure that the shareholders are or are not residents of Australia as required. If beneficial ownership were substituted for simple shareholding, it would be necessary to have tracing rules to look through interposed companies. Such rules have proved difficult to operate on the domestic scene in the tax area, and have encountered enormous obstacles on the international scene in company law contexts in Australia. It is probably for this kind of reason that tests based on residence of the owners of entities have not become international norms although they do exist in a number of countries. Once again the difficulties of putting a desirable test into operation probably prevent its direct adoption at least for the short term (apart from the entrenched nature of the current rules as international norms).

New Zealand (NZITA s.241(2)) adopts the place of incorporation test and, at least in the view of many practitioners, the central management and control test. The Consultative Committee recommended that the current definition be amended to make certain that New Zealand does adopt the latter test and to clarify what the test means (control by directors, centre of management or head office in New Zealand: Consultative Committee 1988c, pp 16-18). Although the Committee acknowledged that the current definition of company residence creates the need for controlled foreign company legislation, it did not consider attacking the residence definition problem directly, apparently because New Zealand is locked into the current tests by its tax treaty network.

The proposed adoption of full accruals taxation of foreign income of residents, including income of non-resident companies in which residents have shares (as in New Zealand by Douglas 1987c, though later abandoned), or the proposed accruals taxation of tax haven income (as in Australia by Keating 1988c), or the enactment of controlled foreign companies legislation (as in New Zealand and as seems likely in Australia), is each intended to enforce the worldwide taxation of income of residents. 'Residents' for this purpose ultimately refers to natural persons who have their closest personal ties with the country concerned, and as such residence taxation should be based on the position of individuals. In fact most foreign income is likely to be derived in the first instance by entities and so the residence tax rules of these regimes are applied to them in the first instance, rather than individuals.

In the case of entities that are classified as residents on the basis of place of incorporation or central management and control, the problem of an inappropriate residence test can now work in the opposite direction to that noted above, that is,

residence taxation may be applied inappropriately to entities which are owned by non-resident individuals. As the net of residence taxation is effectively spread wider by controlled foreign company legislation and the like, the potential for unfairness grows. This is particularly so where more than one country is operating controlled foreign company legislation with respect to entities in the same group, as international double taxation again emerges but in a form that is not necessarily covered by traditional measures to prevent such double taxation.

It may be argued that the remedy to this problem lies in the power of the company group in question: it can restructure itself so that only the controlled foreign company legislation of the country of residence of its ultimate individual owners is applicable. Indeed it seems that this is already occurring across the Tasman before either Australia or New Zealand had final legislation in place. To take the simplest case: if a New Zealand company was a subsidiary of an Australian company and the New Zealand company itself has subsidiaries overseas that would be affected by the controlled foreign company legislation announced on 18 June 1987 (Douglas 1987a) or the comprehensive taxation of foreign of residents announced on 17 December 1987 (Douglas 1987b), the easy response in the short term would be to transfer the subsidiaries of the New Zealand company to its Australian parent. Now that Australia has announced similar legislation (Keating 1988a, 1988c), the choice is likely to be dictated by which country has the strictest regime, and for this and other reasons explored towards the end of this paper, the choice is still likely to settle on Australia.

However, this type of home-made solution is effective only if the ultimate individual owners of a company are all substantially resident in the one country. This condition has held in the past and has been assumed in the prior discussion. As cross border listing and multi-country prospectuses become more commonplace, and as international portfolio and risk management theory and practice become more sophisticated, the condition will be less and less true in future. Already in the case of Australia and New Zealand, there are examples of large companies ultimately owned by individuals divided more or less equally between the two countries.

A possible response to this type of situation is to give companies resident in a country which operates controlled foreign company or similar legislation the opportunity to prove the extent to which its ultimate owners are non-residents and to reduce the amount of income attributed to the company under the legislation accordingly. Such a response will not solve the problem for the country of residence of those ultimate owners, and the difficulties of applying this type of legislation at the level of the individual are immense. Another possible response is not to apply the legislation to a shareholder where the foreign company in which shares are held is based in a country which itself has similar legislation. This solution seems to be emerging indirectly and imperfectly in a number of countries, but whether as the product of conscious decision in every case may be doubted.

Because of these difficulties one possible scenario as the ownership of companies becomes more diverse across countries is that multi-nationals will be incorporated,

controlled and listed in tax havens (as well as on the world's major stock markets). Already signs of such a trend have become evident in Australia and New Zealand. The cost of this response to controlled foreign company or similar legislation is often the forgoing of benefits enjoyed by resident companies (such as the operation of an imputation system).

The final complication in this problem of definition of residence is that it has been assumed in the above analysis that an individual's residence will be easily identified. In fact it is probably the case that the wealthier the individual, the more likely that she or he will both have foreign income and be a 'citizen of the world'. Ultimately the residence definition problem is not susceptible to a clear and decisive solution at either the individual or entity level.

At the same time as Australia and New Zealand have been strengthening the taxation of residents, other tax reform developments may be characterised as moving away from residence taxation. The introduction of indirect comprehensive consumption taxation and the use of the revenue generated to cut income tax rates has the effect of moving the tax system (at least in a formal sense) to a greater reliance on source taxation. In international tax parlance, indirect consumption taxes can be levied on an origin or destination basis. The latter system which prevails around the world is characterised by refunding for exports any taxes paid before export and taxing imports. It effectively taxes consumption in the country concerned by residents and non-residents alike but not overseas consumption by residents of that country. The former system does not refund tax on exports and does not tax imports. It is difficult to characterise in terms of residence and source.

Australians and New Zealanders are great travellers and to the extent that benefits of income tax cuts are used for overseas trips, there is a reduction in residence taxation. It might be considered that the overall effect of the change is insignificant because residents will do almost all their consumption in the country of residence. Nonetheless the switch from income tax to consumption tax is a shift away from residence taxation.

Similarly the flattening of the tax rate scale that is occurring around the world shifts taxation to the place of source. The traditional argument about the relationship of the rate scale and residence and source taxation is that the latter should be levied on a flat rate (for example, Musgrave 1983). A progressive rate scale makes sense only in the context of individuals and only when their total (that is, worldwide) income is brought to tax, as it is total income that is the measure of the individual's capacity to pay tax. Although rate scales do not invariably conform to these principles they are generally observed in international tax practice because most foreign income is derived by companies which are taxed at flat rates in any event, or in passive interest dividends or royalties for which both unilateral and treaty withholding tax rates are flat.

If the US tax reform does indeed produce personal and corporate tax rates that are almost flat and in the 30%-40% range around the world, and if countries use the foreign tax credit system, then residence country tax will be usually reduced to nil by

foreign tax credits and the system will in fact be one of source taxation only in practice. This argument that the foreign tax credit system tends to reduce to an exemption or source based system is not new, but in the past has been made in the US in terms that foreign countries will take advantage of the US foreign tax credit system and raise their rates to the US rate and effect a transfer from the US Treasury to their own (Kingson 1981). What is now happening is that residence countries are turning their rate scales into the kind usually associated with source taxation. It is noteworthy that the US did not lower its 30% rate of tax (apart from treaties) on non-residents in tax reform and in fact in various ways increased its tax rate on non-residents.

Although Australia and New Zealand will nominally be using a mixture of foreign tax credit and exemption systems it has been suggested above that, on certain assumptions, the systems will in fact operate as deduction systems. In that event the flattening of rates to uniform levels around the world will not eliminate residence taxation. Nonetheless, the trend around the world of broadening the tax base and lowering tax rates does suggest that the residence tax problem will be more one of tax havens which levy near to zero tax rates rather than deferral of tax by storing profits off-shore generally. Again this may suggest that controlled foreign company legislation directed particularly at tax havens is more appropriate for Australia and New Zealand if they bring their tax rates down to or below US levels.

In the discussion that follows, the position of Australia prior to the Economic Statement of 25 May 1988 (Keating 1988a, 1988c to take effect from 1 July 1989) will first be considered, followed by an assessment of New Zealand's situation, and then the position in Australia after the Economic Statement. This follows the chronological sequence of development of reform in the two countries and allows exploration of the shift from an exemption to a foreign tax credit in Australia, and the shift in both countries to accruals taxation of foreign income with exemption and foreign tax credit elements.

A Australia Prior to 1 July 1989

Australia introduced a foreign tax credit with a worldwide credit limit for the period 1987 to 1989 (ITAA ss.6AB, 6AC, 6B, and Part III Division 18). That is, foreign income derived by Australian residents is included in assessable income and subject to Australian tax at ordinary rates; a foreign tax credit is then allowed for all foreign taxes levied on the income up to the level of the Australian tax on that foreign income without distinction of the country where the tax is levied and of the varying tax rates on income from particular countries (ITAA s.160AF(1)). The adoption of the worldwide limit allows the averaging of high and low effective foreign tax rates. Moreover it is possible to transfer excess credits (where the foreign tax credit limit is exceeded) within 100% related groups of Australian companies (ITAA s.160AFE).

There are special rules for foreign losses, that is, where the deductions applicable to foreign income exceed that income. Foreign and domestic losses are treated

separately. Foreign losses cannot be set against domestic income in any case (ITAA s.79D), whereas domestic losses can be set off against foreign income by election of the taxpayer (ITAA s.80). Foreign losses can be carried forward for set off against later foreign income but in this case a country by country and type of income restriction is applied (ITAA s.160AFD). For example, business losses incurred by an American branch cannot be matched with business income from a British branch nor can the American losses be set off against American non-business income. The reason why foreign losses cannot be set off against domestic income is to prevent avoidance activity such as establishing a foreign branch, setting its initial losses against Australian income and then incorporating the branch when it starts to become profitable to keep the profits offshore. It is not clear why there are strict limits on utilising foreign losses on one activity against income from another foreign activity. The rules with respect to capital losses are different and it is possible to offset domestic and foreign capital gains and losses in either direction (s.160ZC). This oddity probably arose simply because the topic was dealt with in the capital gains rather than the foreign tax credit legislation.

There are also separate baskets for certain interest and banking income to prevent abuse of the averaging of foreign tax rates permitted by the worldwide credit limit (ITAA s.160AF(7)). In effect the foreign tax credit limit is calculated separately for interest and banking income subject to the rules. Otherwise it would be possible for a taxpayer which was subject to foreign tax in excess of Australian tax on the foreign income to place moneys on deposit in a foreign country, pay little or no tax on the interest and average down the high foreign tax otherwise applicable. Because it is such a simple matter to make deposits on foreign money markets it was considered that this would have been an easy avenue of avoidance. The logic of this approach is likely to be extended to other types of income that can be manipulated in a similar way; indeed the basket for off-shore banking income is a recent addition.

Australia has in some of its tax treaties granted express tax sparing relief for foreign income subject to tax holidays in developing countries. Tax sparing involves giving a foreign tax credit for foreign tax which has not been paid as a result of the holiday as if it had been paid. Such treaty relief was only necessary for passive income subject to treaty tax limits since Australia in the past exempted other foreign income from Australian tax (especially by the intercorporate dividend rebate). As the general foreign tax credit system will wipe out this automatic protection against Australian tax where no express treaty rule is in place, there is power under the foreign tax credit legislation to give tax sparing credits by regulation (ITAA s.160AFF).

In addition to the foreign tax credit for income derived directly by Australian residents there is also an indirect or underlying foreign tax credit for taxes (probably not including Australian taxes) paid by foreign companies which is granted to certain Australian resident corporate shareholders when dividends are received from those foreign companies (ITAA s.160AFC). To qualify for this credit the Australian company must be 'related' to the foreign company in question. The foreign company

can be at any remove from the Australian company in a chain of foreign companies, but there must be at least a 10% interest between any two immediate links in the chain and at least a 5% ultimate interest of the Australian company in the foreign company (ITAA s.160AFB).

Putting aside the transitional period, the credit is calculated by a pooling system based on the pre-tax financial profits (adjusted by adding back any provisions for taxes) of the foreign company (ITAA s.160AFC, Ruling IT2445). All the profits of the company over the years commencing from the first complete accounting after 30 June 1987 as reduced by taxes paid over those years are added together and dividends are treated as coming out of this pool. Similarly taxes paid by the foreign company over the years are pooled and regarded as attached to dividends in the same proportion as a particular dividend is of the balance of the profits pool at the time of payment of the dividend. When a dividend is paid, the profits pool is reduced by the amount of the dividend and the tax pool by the amount of tax attached to the dividend.

This system has the effect of averaging or spreading the taxes paid by the foreign company across its profits as they accumulate. It was chosen in preference to two other variants whereby the company could nominate which profits of which year were being distributed or a last in first out system as both these allow the foreign company to manipulate the tax rate regarded as having been paid on its dividends. For example, if a last in first out system were adopted, an Australian company could have set up two subsidiaries in a particular foreign country and operated them so that each paid high and low foreign taxes year and year about, with one company paying low foreign taxes when the other is paying high taxes. Dividends would be paid alternately from each company in their high tax years so that the low tax profits were stored off-shore. This technique is known as the 'rhythm method' and was used by US corporations under the US foreign tax credit system prior to the introduction of a pooling system in 1986.

The choice of profits as the measure of income of the foreign company was made because it was regarded as impracticable to require Australian companies to recalculate the income of foreign companies in accordance with Australian standards (the foreign company would only have calculated its income by foreign standards unless it operated in Australia and then its calculation of income by Australian standards would only relate to the Australian source income).

The relationship of the capital gains tax and the foreign tax credit should be noted. Australian residents are taxable on their worldwide net capital gains (ITAA s.160L(1)), but non-residents are subject to tax only on their net capital gains on taxable Australian assets (ITAA s.160L(2), which includes such things as land in Australia, assets of an Australian branch, shares in Australian resident private companies, and 10% or greater interests in Australian resident public companies (ITAA s.160T). Thus if an Australian resident sells a foreign asset, any capital gain that results will come within the Australian tax net, but if a non-resident sells a foreign (non-taxable Australian) asset, the capital gains tax will not be activated.

Where an Australian resident has paid foreign tax on the capital gain, it will be

subject to the foreign tax credit in the normal way as will foreign tax paid by a foreign company on a foreign capital gain under the indirect (or underlying) foreign tax credit with respect to dividends received by an Australian company. More specifically, if an Australian company sells shares it owns in a foreign company, it will get credit for foreign tax paid by it on the sale but will not get credit under the indirect credit for any foreign taxes paid by the foreign company on retained profits. If a foreign company controlled by an Australian company sells shares it owns in another foreign company, any gain made on the sale will not be subject to Australian capital gains tax but dividends paid by the foreign company to the Australian company will attract an indirect credit in the usual way. The capital gains tax is subject to indexation and so an Australian company may be better off selling shares in a foreign company rather than having that company sell assets and pay a dividend to the Australian company out of the profit. Whether this is the case depends upon whether the gains from the indexation of capital gains outweigh the gains from the indirect foreign tax credit allowed on certain dividend payments. The higher the rate of domestic inflation the greater will be the gains from the indexation of capital gains.

The interaction of imputation and the foreign tax credit is also of importance and has attracted considerable attention in Australia. Because imputation credits are only granted in respect of Australian company tax paid and because company tax payments are reduced by the foreign tax credit, ultimately foreign income will generate unfranked dividends to the extent of the reduction of Australian company tax by the foreign tax credit. Where the company in question has substantial Australian income, this should not pose a problem because, as explained above, the imputation system treats fully taxed profits as being distributed first. Where Australian tax payments on Australian source income are small because of low effective tax rates or where foreign income of a company is substantial, this issue will be more important.

1. Investment Effects

One object of the introduction of the foreign tax credit was to achieve capital export neutrality, that is, Australian residents should pay the same rate of tax on domestic and foreign investment so that tax considerations would not influence the choice to invest in Australia or overseas. It will be evident from the account of the system above that this object has hardly been achieved. There are all kinds of particular rules that potentially can cause distortions in investment, for example, the treatment of losses, interest and tax sparing. It is not intended to enumerate all the possible departures from the stated goal but rather to look at the larger consequences of the system and then to consider avoidance possibilities.

The first issue is whether the system is properly to be characterised as a foreign tax credit or foreign tax deduction. If attention is simply directed to the position of an Australian company deriving foreign income then it is correct to regard the system as a foreign tax credit. It has already been suggested on the basis of a number of simplifying assumptions and when a broader view is taken that the system operates

quite accurately as a deduction system. (One of the matters assumed away was the problem of inflation and the fact that the capital gains tax, but not the tax system generally, is indexed in Australia.) If this is so then the system encourages investment in Australia where the Australian pre-tax return exceeds the after-foreign-tax return on foreign investment. The most obvious example of the system not being what it seems is in the interaction of the foreign tax credit system with the imputation system, although the outcome is not usually put in precisely these terms.

If it is desired to operate a foreign tax credit system in the context of imputation, then imputation credits should be available to shareholders in respect of foreign tax payments by the company. The problem with this approach is that imputation credits can be used to reduce tax liability on other income, and if the shareholders' average tax rate is lower than the foreign tax rate then the foreign tax paid by the company will effectively reduce Australian tax on Australian income. This outcome is contrary to the intent of the foreign tax credit limit. If need be, a separate accounting mechanism can be created in various ways to ensure that the foreign tax credit limit is preserved but at some considerable cost in the complexity of calculations required of shareholders.

Some would argue that the deduction system is the most desirable treatment of foreign income and if Australia has managed to produce what looks for all the world like a foreign tax credit but operates as a foreign tax deduction, then so much the better as the appearance (and for that matter the substance) of the system accords with international norms (Keating 1988c, pp 31-33). Another way in which this effect as a deduction system can be put is that, to the extent that Australian companies will find it necessary to pay tax, they will be encouraged to avoid foreign tax and so reduce the foreign tax credit and increase Australian tax payments. This in turn will increase the imputation credits that can be passed onto shareholders.

It was also suggested above that the capital gains tax operates as a deduction system with respect to retentions in foreign companies and that in this case it is not possible to produce a workable foreign tax credit. The simplicity of the analysis in the capital gains area needs to be modified by two considerations. First, the Australian tax applies only to assets acquired after 19 September 1985 and secondly, the gain is reduced by an inflation factor. The first factor will decrease in importance over time and will not affect new investment, while the second will often mean that profits will be more effectively extracted by way of capital gains rather than dividends and be more generous than a deduction system which is not adjusted for inflation but less generous than an exemption system.

Suppose that an individual invests $1000 in an Australian company which in turn invests $1000 in a foreign company. The foreign company earns $200 which is subject to foreign tax of $40, and inflation over the period in Australia is 10%. If the foreign company pays a dividend of its full after-tax profits to the Australian company, then the Australian tax liability of the Australian company will be $100 less a foreign tax credit of $40 to give net Australian tax of $60 (assuming a 50% rate for

simplicity). If the Australian company then distributes its after tax profit to its shareholder, the shareholder will receive a fully franked dividend of $60 and an unfranked dividend of $40 so that the shareholder pays a further $20 tax assuming again a 50% tax rate. The shareholder is left with $80. This is the same amount that the shareholder would have received if the $200 foreign income was derived through a branch by the shareholder and had been the subject of a foreign tax deduction ($200 less $40 foreign tax leaves $160 which after Australian tax of 50% reduces to $80). It is less than the amount that the shareholder would have received if the income was derived directly by the taxpayer through a foreign branch and subject to a foreign tax credit ($200 would be subject to $40 foreign tax and $60 Australian tax leaving $100 in this case).

If instead no dividends had been paid and the Australian company had sold its shares in the foreign company for $1,160 (cost plus retained after-foreign-tax profits), then the capital gain would be $60 ($160 less inflation adjustment of $100) and attract Australian tax of $30. If in turn the shareholder sold the shares in the Australian company for $1,130 (cost plus retained profits in the Australian company of $160 less $30 Australian tax), then the capital gain would be $30 ($130 less inflation adjustment of $100) and tax $15 so that the shareholder would be left with $115 after-tax profit. This is more than the amount that would be left if the profits had been distributed by way of dividend by both the foreign and Australian companies, more than the simple foreign tax deduction system would produce if the shareholder had derived the foreign income through a branch, and more than the foreign tax credit system would produce in a branch situation. These calculations ignore any market pricing of future tax benefits and liabilities (the benefit here is the imputation credit stored in the Australian company as a result of the payment of capital gains tax by the company, and the liability is future Australian tax payable on dividends paid by the foreign company if the shares are purchased by another Australian resident).

If the company had retained its shares in the foreign company and the shareholder in the Australian company had sold shares in that company for a price exactly equal to retained profits, then the shareholder would be left with $130 after-tax profit ($160 retained profits in the foreign company less inflation factor of $100 gives a capital gain of $60 and tax of $30 on the shareholder). This increases the return to the shareholder above the dividend route and the double sale of shares (again assuming no pricing effects for tax benefits and liabilities), although the return is still less than the full foreign income exemption system which would produce $160 after-tax profit for the shareholder ($200 less the foreign tax of $40).

These calculations, as already noted, ignore market pricing of inchoate tax benefits and burdens but it is not an implausible assumption, I would suggest, that the market would make relatively minor price adjustments. The greatest source of market price adjustments is likely to be goodwill gains and losses. Moreover, as already noted in the discussion of imputation, there are significant tax distortions in the Australian market and it is not possible to predict the price that would be paid for the shares;

different buyers would be willing to pay different prices. In addition, in the international area the prospect of purchase by non-residents must be considered. For example, if a person resident in the country of the foreign company purchased the shares in that company, there would be no discount for future Australian tax payable on dividends received from the foreign company. Nevertheless, although the calculations may not reflect the outcome in particular cases, they are valid to demonstrate that the capital gains indexation will produce a departure from the outcome under a foreign tax deduction system or a foreign tax credit.

The major problem that is usually attributed to a foreign tax credit system is the advantage of deferral that can be obtained where profits are retained in non-resident companies. This technique is available for both the dividend and capital gains tax route as the payment of dividends can be delayed and capital gains not realised. The deferral problem does not, however, arise from simple postponement of tax. If a number of assumptions about rates of return and tax rates in Australia and a foreign country are made, then it can be shown that the net present value of the Australian tax liability that will be paid when stored (reinvested) profits are repatriated remains the same whenever repatriation occurs, so long as the repatriation activates the foreign tax credit system at that point. On the other hand if the foreign tax credit system is not then activated, then there are considerable advantages in deferral as the deferral at that point becomes potentially infinite. The discussion under the next heading will consider some means by which such repatriation can be achieved.

Before moving onto that issue some of the possible major responses to the introduction of the foreign tax credit will be explored. The most drastic response is simply to move residence out of Australia to a more congenial tax environment off-shore. Moving residence means more than simply incorporating off-shore branches as that tactic simply creates the possibility of deferral. The kind of company for which such a step is likely is one with both substantial off-shore assets and substantial off-shore shareholders. There are a number of large Australian companies with substantial overseas assets though fewer with substantial foreign shareholders. However, the diversity of shareholding has been increasing and this trend can be expected to continue. An example in Australia is AFP which moved residence from Australia to the UK through a Scheme of Arrangement under the Companies Code.

The most extreme version of this restructuring is to break the company up into at least two separate companies, one located in Australia and one located off-shore. The overseas assets are then held by the foreign company and the Australian assets by the Australian company. The shares in both companies are then listed and issued to the shareholders in the original Australian company. Thereafter, trading in the shares should have the tendency that the shares in the Australian company find their way into the hands of Australian residents, and shares in the foreign company find their way into the hands of non-resident and tax exempt shareholders. This scenario ultimately involves the break of the original company into separately owned and controlled companies and for that reason may not appeal to the controllers of the original

company. Nonetheless it has been adopted in Australia by Westfield in relation to its US operations.

A less drastic change would be to adopt the same structure but to staple the shares in the new companies so that they cannot be disposed of separately. Shareholders would be given the choice of the company from which they would receive dividends, and residents could be expected to choose the Australian company and non-residents the foreign company. A formula would be developed to control the relationship of dividend levels from the different companies so that different groups of shareholders were treated as fairly as possible. It is not clear that this type of activity should be regarded as tax avoidance that needs to be prevented since it is a method of dealing with the problem of satisfactorily defining residence of entities where shareholders are resident in different countries. Some schemes of this kind have already been mooted in Australia and a similar scheme adopted in a domestic context by the Stockland Trust involved the stapling of a unit in a unit trust and a share in a company.

The incorporation of branches is also likely to occur in order to gain the benefits of deferral (if such benefits exist). This step may involve capital gains tax problems as there are no roll-overs applicable where an Australian company transfers non-taxable Australian assets to a wholly owned non-resident company for the reason that this transfer thereafter takes the asset in question out of the Australian tax net (no capital gains tax applies to non-taxable Australian assets held by non-residents). Hence tax planning activities will be directed at this problem.

2. Avoidance Possibilities

Of the many possible areas, three will be concentrated on: the conversion of branches to subsidiaries, the making of effective repatriations without activating the foreign tax credit system, and the utilisation of capital gains indexation in relation to interest income. All of these are related to the need for controlled foreign company legislation or the like in Australia which is taken up under the heading Australia Revisited below.

a) Converting Branches to Subsidiaries

One form of tax planning that is used around the world for setting up a new overseas operation is to utilise a branch in the early stages and to seek to use losses generated against domestic income. Then when the branch is profitable it is incorporated and deferral relied on to protect the profits from tax. Australia tries to prevent the first step in this operation by its rules preventing foreign losses being used against domestic income (or even other sources of foreign income). Although these rules are in place, Australia has not developed the necessary deduction allocation rules in order to ensure that what are truly foreign losses are not converted into domestic losses.

To take a simple example, if an Australian has retained profits and borrowing facilities for Australian and overseas expansion, then the profits can be directed to the overseas operations and the borrowed funds to Australian expansion. As a result there should be no limit on interest deductibility as the interest on the tracing approach

adopted for interest in Australia will be regarded as connected solely with the Australian expansion, even though a more realistic view would suggest that the interest paid relates to both the Australian and overseas expansion. There are many variations on this theme but the problem of allocation of deductions will not be discussed further here (see Vann and Parsons 1986, pp 165-177; Ruling IT2446; Keating 1988c, p 34).

When the branch is incorporated, capital gains will not be a problem if the branch assets are regarded as of less value than the investment plus indexation to that point. However, since the transaction will be between non-arm's length parties, the Commissioner of Taxation will have power to substitute market value for the transfer (ITAA s.160ZD(2)(c)) and the company may not want to get into a debate about the value of the branch assets. One way of meeting this problem is to incorporate a resident subsidiary, transfer the assets to that company, and obtain a rollover (which will be available because the transferee is a resident), and then to change the residence of the subsidiary to the country of the branch.

The difficulty of this procedure is that Australia has a departure tax in the capital gains tax so that there would be a deemed disposal of the branch assets at the time of change of residence for market value (ITAA s.160M(8)). Nonetheless if the procedure is repeated twice with the branch assets transferred to a subsidiary and then a sub-subsidiary in exchange for shares in the sub-subsidiary, the subsidiary will be deemed to have acquired the shares at market value and a change of residence by the subsidiary will not attract capital gains tax at that point. That will still leave the branch assets in a resident company but at least a foreign company will have been introduced into the structure without tax consequences. This kind of planning will then be pursued to seek eventually to extract the branch assets into the foreign subsidiary without the levy of capital gains tax.

Controlled foreign company legislation that is limited to tax havens will not touch this kind of problem if the branch is not in a tax haven. On the other hand full current taxation of overseas income would eliminate the problem. If it is not desired to go the latter route because of the difficulties and potential unfairness involved, there are other methods available. The US in this kind of case requires that the permission of the Internal Revenue Service be obtained for the conversion, and one of the conditions for the grant of approval will often be the payment of a special excise to recapture the losses in the branch (Internal Revenue Code 1986 s.387). In cases where a tax haven is not involved and the foreign tax rate is similar to Australia's, the incorporation of the subsidiary will not create such a problem for the revenue.

b) Repatriation of Profits

At least the following methods are available for the repatriation of profits from a foreign subsidiary without activating the foreign tax credit:

(1) to retain profits overseas and ultimately sell the foreign investment subsidiary and repatriate the proceeds to Australia; to have the overseas subsidiary or re-

lated party invest in the Australian parent or associated activity, either by way of loan or equity;

(2) subject to foreign thin capitalisation rules, to establish foreign subsidiaries with loan capital rather than share capital and pay off the debt using retained profits;

(3) to borrow funds for use in Australia secured against overseas assets either from Australian or overseas sources denominated either in Australian or foreign curency;

(4) to manipulate the calculation of profits in the subsidiary so that the ratio of foreign tax to pre-tax profits is 49%;

(5) to utilise two subsidiaries in the foreign country with low taxed profits in one subsidiary and high taxed profits in the other subsidiary, and pay dividends from the high tax subsidiary; and

(6) to buy other foreign companies that will be in an excess credit position so far as Australia is concerned.

The first four of these methods amount to avoidance of Australian tax by by-passing the foreign tax system through the non-payment of dividends. The last three methods are means of ensuring that dividends paid to Australia are effectively not taxed. The details of only a few of these methods will be explored.

Retention of profits overseas and subsequent sale of the overseas subsidiary will result in the achievement of capital gains which will obtain capital gains tax treatment in Australia and avoid the application of company tax on repatriated profits under the foreign tax credit system. Gains from the sale of overseas subsidiaries established before 20 September 1985 will in this context be exempt from any liability to Australian capital gains tax (ITAA s.160L(1)). Where the subsidiary is established after 19 September 1985, it will probably be possible, by a combination of a two tier off-shore structure and changes of residence followed by payment of dividends, to achieve the same effect (Vann 1986b).

This form of planning relies on the international tax rules governing capital gains which have already been outlined. If an off-shore operating subsidiary is owned by an off-shore holding subsidiary, it is possible for the holding subsidiary to sell the operating subsidiary without the levy of capital gains tax or activation of the foreign tax credit. Then the profits can be extracted by means of a change of residence by the off-shore holding company to Australia and payment of dividends to the Australian parent that attract the intercorporate dividend rebate under ITAA s.46. Alternatively, if the holding subsidiary changes its residence to Australia by moving its control there just before it disposes of the off-shore operating company, it will be deemed to have acquired the shares in the operating company for capital gains purposes at their market value on the day of the change of residence (ITAA s.160M(12) so that no taxable capital gain occurs and again a rebatable dividend can be paid to the Australian parent.

If real disposal of the overseas operating subsidiary is not desired, there still should be no obstacle to sale of the subsidiary to a related party at an arm's length price. Then the kinds of planning outlined in the previous paragraph could be utilised even though

in substance no change in ownership has occurred. Such possibilities open up potential for periodic restructuring of operating entities at suitable future dates and repatriating foreign source income to Australia as capital gains rather than as dividends.

The sixth method in the list above is a variation on the 'rhythm method' which has already been described and which the pooling system of the foreign tax credit was designed to prevent. For this purpose it is necessary to have two subsidiaries in a particular country and to arrange the carrying on of the business between them so that high taxed income is generated in one company and low taxed income in the other with dividends paid only from the high tax subsidiary. Given the ability to use inter-subsidiary transactions such as leases of tangible property and licences of intangibles, it should be possible to achieve this kind of result in most countries. The fewer the tax concessions and loopholes in the tax system of the foreign country, the harder this result will be to achieve. Hence the removal in some overseas countries of tax concessions (such as the US and New Zealand) will make this exercise more difficult.

Finally, there is the possibility of trafficking in foreign companies with high effective tax rates. It was apparently assumed that trafficking in excess foreign tax credits was unlikely because of the lack of a carryover of excess credits. While this reasoning is justifiable in the case of foreign branches, it is not applicable to foreign subsidiaries because the only link that needs to be established between an Australian company and a foreign company for obtaining an indirect or underlying foreign tax credit is that the companies were related by the necessary level of shareholding interests at the time when dividends are paid. No relationship needs to be established for the time when the relevant profits and taxes were derived and paid.

The methods addressed here will be met by a controlled foreign company or similar regime limited to tax havens again only if a tax haven is involved. However, in the case of other countries the problems will not be so great as their effective tax rate will approach the effective Australian rate. Indeed in the case of such countries, what Australian companies will be trying to avoid is the effect of the indirect foreign tax credit which, by treating dividends as taxable in full, applying the full Australian tax rate to them and then giving credit at only the average rate of foreign tax, is less generous than the taxation of branch income where the Australian tax rate applied is the effective rate not the statutory rate (that is, the foreign source income attracts the benefits of Australian tax concessions).

On the other hand, the capital gains tax presents problems where there are goodwill gains involved as it may be avoided in particular by changes of residence and payments of dividends. There are a number of other tax obstacles that need to be overcome in such cases but there is clear potential for undermining the tax base. So far as capital gains are generated in other countries besides tax havens, then controlled foreign company legislation limited to havens will not meet the problem. Moreover, it is more likely that in the case of capital gains the foreign country in question will not levy tax so that there is more scope for abuse than in the case of other income. The

answer to this problem, however, is to improve the capital gains tax rather than necessarily introducing comprehensive accruals taxation of foreign income.

c) Exploiting Indexation

It is possible for Australian residents in effect to obtain tax indexation for interest income by investing in an investment company located in a tax haven. The haven company would invest in Australian dollar securities of the highest rating (probably government securities) and would not pay tax on the interest received in the haven (there would also be no Australian interest withholding tax on the interest if the right securities were chosen). The interest would be reinvested in more high grade securities. An associate of the haven company would stand ready to buy shares in it from investors at a price that reflected its asset backing. The investors would receive a capital gain on the investment but if they held it for more than one year, indexation would be available to reduce the tax liability.

This type of activity is not affected by the foreign tax credit system since no dividends are ever paid by the haven country and it pays no Australian (or other) tax. It is thus necessary to control such activity with controlled foreign company legislation (as in the US where the usual control tests do not apply) or other special legislation (as in the UK legislation for off-shore funds). Whatever happens on the general front of deferral, it is inevitable that Australia will adopt legislation to control such practices as soon as they become prevalent in the market place. The important point about this case is that it necessitates in limited circumstances the application of anti-deferral legislation to individuals with even relatively small overseas investments. Such limited application is more feasible than general legislation against deferral.

B New Zealand

The proposals for New Zealand in this area have shifted considerably in a short time from a controlled foreign company regime to full accruals of virtually all foreign income for all residents and back to controlled foreign company concepts. The discussion will focus here on the most extensive proposal for taxation of foreign income, that of 17 December 1987 (Douglas 1987c), and then note how the proposals have been considerably modified as a result of the consultative process. Although the 17 December 1987 proposals are now in a sense history, they will be discussed in the present tense.

The system proposed for New Zealand on 17 December 1987 in relation to foreign income of residents can only be described as a foreign tax credit in a loose sense. The system is considerably more complex and severe than the Australian system (even if a controlled foreign company system is introduced in Australia). Moreover to grasp the system fully, it is necessary to have regard not only to the proposals in the Consultative Document on International Tax Reform (Douglas 1987c), but also to the Consultative Document on Full Imputation (Douglas 1987d) and the Economic

Statement of 17 December 1987 (Douglas 1987b pp 42-48) so far as it relates to the withholding payment system for foreign non-portfolio dividends. Briefly the proposals involve the full accruals taxation to New Zealand residents of foreign income derived by foreign entities (companies and trusts) in which the residents have interests. In addition, imputation credits are to be available for foreign dividend withholding taxes suffered by New Zealand companies in countries with which New Zealand has a double tax treaty. Finally, New Zealand companies with a 10% or more (non-portfolio) interest in foreign companies are to be subject to a withholding payment on dividends received from those companies, with this tax in turn available for imputation credits to shareholders.

The last of these is a withholding tax at the individual tax rate on non-portfolio dividends received by New Zealand companies (which remain entitled to the intercorporate dividend exemption with respect to dividends from foreign companies) in respect of the ultimate individual shareholder's tax liability on the dividend. Pass-through of the tax payment to the shareholder is achieved by a form of imputation that operates in parallel to the imputation system for New Zealand company tax payments (involving a Withholding Payment Account - or WPA - similar to the ICA). The amount of the withholding payment is to be reduced by the amount of any foreign withholding tax suffered by the dividend. The withholding payment is presented somewhat disingenuously as merely one form of withholding tax along with withholding on domestic interest and payments to contractors, but its limit to foreign non-portfolio dividends means that it is essentially part of international tax arrangements and there is no explanation why the regime is not to be applied to domestic intercorporate dividends which are entitled to exemption and do not carry an imputation credit. For such dividends, exactly the same problem of postponement of New Zealand tax results as for foreign dividends. Australia in fact has begun to move down the track of imposing tax on unfranked intercorporate dividends by removing the rebate under ITAA s.46 on unfranked dividends received by private companies, and it will not come as a surprise if Australia and New Zealand ultimately generalise this treatment to all unfranked intercorporate dividends paid by resident companies.

The discussion under this heading will seek to describe briefly the full accruals system for international income and then will tie that system into the imputation and withholding payments systems as well as the capital gains position in New Zealand. The description will thus largely parallel that for Australia above. It is unclear from the Consultative Document on International Tax Reform whether the rules announced for the branch equivalent method will also apply to actual branches where they are relevant. It will be assumed that such is in fact the case (for example, in relation to foreign losses).

New Zealand prior to reform had a foreign tax credit with a country by country and probably a category by category of income type credit limit (NZITA s.293(2)). That is, foreign income derived by New Zealand residents was included in assessable income and subject to New Zealand tax at ordinary rates; a foreign tax credit was then

allowed for foreign taxes levied by the country of source on particular types of income up to the level of the New Zealand tax on that foreign income (using an average rate for this purpose). The system was applied to companies and individuals alike. There was no indirect (or underlying) foreign tax credit for companies in respect of direct investment in foreign companies but the exemption for intercorporate dividends in NZITA s.63 applied to dividends received from foreign companies. The adoption of the country by country and category by category tax credit limit means that the averaging of high and low effective foreign tax rates was not possible and is to be compared with the averaging under the worldwide limit in Australia. There was no need for New Zealand to adopt baskets for particular types of foreign income, as effectively the category by category approach creates separate baskets for every type of income from any particular foreign country.

According to the Consultative Document on International Tax Reform (Douglas 1987c, pp 31-32), there are to be special rules for foreign losses, that is, where the deductions applicable to foreign income exceed that income. Foreign and domestic losses will be treated separately. Foreign losses cannot be set against domestic income in any case as in Australia, whereas domestic losses seem to be set off against foreign income automatically. Foreign losses can be carried forward or set off against later foreign income but in this case a worldwide system seems to apply (or it may be that this occurs only by election). For example, business losses incurred by an American branch can be matched with business income from a British branch or against American non-business income. (This is an extrapolation from the rules outlined in relation to the accruals system for foreign companies' losses, Douglas 1987c, pp 7, 29, 31.)

This system is the converse of Australia with the worldwide limit for foreign losses but not for foreign income. The reason for the difference is that the New Zealand system in many respects seems designed to do everything in its power to deny effective foreign tax credits (despite the fact that carryback and carryforward will continue, Douglas 1987c, p 32). The foreign tax credit limit means that any tax in excess of the limit goes uncredited in the current year and such excess is more likely to arise under the country by country and source by source system. Conversely compulsory spreading of foreign losses from one source of income across other foreign income raises the effective foreign tax rate on the remaining income and makes it more likely that excess credits will arise. It is not indicated how this spreading will occur but presumably it will be *pro rata* unless the system is to be elective.

New Zealand, more extensively than Australia, has in some of its tax treaties granted express tax sparing relief for foreign income subject to tax holidays in developing countries (see the following New Zealand Treaties in respect of income other than dividends: Singapore Article 19(3), Fiji Article 20(3), Philippines Article 23(2), South Korea 23(4)). Moreover, New Zealand has undertaken to continue its exemption system for dividends received from companies resident in treaty partner

countries with respect to the following countries: USA Article 22(2), Singapore Article 19(2), Malaysia Article 20(2), Philippines Article 23(2) and South Korea Article 23(2)). In the case of all but the Philippines and South Korea where the undertaking is absolute, the treaty article relates only to New Zealand companies with a 10% or more interest in the foreign company. Australia has only one such treaty with Singapore (Article 18(2), which it has been announced in any event is to be replaced as from 1988). With the exception of the US, such a provision can be explained as relating to tax sparing relief in the event that New Zealand changes its exemption system.

The dividend withholding payment on foreign non-portfolio dividends has to do, amongst other things, with eliminating the benefits of tax sparing. At least this seems clear from the two types of tax sparing provisions contained in New Zealand treaties with developing countries. The treaties require New Zealand both to treat foreign tax on a foreign company's income as having been paid for foreign tax credit purposes and to exempt dividends from tax in New Zealand. This means that the full accruals taxation of foreign income is faced with the problem of giving credit for foreign tax not paid. Rather than attack the problem directly by abrogating or renegotiating the treaties to eliminate the explicit tax sparing, New Zealand apparently prefers to take an indirect approach with the dividend withholding payment on non-portfolio dividends and the ordinary taxation of portfolio dividends.

It remains to be seen whether those countries will accept the New Zealand explanation for the tax. Fortunately for New Zealand, US tax treaty policy is opposed to tax sparing. Nonetheless the US may be unhappy with the circumvention of its treaty, especially as there is a potential double layer of tax on New Zealand companies that operate through subsidiaries in the US and pay dividends to New Zealand. The anticipation probably is that the New Zealand companies controlling off-shore subsidiaries will ensure that they will not pay dividends and so avoid the withholding payment (the profits will be able to be realised in other ways considered below). Even so it will be necessary to renegotiate the Philippines and South Korea treaties as is acknowledged in the Economic Statement (Douglas 1987b, p 19), and, it would seem, the UK treaty (see Article 22(2)(b)).

1. Full Accruals Taxation of Foreign Income

In addition to the foreign tax credit for income derived directly by New Zealand residents, an indirect (or underlying) foreign tax credit for taxes paid by foreign companies in which New Zealand companies or individuals have an interest is effectively proposed in the context of the full accruals taxation of foreign income. Taxpayers with interest in foreign entities are required to report the income of the entity in their own returns on a current basis, that is, as it is derived by the foreign entity, and then generally to take a foreign tax credit in respect of taxes paid by the entity. As a *de minimis* rule, an individual with less than $10,000 worth of shares in foreign companies is generally exempt from the accruals system with respect to

foreign income. This system involves not only an indirect credit but, so it is claimed, the end of deferral. Three methods of measuring foreign income are set out, the branch equivalent method, the comparative method and the imputed return method. The discussion will initially consider the first of these and then the comparative value method. Only the former, however, applies foreign tax credit principles. Although the proposed regime applies to foreign trusts as well as foreign companies, trusts will not be analysed at this point but they will come up later.

The branch equivalent method (Douglas 1987c, chapter 5) applies to any New Zealand resident with an interest in a foreign company if an election is made to apply the method. Where the method is elected the taxpayer gets a foreign tax credit for taxes paid by the foreign company. There is no requirement that the taxpayer be a company for the credit for foreign taxes paid by the foreign company or that the taxpayer have a specified interest in the company (compare Australia's underlying foreign tax credit). However, the conditions that apply to the branch equivalent method mean that only a company with a substantial interest in a foreign company is likely to use it (and for similar reasons the method is unlikely to be used in a chain of companies which is not majority or wholly owned).

First, the method requires the recalculation of the income of the foreign company according to New Zealand income tax rules, which in turn will require access to all the internal records of the company (and in fact the taxpayer will be required to be able to make these records available to the New Zealand revenue). When one considers, for example, the application to a foreign company of the New Zealand accrual rules adopted in 1987 in relation to financial instruments, it will be clear that the method will be used only by 100% owners of foreign companies. Secondly, the penalties for being unable to apply the branch equivalent rules, having elected to do so, are severe. If the taxpayer cannot get the required information the imputed return method is then used automatically for 4 years thereafter, no matter how unfair that method may be (under this method a high rate of return is imputed to the investment in the foreign entity without any credit for foreign taxes paid).

Having calculated the income of the foreign company, the taxpayer is then taxed on its percentage interest in the foreign company and given credit for its percentage interest in taxes paid by it. The percentage interest is calculated by taking in effect the highest possible interest that the taxpayer could have in the foreign company if it exercised all the rights that it has in relation to the entity (for example, if it has an option to buy shares in the company those shares are included in calculating its percentage interest). This rule is subject to a limit that if more than 100% of the income of the foreign company would be attributed to New Zealand residents on this basis, the attribution will be reduced effectively to 100%. The problem in this area is that it is necessary to have strict rules to prevent avoidance but it is likely both that the rules will be avoided and that they will create unfairness.

For example, it is difficult to know how to deal with the case where the directors of a foreign company are willing to allot a swamping number of unissued shares to a

New Zealand company but there is no formal agreement to do so (in the meantime the large proportion of shares would be held by a non-resident party). A number of devices of this kind have been used over the years to avoid the central management and control residence tests for companies, and the US has had to deal with a number of income extraction techniques in its campaign against treaty shopping which may be used in this area.

Conversely where it is possible that more than 100% of the income will be allocated to New Zealand shareholders, the conditions for getting relief are so strict that genuine cases will often find it difficult to comply with them. For example, a New Zealand company through its Australian subsidiary may have entered into an incorporated mineral joint venture in Australia with an Australian participant in equal shares. The various joint venture agreements will have standard dilution, sole risk, independent operations etc. clauses by which the New Zealand company could be reduced in interest to zero or could take up to 100% depending on circumstances. Because there is only one New Zealand participant the rules as to more than 100% of income being allocated to New Zealand shareholders simply do not apply. Does this mean that the New Zealand company will be taxed on all the income of the joint venture? If so New Zealand companies will simply be excluded from standard international joint venture activities.

The creditable taxes under the branch equivalent method may include New Zealand tax - Australia does not seem to have this sensible rule under its indirect foreign tax credit. They also include foreign withholding taxes levied on distributions by the foreign company.

The combination of the branch equivalent method with the treatment of dividends received from the foreign company produces many unfair outcomes. To prevent double counting of the profits distributed in the dividend the branch equivalent income for the year is reduced by the amount of the dividend (but not below zero: if the dividend exceeds the branch equivalent income, the excess is set off against other foreign income of that or a later year). If the New Zealand company has a 10% or more shareholding (this apparently means actual shareholding and not the percentage interest which may be higher), then dividends received will be exempt from company tax in New Zealand but the dividend withholding payment will become payable. The result of this regime in a typical situation involving no tax avoidance at all is disastrous.

The following example is based on the assumption that the company tax rate is 33 1/3% and the individual flat tax rate is 25%. At the time of the Consultative Document on International Tax Reform such tax rates seemed likely, though in the event the company rate was set at 28% and the flat individual rate abandoned in favour of a progressive rate scale with a maximum rate of 33% (Douglas 1988a). Suppose that a New Zealand company wholly owns a foreign company which derives income of $3,000 in year 1 and pays foreign tax of $600. The New Zealand tax in year 1 is $400 ($1,000 at a rate of 33 1/3% less credit for $600). If the foreign income and foreign

tax in year 2 is the same but the company pays a dividend of $1,500 out of the profits of year 1 subject to dividend withholding tax of $150, the branch equivalent income in year 2 is $1,500 on which the New Zealand tax liability is $500. This is exceeded by the foreign tax and dividend withholding tax of $750 and so $150 of foreign tax goes uncredited. However, the dividend received attracts a dividend withholding tax payment of $375 (assuming a rate of 25% for this payment), which is creditable to the Withholding Payment Account, and the foreign dividend withholding tax is creditable to the ICA of the company along with the $400 company tax paid in year 1. Thus at this point the profits of year 1 have borne tax of $1,525 and the dividend received by the New Zealand company has had to support New Zealand tax payments of $750. Moreover, the problems of uncredited foreign taxes and large New Zealand tax payments arise every time the foreign company pays a dividend to its parent.

If the New Zealand company has less than a 10% shareholding in the foreign company and is managing to use the branch equivalent method, the outcome is just as bleak. Dividends are now taxable in New Zealand and there is credit only for the withholding tax against this liability (not the foreign company tax), though the dividend withholding payment is not payable. Using the example in the previous paragraph (and ignoring the fact that more than a 10% shareholding is involved), the result is that when the dividend is paid to the New Zealand company, it is subject to tax of $500 with a foreign tax credit of $150 leaving a tax payment of $350. Thus at this point the profits of year 1 have borne tax of $1,500 and the dividend received by the New Zealand company has had to support New Zealand tax payments of $750 and the ICA will be in credit for $900.

Where the branch equivalent method is not elected, the comparative value method applies, in effect an accruals capital gains tax without credit for foreign company taxes. The comments that can be made on this tax are many. Firstly, it is justified on a premise that is bound to be invalid in the large majority of cases, that is, that accrued capital gains are a fair proxy for retained profits (goodwill gains and losses are ignored in the justification of the tax). Secondly, New Zealand now has two particular accruals capital gains taxes (for financial instruments and interests in foreign companies and trusts), but no general capital gains tax, and this is bound to produce investment distortions. The accruals capital gains taxes each apply differently in the international context. The financial accruals tax applies to the domestic and foreign gains of residents but not to the gains of non-residents, while the international accruals tax applies to the foreign but not the domestic gains on equity of residents and does not apply to non-residents. Thirdly, in the case of unlisted shares the valuation rules will prove either unduly onerous or unfair (as is generally the case with annual wealth taxes overseas).

The relation of the tax to the taxation on dividends is also complex. Returning to the example above, assume that retentions are exactly reflected in share values and that the comparative value method is applied. At the end of the first year the New Zealand company will be taxed on an accrued gain of $2,400 resulting in a tax liability

of $800 and a corresponding credit to the ICA. When the dividend is received in the second year, it has the effect that the accrued gain in that year is $900 on which the New Zealand tax is $300. If the company is applying the dividend rule for non-portfolio dividends, the dividend attracts a dividend withholding payment again of $375 and foreign dividend withholding tax of $150. The profits of year 1 thus have attracted tax of $1,925 (with some consequent reduction of tax in the year 2), including New Zealand tax of $1,175. If the dividend rule for portfolio dividends is being used, then the tax on the dividend is again $350. Total taxes on the profits of year 1 are $1,700, New Zealand taxes are $1,150 and credits to the ICA $1,300.

The interaction of the imputation system and the accruals system has in effect been dealt with in the examples discussed above. The concern about the cancelling out of the foreign tax credit by failing to give credits to the ICA for foreign taxes still applies for other than foreign withholding taxes. The relationship of the ICA and the Withholding Payment Account is not clear. It seems that credits from both accounts can be attached to dividends up to the full tax rate for each but how they interact when both are attached to dividends is doubtful. On one view it seems possible that in effect dividends can carry tax credits more than double the tax liability on them. If so, some possible problems arising out of the example above may be solved (in particular the company may not have enough profits left after all the various taxes are paid to pay dividends that will exhaust the ICA and Withholding Payment Account).

2. Investment Effects

It is difficult to characterise the operation of the New Zealand system for the taxation of foreign income of residents. The Consultative Document on International Tax Reform is equivocal in that it does not positively state whether the goal is effectively a foreign tax credit or a foreign tax deduction system and the discussion of principles is sufficiently vague to be consistent with either possibility. The general thrust of the reforms seems to have been influenced in part by Richard Bird's 1987 Occasional Paper for the Institute of Policy Studies, *The Taxation of International Income Flows: Issues and Approaches*, and as he is generally an advocate of the foreign tax deduction system, it might be presumed that the deduction system is intended.

The proposals probably have come close to such a system but this is not as clear as in the Australian system. The complications arise from the dividend withholding payment and from imputation credits being granted for foreign withholding taxes. The key to understanding both these features of the system is a comparison of New Zealand companies holding shares in foreign companies and New Zealand individuals holding shares in foreign companies. The position of individual shareholders in foreign companies under the New Zealand and Australian tax systems has been left out of account so far.

In Australia both under the former and current system, the individual is entitled to a foreign tax credit for dividend withholding taxes levied on dividends received from foreign companies, but does not receive credit for foreign company taxes paid on the

profits out of which the dividends are paid (ITAA ss.45, 160AF). Thus the system operates as a foreign tax deduction system so far as foreign company tax on distributions is concerned, but as a foreign tax credit system so far as foreign dividend withholding tax on distributions is concerned. This is more advantageous for the individual as far as the foreign dividend withholding tax is concerned, as compared to dividends received from an Australian company under the imputation system, because as already explained, the imputation system causes the overall outcome to be equivalent to a foreign tax deduction system for all foreign taxes levied directly or indirectly on the Australian company.

In the case of retentions, the previous Australian system operated as a foreign tax exemption system for foreign company taxes in the absence of a capital gains tax, and the dividend withholding tax was irrelevant since it is not levied on retentions, so that the individual shareholder was better off with retentions to the extent that they were reflected in share prices. Under the current system with a capital gains tax, the individual shareholder is no better off with retentions since the elimination of the foreign tax credit for dividend withholding tax is compensated for by the capital gains tax and the system operates purely as a foreign tax deduction system for foreign taxes on the foreign company (apart from the benefit of indexation and again to the extent that retentions are reflected in share prices). Thus there is a discordance in Australia for resident shareholders in foreign companies between distributions and retentions under the new system, with the former being more favourably treated. There is also a discordance between investment directly in foreign companies and investment in such companies via a resident company.

In New Zealand, the previous system was the same as Australia's previous system for an individual shareholder in a foreign company, with a foreign tax credit available for foreign withholding taxes but not foreign company taxes and no capital gains tax. The complications of the proposed new system are designed to produce a much closer treatment of income derived through foreign companies where it is received directly by an individual New Zealand shareholder and where it is received through a New Zealand company. This is demonstrated by Sieper (1988) in the following four examples. (These examples, like many given above, were constructed at a time when it appeared that the personal tax would be flat rate and below the corporate rate.) The examples deal with full distribution of after-tax profits since New Zealand is seeking to tax income as it accrues.

Assumptions:Gross foreign income	=	$100
Foreign corporate rate	=	0.40 or 0.10 or zero
Foreign withholding rate	=	0.15
NZ corporate rate	=	0.30
NZ personal	=	0.20

Example 1: Portfolio investment by individual taxpayer (full distribution imposed)

	High Tax (0.4)	Low Tax (0.1)	Zero Tax (0.0)
Gross foreign income	100	100	100
Foreign company tax	40	10	-
Gross dividend received	60	90	100
Dividend withholding tax	9	13.5	15
Net NZ dividend	51	76.5	85
Personal tax	12	18	20
Withholding tax credit	9	13.5	15
Net personal tax	3	4.5	5
Net investor dividend	48	72	80
Total NZ tax	3	4.5	5
NZ tax as % of NZ dividend	5.88%	5.88%	5.88%
	(3/51)	(4.5/76.5)	(5/85)
Total tax as % of gross return	52%	28%	20%
	(52/100)	(28/100)	(20/100)
NZ share of total tax	5.77%	16.07%	25%
	(3/52)	(4.5/28)	(5/20)
Investor dividend as % of gross income	48%	72%	80%
	(48/100)	(72/100)	(80/100)

This example gives the result for portfolio individual investment under the pre-reform system in New Zealand (and under the proposed reform in the Consultative Document (Douglas 1988c) where the *de minimis* rule for individuals applies). The outcome is more generous than a pure foreign tax deduction system which would tax the net NZ dividend at the personal rate of 20% and gives a net shareholder return of 40.8, 61.2 and 68 respectively, as opposed to the 48, 72 and 80 net investor dividend in the example.

Example 2: Non-portfolio corporate investment: 'Australian-style' foreign tax credit system (full distribution imposed)

	High Tax (0.4)	Low Tax (0.1)	Zero Tax (0.0)
Gross foreign income	100	100	100
Foreign company tax	40	10	-
Gross dividend received	60	90	100
Dividend withholding tax	9	13.5	15
Net NZ dividend	51	76.5	85
NZ company tax	30	30	30
Foreign tax credit (foreign co & WH tax)	49	23.5	15
Net company tax	-	6.5	15
Gross dividend paid (cash:credits)	51 (51:0)	76.5 (70:6.5)	85 (70:15)
Personal tax	10.2	15.3	17
ICA credits	-	6.5	15
Net personal tax	10.2	8.8	2
Net investor dividend	40.8	61.2	68
Total NZ tax	10.2	15.3	17
NZ tax as % of NZ dividend	20% (10.2/51)	20% (15.3/76.5)	20% (17/85)
Total tax as % of gross return	59.2% (52/100)	38.8% (38.8/100)	32% (32/100)
NZ share of total tax	17.23% (3/52)	39.43% (15.3/38.8)	53.13% (17/32)
Investor dividend as % of gross income	40.8% (40.8/100)	61.2% (61.2/100)	68% (68/100)

This example reflects the point made about the interaction of the imputation and foreign tax credit systems in Australia above. The net investor dividend (40.8, 61.2 and 68) is exactly the same as would be produced by a simple deduction system. The way that New Zealand addresses this problem is demonstrated by the next example.

Example 3: NZ branch-equivalent system (full distribution imposed for high tax country case - full distribution implied in other cases)

	High Tax (0.4)	Low Tax (0.1)	Zero Tax (0.0)
Gross foreign income	100	100	100
Foreign company tax	40	10	-
NZ company tax	30	30	30
Indirect tax credit	40	10	-
Net NZ company tax	-	20	30
Gross dividend received	60	90	100
Dividend withholding tax	9	13.5	15
Net NZ dividend	51	76.5	85
Dividend withholding payment	12	18	20
Withholding tax credit	9	13.5	15
Net withholding payment	3	4.5	5
Net cash flow for company	48	52	50
Gross dividend paid (cash:credits)	60	90	100
	(48:12)	(52:38)	(50:50)
Personal tax	12	18	20
ICA and WPA credits (UCA:WPA)	12	38	50
	(9:3)	(33.5:4.5)	(45:5)
Net personal tax	0	-20	-30
Net investor dividend	48	72	80
Total NZ tax	3	4.5	5
NZ tax as % of NZ dividend	5.88%	5.88%	5.88%
	(3/51)	(4.5/76.5)	(5/85)
Total tax as % of gross return	52%	28%	20%
	(52/100)	(28/100)	(20/100)
NZ share of total tax	5.77%	16.07%	25%
	(3/52)	(4.5/28)	(5/20)
Investor dividend as % of gross income	48%	72%	80%
	(48/100)	(72/100)	(80/100)

This is the system proposed by the Consultative Document on International Tax Reform. It will be seen that in this example the result is exactly the same as example 1 where a dividend in a foreign company is received directly by an individual New Zealand shareholder (with the shareholder receiving net of all taxes 48, 72 and 80). Before a dividend is paid by the New Zealand company, its cash flow available for dividend payment net of both foreign tax and New Zealand company tax dividend withholding payment is 48, 52 and 50. The example shows how the grant of

imputation credits for foreign withholding tax removes the bias thrown up by example 2 against investment by New Zealand individuals in foreign companies through New Zealand companies. Moreover, through the operation of the withholding payment system, the cash flow position of the New Zealand company is no better than the ultimate position of the shareholder. It will be apparent from the example that it is where the foreign tax rate is higher than the New Zealand company tax rate that the withholding payment system is necessary to bring the company cash flow into line with ultimate shareholder cash flow.

Example 4: NZ branch-equivalent system: no foreign company tax credit (full distribution implied in all cases

	High Tax (0.4)	Low Tax (0.1)	Zero Tax (0.0)
Gross foreign income	100	100	100
Foreign company tax	40	10	-
NZ company tax	18	27	30
Gross dividend received	60	90	100
Dividend withholding tax	9	13.5	15
Net NZ dividend	51	76.5	85
Dividend withholding payment	12	18	20
Withholding tax credit	9	13.5	15
Net withholding payment	3	4.5	5
Net cash flow for company	30	45	50
Gross dividend paid (cash:credits)	60	90	100
	(30:30)	(45:45)	(50:50)
Personal tax	12	18	20
ICA and WPA credits	30	45	50
Net personal tax	-18	-27	-30
Net investor dividend	48	72	80
Total NZ tax	3	4.5	5
NZ tax as % of NZ dividend	5.88%	5.88%	5.88%
	(3/51)	(4.5/76.5)	(5/85)
Total tax as % of gross return	52%	28%	20%
	(52/100)	(28/100)	(20/100)
NZ share of total tax	5.77%	22.5%	25%
	(3/52)	(4.5/28)	(5/20)
Investor dividend as % of gross income	48%	72%	80%
	(48/100)	(72/100)	(80/100)

Again at the end of the day the outcome for the shareholder is exactly the same as in the first example with net investor dividend as 48, 72 and 80, again because the foreign withholding tax gives rise to imputation credits. In this example the further point is made that whatever system for the relief of international double taxation is applied at the company level (or even if there is no such system as in the example for the foreign company tax), the imputation system will negate the effect of the relief at the company level if it is not carried through to the individual shareholder level.

Although the ultimate outcome in this case is the same as example 3, the cash flow effects are noteworthy for what they imply as to company distribution policies. In example 4, the shareholder is better off in each case by full distribution of the profits by both the foreign and the New Zealand company because New Zealand (it is assumed in the example) gives no relief for foreign company tax and the company tax rate is higher than the individual tax rate. Thus after foreign company and New Zealand company tax, the position of the New Zealand company is 42, 63 and 70 which is less than the ultimate outcome for the shareholder (48, 72 and 80). In example 3 the individual shareholder is also better off with full distribution in the low and zero tax cases as the combination of the New Zealand company tax and the foreign company tax is to reduce the position of the New Zealand company below that of the individual shareholder (60 and 70 compared with 72 and 80 respectively). In the high foreign tax case, however, the New Zealand individual shareholder is better off if no distribution is made by the foreign company as the only tax then suffered is the foreign company tax to give a retention of 60 as compared to 48 for the shareholder on full distribution. (This is why full distribution was *imposed* rather than *implied* in this case in the example.)

To speak of the incentives for distribution, however, is to highlight the assumptions implicit in the examples. It will be recalled that, subject to a small *de minimis* exception, the accruals system is proposed to apply to all investments by New Zealand residents in foreign companies. In the ordinary course the New Zealand resident shareholder will not be able to control distribution policies of foreign companies unless the shareholder (or a small group of shareholders) has effective control of the foreign company. Hence the analysis based on the examples makes sense only in the case of an explicit control test or a market situation where full distribution will follow without control. There is nothing to suggest that New Zealand shareholders in the ordinary case of portfolio investment in foreign companies will have such control or that full distribution will follow without control.

Hence, although the examples demonstrate the way in which New Zealand has sought to ensure that foreign investment effected through a New Zealand company is taxed in the same way as investment by a New Zealand individual in a foreign company, it may be questioned how relevant such comparability is. It seems intuitively unlikely that New Zealand investment in foreign companies has been driven in any direction by the tax treatment of individual investment. Moreover, individual investment under the proposed accruals rules is more likely to be taxed

under the comparative value method than the branch equivalent method. But whether the proposals have achieved their aim in this regard, especially in view of the differing treatments under the branch equivalent method and the comparative value method, they certainly will produce investment behaviour that can hardly be described as not being determined by the tax laws (the stated object of the new system).

One apparent intention of the proposed rules is to influence companies to operate overseas by way of branches. This avoids the complications of the rules with respect to dividends and achieves current taxation of foreign profits as the proposals intend. However, it is not the case that foreign companies are set up solely for the purpose of deferral of residence taxes. Some foreign countries will favour investment by way of subsidiaries. In other cases involving joint ventures, a foreign company operating in the country concerned is the natural way to go. Another apparent intention is to drive the small to medium firm out of international investment. This seems to be the conclusion from the compliance burdens that the system imposes. A further result will be to drive the individual investor (despite the $10,000 *de minimis* limit) out of overseas markets for shares and into the relatively smaller and more volatile New Zealand market.

At the level of changes of residence, the system is certainly likely to have effects although in which direction cannot be predicted. There would seem to be an incentive for wealthy New Zealand individuals (who are internationally very mobile in most cases) to move to other countries where they have substantial investments, particularly Australia (although they will no doubt await the outcome of the current Australian intention to introduce an accruals system for foreign income, Keating 1988c)). There may also be incentives for New Zealand companies which have substantial Australian assets and shareholders to locate there and run their New Zealand operations as a subsidiary. On the other hand, foreign companies substantially owned by New Zealanders that operate substantial operations in New Zealand may be encouraged to locate in New Zealand to avoid the need for shareholders to suffer the accrual capital gains tax.

3. Avoidance Possibilities

At the structural level there are a number of problems about the proposed new treatment of foreign source income of residents in New Zealand which have been outlined above. In the short-term there will be considerable concern about the implications of the system (whatever its final form) and possible discussions of substantial restructurings of New Zealand businesses. In the longer term, as taxpayers become accustomed to the new system, it is likely that the response will be more low key. That is, taxpayers will quietly discover ways of either alleviating or avoiding altogether what they perceive as the adverse consequences of the new system through the use of tax planning. This phenomenon has already become apparent in Australia in relation to imputation and the foreign tax credit.

The kind of responses to the new system in New Zealand depend upon the details

of the legislation but at the time of the full accruals taxation proposal, the kinds of devices outlined below seemed likely candidates. However, it can be predicted that they will take one of two major forms which are characteristic of all tax planning activities. First, taxpayers will seek to avoid the system by various means in the sense that the system will not effectively apply to them. Secondly, taxpayers will seek to work within the system in order to bring about the best result. It will be apparent that not only do they involve potential avoidance of the effects of the new system, but also they will create biases in investment patterns which is contrary to the intention of the proposals.

a) Life Insurance Policies

Despite the new treatment announced in the Economic Statement with respect to life insurance and superannuation funds (Douglas 1987b, 1988a), life policies will provide, it seems, an avenue for avoiding the new system with respect to international taxation of residents. The new system operates on only two forms of property. First, it operates on shares in foreign companies and secondly it operates on settlors of foreign trusts. The reason that it is limited in this way is that it is anticipated that all other income will be taxed on a branch basis in New Zealand. Whilst this assumption is generally correct, it overlooks the close parallel that is available today between life insurance investment products (commonly referred to as insurance bonds) and interests in trusts and companies.

If a New Zealand resident acquires a life policy which is essentially an investment policy from a foreign life company then the return on that policy (if it amounts to foreign source income) will not be taxed in New Zealand. Nor, under the international tax proposals of the Consultative Document, does it seem that the funds received on the surrender of the policy will be taxed in New Zealand. Hence it is quite possible that Australian life companies will commence to offer products specially tailored for the New Zealand market.

The policy holder could be given quite a large degree of control over the investment in a similar way to that currently occurring with insurance bonds, and no New Zealand taxation would apparently arise in relation to the policy. If the investment by the company is outside Australia then there will be no taxation in Australia of the return on the policy on a current basis due to the special treatment of life companies under the foreign tax credit system whereby foreign source income is subject only to Australian tax and the foreign tax credit when it is remitted to Australia (ITAA s.112B).

It will thus be necessary in order to protect the new international rules that special rules be developed to deal with life policies. These rules will in effect require New Zealanders to take out policies only with local companies or to tax foreign policies held by New Zealand residents on an accruals basis. Whether this is a desirable development may be doubted and it will certainly complicate the new rules being established in relation to life insurance.

b) Trusts

The rules with respect to trusts set out in the Consultative Document on International Tax Reform (Douglas 1987c, pp 25-27, 33-35, 55-59, 61-62) give obvious scope for avoidance. The settlor of a foreign trust will be taxable in New Zealand until the settlor dies in the case of a natural person, or until the settlor is wound up in the case of a company or trust acting as a settlor. This invites a number of obvious planning responses.

First, trusts will be established by deceased taxpayers in their wills and if rules are devised to meet this obvious response, then taxpayers will create foreign trusts in anticipation of death. The reason why death is an exception in relation to the new rules, of course, is that taxpayers will not deliberately die in order to achieve a tax advantage. However, as death comes to all of us, death in New Zealand may take on a new dimension.

One is reminded of the so-called morbid trusts which used to be created in Australia where elderly persons in nursing homes would be approached and asked to create a multiplicity of trusts in their wills for people they did not know. (Under the Australian rules as they were then, the unknown beneficiaries of the trusts could after the death of the testator feed property into the trust and have the income taxed at very beneficial rates.) It has been necessary in Australia to devise fairly elaborate rules to deal with this problem and similar rules will be necessary in New Zealand to deal with substantial property in deceased estates.

An even simpler device is provided in the case of companies and trusts. Whilst it may not be possible to plan an individual's death for tax purposes, it is quite easy to plan the 'death' of a company or trust in order to get tax benefits. Thus it is likely that New Zealand companies and trusts will be created for the sole purpose of settling foreign trusts and then liquidating the New Zealand trust or company.

The Consultative Document suggests that this avenue will be foreclosed to some extent in the sense that indirect contributions of properties to foreign trusts will be taxed back to the original settlors and not any intermediaries used in the process, but this has the result that the new rules will simply favour those very wealthy individuals whom, according to the Consultative Document, the new rules are designed to catch. Such individuals will almost certainly have in existence already companies and trusts to which their contributions in money and property will be relatively small (and in many cases difficult or impossible to trace, especially where, for example, an interest has been inherited in a family company). Such individuals will be able to procure their companies to settle foreign trusts and then the companies can be wound up.

Whilst this may seem a rather futile and self-defeating exercise in the case of an active operating company, if New Zealand is like Australia there will be many redundant companies in existence with substantial assets which cannot currently be liquidated because of the tax consequences of liquidation. New Zealand is introducing very similar rules to Australia in the liquidation situation, and therefore even if such redundant companies are not common at the moment, they will become

common. In the past there have been difficulties in settling trusts through the medium of companies, but in Australia at least company law rules have been changed in recent times in ways which make such settlements easier (by giving companies all the powers of natural persons and doing away with the doctrine of *ultra vires*), and the general trend in the Common Law world with respect to company law is to move in a similar direction.

It will be very difficult to prevent this avenue of avoidance as draconian rules will be required to substitute a taxpayer when the company or trust goes out of existence after creating the foreign discretionary trust.

c) Debt Financing and Capital Gains

The introduction of the accruals system for taxation of financial instruments in New Zealand means that foreign companies or foreign branches of New Zealand companies will be able to use zero coupon bonds to considerable effect to avoid the operation of the new system.

The bond will not have a cash flow effect on the company until it matures but will presumably give rise to tax deductions on an accruals basis. The bonds will be raised from non-residents and will not give rise to any New Zealand interest withholding tax.

If the bonds can be matched with assets where the expected return is largely in the form of capital gains, then the new system will have no effect on the New Zealand company since capital gains will still be exempt where the company is accounting on a branch equivalent or actual basis and the interest deductions will match any current income from the asset in question. Thus the system will favour New Zealand companies which engage in debt financed purchases of assets where the return is not effectively taxed. However, companies with offshore cash flow businesses will be prejudiced.

4. Changes Arising in the Consultative Process

The Consultative Committee (1988a, 1988c) quickly came to the conclusion that the proposals of the Consultative Document on International Tax Reform were in need of modification. In place of the comprehensive accruals taxation of virtually all investments in foreign companies or trusts, with the comparative value method as a second best backup for the branch equivalent method of calculating foreign income, the Committee opted for a less complete but more targeted approach.

First, a control test is introduced (or rather re-introduced in view of the original announcement of 18 June 1987, Douglas 1987a); the test requires that five or fewer New Zealand residents (taking into account associates) control 50% or more of a foreign company (including constructive control of various kinds). Secondly, a partial exception to the system is created for companies based in other countries with controlled foreign companies legislation of their own (Australia, Canada, France, Japan, West Germany, the UK and the US) on the basis that the system is generally unnecessary in such cases. Third, a foreign investment fund regime is created to

prevent the conversion of income into capital gains through foreign low tax investment funds (including life insurance policies).

The trust regime of the Consultative Document survives largely intact in the Committee's reports. The branch equivalent method of reporting foreign income also survives as the method to be applied in the controlled foreign company situation, while the comparative value method survives as the method of reporting income of foreign investment funds.

The Committee also made detailed proposals for integrating the international and imputation systems and dealing with the problems of reconciling the treatment of currently accrued income and later distributions. The New Zealand government decided to abandon the proposal to give imputation credits for foreign dividend withholding taxes before the Committee reported on imputation (Consultative Committee 1988b, paras 3.2.2-3.2.3), on the bases that it was contrary to international practice and that it created distortions as between equity and debt investments.

The Committee recommended that companies be given the opportunity to maintain a branch equivalent tax account (BETA) to record New Zealand company tax paid under the controlled foreign company regime. With regard to dividends received by New Zealand companies from foreign companies, the Committee recommended that all should be exempt from taxation as under the pre-reform system, rather than just non-portfolio dividends.

Conversely all dividends received from foreign companies will be subject to the dividend withholding payment (with a rate equal to the company rate rather than the individual rate in view of the announcement of actual tax rates in New Zealand, Douglas 1988a). Any balance in the BETA will be available to offset the withholding tax payment liability on dividends received from companies whose income the New Zealand shareholder is required to report on a branch equivalent basis. In this way a much more accurate correlation of the taxation of accruals and distributions is achieved. Alternatively balances in the BETA may be transferred to the ICA to attach imputation credits to dividends paid by the company.

The WPA remains intact although it becomes optional like the BETA. The difference between imputation credits attached to dividends from the ICA and the WPA is that the latter may give rise to refunds of tax where the credits exceed shareholder tax liability, whereas the former, like imputation credits in Australia, can never give rise to refunds. Where the company does not adopt the BETA and/or the WPA, the credits and debits that otherwise would be made to these accounts are made in the ICA and are subject to the rules applicable to that account accordingly.

The outcome of the changes is to meet many of the concerns raised in the previous discussion. The net result is, however, to move away from the achievement of parallel treatment of New Zealand individual and company investors in foreign companies (as discussed in the examples above), though the prevention of deferral in New Zealand companies is still maintained through the dividend withholding payment.

C Australia Revisited

Australia has now also announced the introduction of an accruals system for the taxation of foreign income which obviously owes much to the New Zealand debate (Keating 1988c). The announcement is subject to a consultative process and it may be expected that the proposals will be considerably changed as a result. The current target date for introduction is 1 July 1989. Australia has rejected for the time being a control test and an active/passive income distinction on the basis that any such tests must be arbitrary and subject to avoidance opportunities (the active passive distinction has now appeared in New Zealand in the foreign investment fund area).

Targeting of the Australian proposals is sought to be achieved by two major means. First, the system is confined to designated tax haven countries (about 50 in number). Concomitantly, the exemption system for branch and non-portfolio dividend income is reintroduced for Australian companies with respect to other countries (so called comparable tax countries), on the basis that little or no Australian tax would be collected under the foreign tax credit system or the accruals system in view of the comparability of tax rates in such countries. Secondly, the accruals system does not apply to portfolio (less than 10%) investments by Australian residents in foreign public (listed) companies.

In more detail the proposals are as follows. The accruals system will apply to an Australian resident taxpayer deriving income directly or indirectly from a designated low tax country or pursuant to a designated tax concession. A fairly full list of the former (the Part A list) is contained in the Consultative Document on Taxation of Foreign Source Income and includes all the well known tax havens, but the latter list (the Part B list) is brief at this stage and can be expected to grow (but tax sparing relief in developing countries not on the A list will not be targeted, nor apparently will offshore banking units legislation in other countries). The subsequent discussion will limit itself to the A list countries for simplicity.

If the income is accrued to an Australian individual, it will be taxed to the individual. If the income is accrued to an Australian company or trust, there will be no further look through the Australian entity to the individuals that lie behind it except in the case of the trust where beneficiaries are presently entitled to the income. Where the income is derived directly then taxation and the foreign tax credit will proceed as in the present manner.

Where the income is derived by a foreign company, then the income will be calculated in accordance with Australian tax rules (with some flexibility to use a proxy measure such as financial profits for cases where this is strictly not possible) and attributed to the Australian taxpayer in accordance with the interest of the taxpayer in the share capital or dividends of the foreign company, whichever is the greater. In the case of accrual of the income of a foreign company there will be no foreign tax credit and Australian tax will be levied on the foreign income net of foreign tax except where the taxpayer is a company and has a 10% or more voting interest in the foreign

company, in which case a foreign tax credit will apply (this is consistent with the current treatment of interests in foreign companies under the foreign tax credit). The problem of two countries applying accruals taxation to taxpayers resident in their jurisdiction in respect of the same income will be addressed if it seems likely to be common. Foreign dividend withholding taxes will effectively go uncredited under the method of operation proposed for the system where dividends from the foreign company are exempt (that is, for Australian companies with a 10% or more interest).

If the foreign company is a resident of an A list country then it seems that all the income of that company except branch income derived in a comparable tax country will be attributed wherever it is derived (perhaps even if derived in Australia), but if the company is a resident of a comparable tax country the attribution will occur only in respect of income derived in A list countries, with a *de minimis* rule and then only if not taxed in the comparable tax country.

Here is the first pressure point in the system. Presumably Australian source rules will be used to determine when the income is to be regarded as derived from the A list country. Our source rules are susceptible of manipulation (Vann and Parsons 1986, pp 150-165), and it should be relatively easy to produce the outcome that income of, say, a Singapore (comparable tax country) company is regarded as sourced in Hong Kong (A list country) for Singapore purposes and not taxed in Singapore and yet is treated as Singapore source income by Australia. Hand in hand with this kind of tax planning will go the metamorphosis of income from one type to another. If the system is to be made effective it will be necessary to reform Australia's source rules.

It may be necessary to trace through more than one foreign company to get to the A list income and tracing rules are proposed for this purpose. This will be another pressure point as means of controlling companies and their income beyond the mechanical tests proposed abound such as the power to appoint a receiver and the getting in of the debts of the foreign company for channelling out income. The New Zealand rules proposed in relation to constructive control will provide a model for Australia in this regard. There is to be an exception for a portfolio interest in a foreign public company and this will also add to the pressure despite the intention to use anti-avoidance measures to protect the exception. This exception, for example, is likely to permit the kind of investment funds designed to turn interest income into capital gains that are now dealt with in New Zealand by the foreign investment fund regime. There is also to be an exception in the form of a *de minimis rule* for an Australian individual taxpayer with shareholding interests in foreign companies of less than $20,000 market value.

If the taxpayer has an interest in income under these tests that is attributable under the new system, then the income is to be measured in accordance with Australian rules (subject to some modifications) and included in the year of income of the Australian taxpayer in which the relevant accounting year of the foreign company ends. Intercorporate dividends are excluded from income of the foreign company unless paid on a portfolio interest and losses in the foreign company are carried forward in

that company with the usual 7 year time limit rather than being attributed to the taxpayer. Capital gains will be included for assets acquired after 19 September 1985 even though the new system does not commence until 1989. More stringent disclosure rules will be implemented to ensure that taxpayers disclose the relevant information in their returns.

Although these proposals do not go as far as the New Zealand proposals of 17 December 1987 (Douglas 1987c), it is considered that the outcome in Australia will not be unlike that in New Zealand. The lack of a control test does not remove pressure points from the system, it simply moves them from one point (the control test) to another (source rules, for example). On the other hand, the lack of a control test does create unfairness in that it requires taxpayers to calculate income of foreign companies on an Australian basis where the shareholder does not have the necessary information or the power to get it. Hence it is considered that Australia will probably adopt a control test. Further, a foreign investment fund regime is necessary to deal with a simple means of taking advantage of capital gains indexation on what is essentially interest income. Finally, there will be a settlor's regime for trusts as proposed in the Consultative Document on Taxation of Foreign Source Income (Keating 1988c, pp 38-41).

On the other hand the current interface of the international tax regime and the imputation system will remain intact with no imputation credits for foreign tax of any kind, and no system comparable to the withholding payment of New Zealand. The Consultative Document (Keating 1988c, pp 31-33) frankly admits that the effect of imputation is to cancel out whatever method of relieving international double taxation is applied at the level of the company (see the analysis above). Indeed this effect is relied on to justify the failure to make any attempt to deal with foreign dividend withholding taxes at the Australian company level.

D Tax Treaties and the Accruals System

Tax treaties are built on the assumption that the income of companies will be taxed to the company initially and only to shareholders when distributed. Hence the OECD model treaty (1977) provides for no taxation of a foreign company on business income unless the company has a permanent establishment in the country which is seeking to tax it (Article 7), and in the case of a domestic subsidiary of a foreign parent, tax on the parent is postponed until dividends are paid (Article 10). Moreover, if profits are being shifted away from a branch or subsidiary to the head office or parent company, the treaty provides for adjustment of the profits of the branch or subsidiary with tax levied on the adjusted basis, rather than tax being applied directly to the head office or parent company (Articles 7 and 9). Australia and New Zealand follow this practice in their treaties negotiated since the OECD model was finalised. This system is buttressed in the model by denying the source country the right to tax income derived by residents of treaty countries where a right to tax the income is not expressly

conferred in the treaty (Article 21). Although Australia and New Zealand do not adopt this provision in their typical treaties, they do follow the international norm of taxing non-residents only on income sourced in Australia or New Zealand.

The assumptions underlying this structure for international taxation arrangements are contradicted by the current taxation of shareholders in foreign companies before profits are distributed by way of dividend. The controlled foreign company regime and the wider accruals proposals discussed above exhibit this contradiction. It is necessary to tax the shareholder under these regimes precisely because the international norms as embodied in tax treaties prevent the taxation of the foreign company deriving the income. The result is that the possibility of unrelieved international double taxation is once again created despite the fact that the treaties are designed to remove it.

While the countries adopting these regimes were small in number, the problems of the clash of the regimes with assumptions underlying tax treaties were relatively minor. Moreover, while the regimes were relatively limited in scope and operated as anti-avoidance legislation, they could be regarded as legitimate practice to deal with a very focused problem. Now that the number of countries adopting these regimes is growing and the regimes are becoming more and more extensive in effect, the possibility of double taxation in cases where tax avoidance is not in issue is increasing. For example, under the 17 December 1987 proposals in New Zealand, a UK company with New Zealand shareholders and with a subsidiary in Hong Kong might be subject to the controlled foreign company regime of the UK and the accruals system of New Zealand, with no adjustment between the UK and New Zealand regimes (which would be operating on different shareholders).

This type of problem is much reduced by the retreat in New Zealand to controlled foreign company legislation and a white list of countries which includes the UK where the regime will not be applied, but the example in the previous paragraph would still create problems of reconciling the two systems. In the first instance, unilateral measures are likely to be enacted to cope with the problem, as is being contemplated in Australia (Keating 1988c, p 25), but in the longer term it is likely that treaties will be needed to allocate taxing rights in a sensible manner.

4 Domestic Income of Non-Residents

In New Zealand little attention has been paid so far to the other side of the international coin, the taxation of non-residents on New Zealand source income. (Despite the title of the Consultative Document on International Tax Reform, it dealt ultimately only with the tax position of New Zealand residents as was acknowledged, with the problems of non-residents left for another day - Douglas 1987d, p 1.) In Australia more attention has been given to the problems of taxing non-residents with amendments to interest, royalties and natural resource payment withholding taxes, and the enactment of thin capitalisation and repatriation of capital measures. Even in the Australian case, however, the approach to non-residents has not been in the same comprehensive manner as for the taxation of residents, with the amendments and changes being made piecemeal. Indeed the major 'reform' to the taxation of non-residents in both countries has gone almost unnoticed, namely the reduction in the company tax rate.

The discussion under this heading will focus on international tax changes which affect equity investments of non-residents in Australian or New Zealand branches or subsidiaries, and the likely tax planning response to the changes. Under international norms income received from equity investments by non-residents may be taxed in the host country at full tax rates, whether the investment is by way of a branch (referred to as a permanent establishment in tax treaty parlance) or a subsidiary. In the normal case this will mean that the profits from the investment are subject to at least the company tax rate of the host country, with further possible taxes such as the dividend withholding tax or the branch profits tax. One object of international tax planning by non-residents is usually to reduce or eliminate these taxes.

Such reduction or elimination can be accomplished in a number of ways. One is to recharacterise the type of income from the return on equity investment to passive income that is subject to low withholding tax rates either under the tax law or the tax treaties of the host country. For example, the non-resident may invest in a wholly owned subsidiary in the host country by way of loans rather than shares, with the intention of obtaining interest deductions (and so eliminating the host country company tax on the profits represented by the interest) and attracting the relatively low rate of withholding tax on interest (10% in the case of Australia and 15% in the case of New Zealand, both under domestic law and tax treaties), which themselves may be subject to avoidance. Alternatively, through the manipulation of source rules and/or transfer pricing, the profit may be diverted from the branch or subsidiary to an associated company in another country, and host country tax avoided through tax

deductibility of the payment and low or non-taxation of the associated company.

Specifically the focus will be on the cut in the company tax rate, the tax arbitrage opportunities arising under the imputation system for non-residents, thin capitalisation and repatriations of capital.

A The Company Tax Rate

When a full imputation system is operating and imputation credits are confined to dividends paid by resident companies to resident shareholders (as in Australia and New Zealand), the company tax becomes an effective tax only so far as non-resident shareholders are concerned. For residents the company tax disappears as a separate tax and performs only a withholding function (although it does have cash flow consequences for domestic companies and shareholders as regards the timing of tax payments). Hence a cut in the company tax rate is of direct benefit (in the absence of personal tax rate cuts) to non-residents. This simple proposition does need, however, to be viewed in the overall context of company tax arrangements: it is possible to cut the company tax rate and yet to increase the tax burden of non-residents as occurred, for example, in the US 1986 reforms.

1. Australia

The Australian arrangements for non-residents under imputation in the period before the Economic Statement of 25 May 1988 were that they were not entitled to imputation credits directly, but the branch profits tax of 5% that applied prior to imputation was removed as was the dividend withholding tax for fully franked dividends (the tax is usually 15% of the amount of the dividend in the case of a shareholder resident in a country with which Australia has a double tax treaty). At the time of introduction of imputation, the company tax rate was increased from 46% to 49% to be in line with the maximum individual tax rate, so that the overall tax effect of the introduction of imputation was ambiguous for non-residents. The removal of the branch profits and dividend withholding taxes on fully franked dividends can be explained by the alignment of the individual and company tax rates - it would be difficult for Australia to justify the taxes when company profits already bore the highest tax rate imposed.

The picture changed dramatically with the Economic Statement of 25 May 1988 (Keating 1988a) in a number of ways for non-residents. The cut in the company tax rate to 39% combined with the bringing into the imputation system of the major institutions that were previously tax favoured or tax exempt means that the company tax has any real effect only for non-residents. This can be demonstrated by a simple numerical example. Suppose that a company has one shareholder, has taxable income of $100, and pays all its after tax income out as a dividend.

	Previous system			New system		
	Resident shareholder 40% tax rate	49%	Non-resident shareholder	Resident shareholder 40% tax rate	49%*	Non-resident shareholder
Taxable income	100	100	100	100	100	100
Company tax	49	49	49	39	39	39
Dividend	51	51	51	61	61	61
Shareholder tax	(9)	0	0	1	10	0
Total tax	40	49	49	40	49	39
Net return	60	51	51	60	51	61

* The new tax rates for individual shareholders are not yet known but the table demonstrates that the tax for individual shareholders depends on the marginal rate of the individual while for the non-resident it depends simply on the company rate.

Of course this simple example does not represent the real world in its simple assumptions, but its basic message is true enough - namely that the company tax rate cut has a direct effect at both the company and shareholder level for non-resident shareholders, whilst for resident shareholders the story is more complex depending on a number of factors including dividend payout ratios, shareholder marginal rates and the impact of capital gains tax.

The benefits of the tax cut are further enhanced for non-residents (the second benefit) by the probable increase in the value of imputation credits, though the cut in the tax rate may in fact partly offset this. The incentives for trafficking in imputation credits, as elaborated under previous and the next headings, are that the major change arising from the bringing of superannuation funds and life companies within the imputation system is that these institutions change from sellers of imputation credits to buyers, whilst non-residents remain sellers in a much enlarged sellers market.

Finally the introduction of the accruals system of international taxation (and its combination with imputation) is designed among other things to reduce the effects of transfer pricing by residents (Keating 1988c, pp 4-5). To the extent that this implies that future administrative efforts will be directed at enforcing the accruals system rather than transfer pricing, it follows that non-residents are again benefited since they can equally engage in transfer pricing but are unaffected by the new system of international taxation. Transfer pricing by both residents and non-residents is taken up below.

2. New Zealand

In contrast to Australia, New Zealand will be retaining its branch profits and dividend withholding taxes after the introduction of imputation. At the time of the Consultative Document on International Tax Reform, the fate of these taxes was unclear: the

present arrangements would certainly have been difficult to maintain if, as appeared likely at the time, the company tax rate was higher than the maximum individual tax rate. Although the US has adopted such a system in 1986, there is the critical difference that the US retains a classical or separate system of company taxation; that is, no attempt is made to relate company and shareholder taxation, unlike imputation (for the problems posed in this area, see Vann 1985, pp 465-486). At the same time, as the new tax rates in New Zealand were announced, it was also made clear that the branch profits and dividend withholding taxes would remain intact, and as the company rate of 28% is below the maximum individual tax rate of 33%, they are easier to justify.

Even so, as the revenue for the tax cuts is being found in the controlled foreign company regime and the Goods and Services Tax, both of which have their greatest impact on New Zealand residents, in a relative sense non-residents with equity investments in New Zealand are receiving the greatest advantage from the cut in the company tax rate. Similarly, as one of the reasons advanced for the accruals taxation of foreign income is to prevent transfer pricing by residents (Douglas 1987d, p 16), it may be inferred that transfer pricing by non-residents will be let off more lightly in future. In the arbitrage area, however, although the incentives are created for non-residents to sell imputation credits, the scope for doing so is considerably less than in Australia.

B Tax Arbitrage

The extension of the imputation system to superannuation funds, life companies and the like in Australia and New Zealand seems at first glance to be giving with one hand and taking away with the other, as the dividends will be effectively taxed and then subject to imputation credits, whereas previously by various means and in most situations dividends were not taxed. Nonetheless the change removes the incentive out of the system for superannuation funds etc. to engage in tax arbitrage activities with the object of selling imputation credits to taxpayers who could utilise them. In fact, the incentive for such bodies under the new arrangements is reversed. This feature of the imputation system has been explored at length above. It remains here to draw out the implications for non-residents.

In Australia, the pressure for arbitrage will be greater than in New Zealand as the most significant potential buyers of the credits (superannuation and other similar funds taxed at a rate of 15%) obtain a greater benefit for each dollar of credit because of the large differential between the imputation credit rate (currently 49% to fall to 39% on 1 July 1989) and the tax rate of the funds. By contrast in New Zealand the differential is 28% for company tax and 25% for superannuation funds (Douglas 1988a, pp 97-99, and accompanying Press Release 'Background note on transitional arrangements for superannuation and life insurance' 4 March 1988, p 3). Moreover the tendency in Australia will be magnified by the fact that imputation credits can be

used by superannuation funds to offset the 15% tax levied on employer contributions (in New Zealand the fringe benefits tax is applied to contributions and therefore imputation credits cannot be used to reduce the tax burden).

Similarly it is easier to achieve the sale of imputation credits in Australia than New Zealand. A simple example in the earlier discussion of arbitrage was given of the sale by a non-resident parent of shares in a domestic subsidiary to a resident, with the purchase price left outstanding and the right of the non-resident to re-acquire the shares protected by an option. At this stage there does not seem to be any insuperable obstacle in Australia to this arrangement, and in any event there are various other devices for the sale of credits that have been canvassed in the earlier discussion. New Zealand has set itself against the sale of credits and adopted much more stringent legislation to prevent the practice. Nonetheless the incentive is certainly there for non-residents to sell credits stored in New Zealand subsidiaries, especially as the dividend withholding tax is applied equally to franked and unfranked dividends. The legislation that gives effect to anti-streaming measures in New Zealand will come in for close scrutiny by non-residents.

In the case of a branch operation in Australia or New Zealand by a non-resident company, the question of sale of imputation credits will not arise as only resident companies can effectively maintain a franking account or ICA. It follows that if a non-resident wishes to extract some value for company tax payments in Australia or New Zealand by the sale of imputation credits, it will be necessary to operate through a domestic subsidiary. In both Australia and New Zealand there is some tax downside to this method of operation. In the former withholding tax on unfranked dividends is applicable whereas there is no special tax on branches or branch remittances. In the latter there is dividend withholding tax on all dividends but to some extent this is matched in the branch situation by the branch profits tax.

C Thin Capitalisation

One way for non-residents to prevent the payment of company tax in Australia and New Zealand, and being faced with the problem of dealing with imputation credits to the best advantage, is to recharacterise company income as interest payments to the parent company of a domestic subsidiary or to an associated company where investment is by way of a branch. The interest deductions generated will reduce tax paid by the company and the tax reduction will not be matched by the interest withholding tax payable on the interest (assuming that avoidance of the interest withholding tax has not occurred as seems to be common in Australia and New Zealand). Australia has sought to deal with this manoeuvre with its thin capitalisation legislation enacted in 1987 and 1988. New Zealand is yet to act directly in this area of tax law.

On 30 April 1987 the Australian Treasurer (Keating 1987) announced that the existing thin capitalisation measures applied by the Foreign Investment Review

Board would be incorporated in the tax legislation on the basis that "it is desirable to incorporate taxation requirements in legislation rather than impose them under foreign investment policy". Thus it appeared at first sight that the legislation would consist simply of re-enactment of the then current thin capitalisation law in another guise together with relatively narrow anti-avoidance legislation, but this appearance was very misleading and the resulting legislation has caused considerable problems for harmless transactions. The changes are effective for the year of income commencing 1 July 1987, though there is a degree of progressive implementation in the transitional provisions.

In one sense the thin capitalisation measures can be viewed as the converse of the accruals proposals for the taxation of foreign income of residents (Keating 1988c). The latter are designed to prevent Australian resident taxpayers avoiding tax on foreign income by storing the income in foreign entities, while the former are designed to prevent non-residents avoiding tax on Australian source profits by diverting the income to non-resident entities through the medium of debt and interest deductions. It is necessary to have similar legislative concepts in both cases such as tracing rules to determine the interest of the taxpayer in the relevant entity, back to back anti-avoidance provisions etc. Some comparisons will be drawn between the two areas in the course of the discussion.

1. What is the Problem?

Although the intention of the thin capitalisation measures is obvious enough, it is helpful to stand back and look at why the problem arises. Essentially the question is one of characterisation of investment as debt or equity. Even in domestic contexts, this can be an issue. Under the classical system of company taxation it was often stated that there was a bias in favour of debt over equity since interest is usually deductible to a company whereas dividends are not. It was thus possible with investment in companies by way of debt to avoid the two layers of tax, one on company profits and the other on dividends paid out of those profits, and to replace it with a single layer of tax on the interest.

a) Domestic Tax Law

The argument in this simple form concealed as much as it revealed. For instance, it did not deal with hybrid debt equity instruments such as convertible notes where the company sought interest deductions while the investor sought to lock into company profits by way of the conversion right. For many years Australia has had legislation to deal with this type of instrument which seeks to ensure that the debt element is uppermost if interest is to be deductible (ITAA ss.82L-82T). New Zealand also for many years controlled interest deductions on convertible notes (NZITA ss.4(1)(f), 196). So far as there has been a major problem of the characterisation of debt and equity in recent years it has been of exactly the opposite kind in the form of redeemable preference share financing transactions. In these transactions debt is disguised as

equity and the intercorporate dividend rebate or exemption is relied on to return a tax free return to the financier. In the first instance Australia dealt with this problem, which is common to the many countries that do not adopt a substantive approach to the characterisation of debt and equity, by disallowing the ITAA s.46 rebate and treating the dividend as deductible interest (ITAA ss.46C and 67AA). The international ramifications of the Australian treatment (particularly as regards New Zealand) and other problems led to the current regime whereby the rebate is denied and there is no deduction for the dividend (ITAA s.46D). New Zealand also had legislation allowing a deduction for the dividend and denying the intercorporate dividend exemption (NZITA ss.63, 194), but this was changed with the introduction of the accruals system for financial instruments in 1986.

The imputation system largely removes the problem of substituting debt for equity in the purely domestic context in Australia and New Zealand although this process was not complete until the Australia Economic Statement of 25 May 1988 when the major tax exempts were brought into the tax system. Until that happened, superannuation funds were exempt from tax on capital gains and interest but did not receive imputation credits. This meant in their case, as has been explained above, that there was a significant incentive for tax arbitrage activities with resident companies and individuals (in the latter case through trusts and partnerships) whereby fully franked dividends of the funds were exchanged for interest and capital gains, that is, equity was characterised as or exchanged for debt. The recently announced changes have not taken the pressure off arbitrage entirely but have changed its nature, with the incentive now for non-residents to exchange equity for debt. (Ironically, as elaborated below, this means in the international context that the future problem is going to be with non-residents seeking to characterise equity as third party debt rather than equity as in house debt - the current thin capitalisation provisions will have no effect on such transactions.)

It should thus be clear that thin capitalisation is but one example of the problem of the debt equity characterisation issue. Generally speaking the Australian and New Zealand approach is to accept the formal characterisation of a transaction that the legal forms adopted produce and then to seek to change the effect of the tax outcome by disallowing interest deductions or dividend rebates. There is some slight Australian authority in the domestic context for a more substantive approach to the characterisation issue (Boulder Perseverance (1937) 58 CLR 223 and note NZITA s.192 on floating rate debentures); but in general the legislation accepts the formal legal view of a transaction. In this regard Australia and New Zealand are to be classed with Canada and the UK, and contrasted with the US where a substance approach is adopted, though with no more success than the formal approach.

b) International Tax Law

When we turn to the international area, the problem of thin capitalisation still persists for two reasons - the continuance of the classical system of company taxation for non-

resident shareholders because of the denial of imputation credits to them, and the low rate of tax on interest income paid to a non-resident without a permanent establishment in Australia or New Zealand (under domestic law and treaties the tax rate is respectively 10% and 15% gross on the interest if the interest is taxed at all).

The obvious way to attack the problem is to level the international playing field by having similar rates of tax on debt and equity, but the current treatment is the entrenched international norm and therefore in the short term is unlikely to be changed. It thus becomes necessary to adopt indirect measures to deal with the problem and the thin capitalisation legislation is to be seen in this context. There are two basic approaches to the issue - one uses fixed ratios and the other takes a case by case approach looking at the characteristics of the investment involved (OECD 1987, pp 15-16). Australia has opted for the first of these.

Thin capitalisation is an issue that has been on the international tax agenda for many years, but it is only in recent years that it has begun to assume a higher profile. For example, in 1984 a comparative study revealed little interest in the area among major Western countries (Forry 1984), but a recent OECD report (1987) is likely to produce a more active interest in the problem. Other comparable countries such as Canada and the UK have had relatively brief statute laws on the issue for a number of years (Income Tax Act (Canada) s.18(4), Income and Corporations Taxes Act 1988 (UK) s.209(2)(d)(v) reproducing earlier versions to the same effect), while the US has relied on its court decisions and administrative practice in default of a satisfactory statutory resolution to the problem. Until recently Canada could probably claim the pride of honour in length and complexity of legislation, but Australia has now clearly taken a large lead in the quantity of legislation stakes. The lead may be shortlived as the UK and the US seem likely to act on the problem in a more comprehensive fashion (Fairley and Penney 1988, Zins 1987).

2. The Australian Legislation

It is intended here simply to outline the legislation as more detailed technical comments can be found elsewhere (Spence 1988, Williams 1988). The purpose of the outline is to assist in the understanding of the problems and avoidance possibilities of the current legislation as well as to point up comparisons with the accruals proposals for foreign income. The effect is that excessive interest deductions on in house debt will be denied if the ratio of in house interest bearing debt to equity exceeds 3:1 in the general case or 6:1 in the case of financial institutions. It should be noted that interest payments on debts owed to unrelated non-residents at arm's length are not affected by the changes; nor are interest free non-arm's length debts.

a) Foreign Investment

The legislation comprehensively defines the various types of foreign investment in Australia to ensure broad coverage (ITAA ss.159GZA, 159GZC, 159GZE, 159GZH). "Foreign investor" is defined to include any non-resident in receipt of Australian source income apart from partnership and trust situations which are dealt

with separately. The main application of this concept would be to an Australian branch of a non-resident company. With respect to Australian companies a foreign controller is defined as a non-resident which alone or together with associates, resident or non-resident, has the right to 15% of the votes in an Australian company or 15% of dividends or capital distributions. The simple test is hedged with many anti-avoidance provisions. "Associate" is widely defined for this purpose and the legislation makes clear that in calculating whether a non-resident has a 15% interest, interposed companies, trusts and partnerships will be looked through. This definition has its most important impact on Australian resident subsidiaries of foreign parents and may be expected to form a model so far as tracing is concerned for the accruals taxation of foreign income. There is an exception where the non-resident in question is itself 85% or more owned by Australian residents. In such a case the non-resident is not regarded as a foreign controller. A similar 15% in votes, profits or capital is applied in determining whether a non-resident is a foreign controller in relation to a partnership or trust.

It is noteworthy that the threshold in this case is 15% ownership by the non-resident. This can be explained by the Foreign Investment Review Board background where 15% is also the operative limit. It is to be contrasted with the Australian accruals legislation where 10% (defined in slightly different ways for different purposes) will be an important threshold as regards the exemption treatment of dividends and the portfolio exemption for investment in foreign listed companies. The 10% limit is to be explained in one respect at least by Australia's double tax treaties which adopt this as the critical limit for the grant of the indirect foreign tax credit. Apparently the 10% figure has been the subject of many submissions to the effect that it is too low and certainly the thin capitalisation legislation can be relied on for this kind of argument (why should non-residents be treated more favourably than residents?).

b) Foreign Debt

"Foreign debt" is variously defined depending upon the precise foreign investment situation involved, whether it is a branch, an Australian subsidiary or a partnership or trust situation. There are three basic tests which have to be fulfilled for debt to be treated as foreign debt for the purposes of the legislation. Firstly, interest on the debt is payable to the foreign controller or to an associate of the foreign controller. In the case of a foreign investor, the interest must be payable to a non-resident associate of that investor as Australian tax law does not recognise the accounting concept of payment of interest by a branch to head office (Max Factor 84 ATC 4060). Secondly, the interest is allowable as a deduction for Australian tax purposes. Thirdly, the investment is not assessable income of the non-resident or its associates. That is, in the usual case, the interest is subject to withholding tax of 10% only (or is specifically excepted from withholding tax) and is therefore exempt income.

Foreign debt interest is interest payable on foreign debt (ITAA ss.159GZF, 159GZK, 159GZX). There are special provisions to ensure that all kinds of interest

and interest-like payments are caught, for example, in relation to the interest component in a hire purchase transaction, indemnification payments with respect to the discount element on a bill of exchange or promissory note, and deferred interest securities.

It would be relatively easy to overcome the definition of foreign debt by back to back transactions if special provision were not made for this case (ITAA s.159GZO). For example, a foreign parent may deposit monies with a foreign bank which is not associated with the foreign parent, and then the foreign bank may lend to the Australian subsidiary of the foreign parent. In these circumstances, the legislation deems the loan by the bank to the Australian subsidiary to be a loan from the foreign parent and within the terms of the legislation accordingly.

c) Foreign Equity

Again, different rules are provided for the calculation of foreign equity depending on the precise type of investment in Australia by a non-resident (ITAA s.159GZG). It follows that a subsidiary of an Australian company cannot have foreign equity. From this apparently simple proposition some important problems can flow as elaborated hereafter.

When dealing with a foreign controller of an Australian company, the accounts of the company form the basis for the calculation of foreign equity. First, the total of the non-resident's entitlement to share capital and share premium account as at the end of the year of income and its share of accumulated profits as at the beginning of the year of income is calculated. From this total is then subtracted any amounts owing to the Australian company by the non-resident or the non-resident's associates, accumulated profits capitalised by share issues during the year of income to the extent that the non-resident's entitlement to such shares, and the non-resident's entitlement to accumulated losses as at the beginning of the year of income to the extent to which the losses represent a deficiency of capital. It will be noted that share capital and share premium is taken into account at the end of the year of income and that accumulated profits or losses are taken into account as at the beginning of the year of income.

There are anti-avoidance provisions aimed at inflated asset revaluation reserves and at manipulations of the share capital and share premium at the end of the year of income (for example, by injecting very short- term funds into the company by way of a redeemable preference share issue). Any such issue must remain in place for at least 2 years following the year in question. The use of accumulated profits as shown on the balance sheet calculation will create problems for a number of companies with respect to goodwill and foreign exchange movements because of the treatment of these items required by accounting standards in Australia.

In the case of investment in a branch by non-residents or investments in partnerships or trusts, the calculation of foreign equity requires the preparation of a notional set of accounts which deal only with the assets and liabilities related to the income derived from its investment by the non-resident. The equity element in this notional

balance sheet is the foreign equity of the non-resident for the purposes of the thin capitalisation provisions. Where a foreign controller in a partnership or trust situation borrows from a non-resident associate to fund its contribution to the capital of the partnership or to the corpus of the trust estate, the equity in the partnership or trust so funded is deemed effectively to be foreign debt (ITAA s.159GZQ). This anti-avoidance provision is designed to ensure that the debt equity ratios are not manipulated by a debt equity swap in a partnership or trust situation.

The foreign equity is then used to calculate the foreign equity product which is the means by which the debt equity ratios are effectively applied (ITAA s.159GZA). For a financial institution, the foreign equity product is six times the foreign equity of the non-resident. In any other case, the foreign equity product is three times the foreign equity. These ratios apply to a resident subsidiary of a foreign parent and a branch of a foreign company in Australia. In the case of partnerships and trusts, the foreign equity product is three times the foreign equity as a basic rule. To the extent that the trust or partnership participates in the activities of a financial institution, there is an adjustment to the foreign equity product by segregating the activities of the financial institution and the other activities and applying a 6:1 and 3:1 ratio to the separate activities (ITAA ss.159GZM, 159GZN). This will produce a composite debt equity ratio for the partnership or trust in the range of 3:1 to 6:1. A similar adjustment occurs where there is an Australian company group and one of the companies in the group is a financial institution.

d) Reduction of Interest Deductions

Where the greatest total foreign debt of a taxpayer at any time in the year of income exceeds the foreign equity product of the taxpayer in the year of income, a fraction of the foreign debt interest on the foreign debt is disallowed as a deduction (ITAA ss.159GZS-159GZW). The fraction is the excess of the foreign debt over the foreign equity product divided by the foreign debt. Unpaid interest added to a foreign debt will increase the exposure to disallowance of part of current interest. For example, assume a foreign parent has loaned $100 to a wholly owned Australian subsidiary, that the equity of the foreign parent in the subsidiary is $10, and that the interest payable on the debt is $10. If the subsidiary is not a financial institution, the foreign equity product will be 30. The debt exceeds the foreign equity product by 70 and so the fraction of interest deduction disallowed is 70/100, that is, $7. The example given relates to a foreign parent with an Australian subsidiary, but there is a similar disallowance of interest deductions in the partnership, trust and investment in a branch situation.

It will be noted that this formula does not treat the debt on which the interest deduction is disallowed as if it were equity, but simply ignores that debt effectively. In order to prevent the disallowance in this situation, the foreign parent should consider capitalising an appropriate amount of debt towards the end of the year of income to boost the foreign equity in the Australian subsidiary. If part of the debt is

capitalised, it will be necessary to retain it in place as equity for the 2 years of income following the year in question.

Where there is a resident company group involved in a foreign investment situation, the thin capitalisation rules are applied on a group basis, rather than separately to each company in the group. A company group for this purpose is defined in a similar way for the grouping of losses (ITAA s.159GZI). That is, 100% effective partnership of each company in the group by the non-resident is required. Further, the test only applies with respect to Australian resident companies so that there may be situations where there is 100% effective ownership by a non-resident controller but the companies involved will not form a resident company group. For example, if a non-resident company owned 100% of an Australian Company A, and 100% of an Australian Company B, and A and B own 50% each of another Australian Company C, A, B and C will not constitute a resident company group for the purposes of the legislation. This is because the 100% ownership treatment in the case of C must be satisfied with respect to one Australian holding company only. On the other hand, if a non-resident controller owned 100% of Australian Company A and A owns 100% of Australian Company B, then if Australian Company C is owned as to 50% by A and as to 50% by B, A, B and C will form a resident company group since 100% ownership of B and C can be traced back to A.

The debt equity ratios in the resident company group situation are applied by totalling the foreign debt of each company in the group (ITAA s.159GZT). Loans between Australian companies in the resident company group will generally not constitute foreign debt for this purpose, although there can be difficulties in the back to back provisions of the legislation which have been referred to above. Foreign equity for this purpose includes only the foreign equity of the Australian holding company of the group. If the foreign equity product with respect to the Australian holding company is less than the foreign debt of the resident company group in its entirety, then there will be a disallowance of a proportion of the interest in the same way as outlined above. The disallowance is achieved by denying an allowable deduction to each company in the resident company group with foreign debt for an equal proportion of its foreign debt interest payments.

Because only the resident company of the Australian holding company in the group is taken into account, it is necessary to ensure that profits of other companies in the group are captured in the balance sheet of the holding company. This can be achieved in various ways, such as the payment of dividends by the other companies to the Australian holding company. However, the simplest means will usually be by a revaluation of the holding company's shares in the subsidiary. There are anti-avoidance provisions in relation to the resident company group situation to ensure that sales of assets between companies in the group at inflated values are not used to boost the foreign equity of the Australian holding company for the group.

3. Problems and Possibilities

The provisions outlined above present various technical problems, some of which disadvantage the taxpayer and others which impact on the revenue. This is not an unexpected result, but considering the effort that seems to have been put in to getting the legislation right, it seems likely that the drafting of the accruals taxation of foreign income is going to be a much more difficult task.

a) Back to Back Transactions

The anti-avoidance provision with respect to back to back loans is a case in point (ITAA s.159GZO). It is not confined to back to back transactions involving non-associates of the non-resident, and this can give rise to potentially odd consequences. For example, a non-resident parent lends to a wholly owned Australian subsidiary which in turn lends to a partly-owned Australian sub-subsidiary. The anti-avoidance provisions dealing with back to back transactions may be interpreted in this instance to disallow the interest deduction to the sub-subsidiary entirely. This is by reason that, although the sub-subsidiary is deemed to have foreign debt due to the back to back provisions, it has no foreign equity (which is confined to the Australian holding company) and hence is unable to satisfy the 3:1 ratio. The Australian Taxation Office has indicated that the legislation will not be applied in this way where the debt follows the equity chain downwards (Ruling IT 2479 paras 6-8). However, when an Australian subsidiary lends sideways to another Australian subsidiary of the foreign parent rather than to a sub-subsidiary partially owned by the Australian subsidiary, the back to back provisions will treat the loan as foreign debt. Interest paid by one subsidiary to the other will or will not be disallowed depending upon the foreign equity of the borrower.

On the other hand it is very easy to get around the back to back provisions by an equity debt swap through a non-resident financier. For example, if the non-resident parent of an Australian subsidiary invests in redeemable preference shares of the financier, and the financier then lends an equivalent amount to the subsidiary, the back to back provisions are simply ineffective because they relate only to debt for debt transactions. This problem arises because Australia adopts a formal approach to the characterisation of debt and equity (which the thin capitalisation provisions are designed to counter!).

There are provisions to prevent debt equity swaps in the case of partnerships and trusts, that is, where the partner or beneficiary borrows to invest by way of capital/corpus in the partnership or trust (ITAA s.159GZQ). Sadly, these are perhaps the most defective of the anti-avoidance efforts of the new legislation. They do not apply to the purchase of an interest in a partnership or trust, only to the initial investment of borrowed funds by way of capital/corpus. Further, even in the initial investment situation, the deeming is simply inapt. The legislation deems the capital investment to be foreign debt but does not deem the partnership or trust distributions to be interest, so that they do not enter the calculation of net income of the partnership or trust as

allowable deductions and are irrelevant for this purpose at the partnership or trust level. At the level of the beneficiary or partner the deeming does not purport to have any operation and so does not prevent the partner or beneficiary claiming the deduction against its partnership or trust income.

b) Calculating Debt and Equity

There are a number of problems in calculating debt and equity. It will be recalled that foreign debt is the highest level of debt throughout the year of income. Where the debt is in foreign currency, does this mean that it has to be valued daily in the light of exchange fluctuations (as occurs in Canada)? The Australian Taxation Office has taken the view that the exchange rate on date of draw down is applied for this purpose but in the case of fluctuating debt, a first in first out principle is adopted that will be very difficult to apply in practice (Ruling IT 2479 para.23). In the case of financiers the problems are formidable because there are daily transactions back and forth between parent and subsidiary as books are balanced, accounts cleared, short-term positions covered, markets made and transactions underwritten. Fortunately it will probably be impossible to disentangle from the records of financiers just what the daily position is on very short- term transactions between parent and subsidiary so that only relatively long-term debt will be counted.

Similar problems are encountered in the calculation of equity especially where a company group is involved since all the equity must be found in the Australian holding company and it becomes necessary to revalue shares in subsidiaries. There has already been amendment to the equity calculation to overcome defects in the legislation. Indeed the amendment is itself a source of possible tax planning. Originally it was enacted that if equity decreased in the 2 years after the year of income in question, then the lower level of equity that resulted was substituted in the original calculations and the interest deduction redetermined accordingly. This meant that the various events in a subsequent year could prejudice interest deductions not only of that year but also earlier years. This problem was addressed by an amendment which requires tracking of particular equity to see whether it is withdrawn in subsequent years. In its turn this permits the introduction of 3 year rolling equity in the form of redeemable preference shares with an equivalent introduction on 30 June and withdrawal on 1 July to inflate equity artificially, which is the very result intended to be prevented.

c) Avoiding Interest and Equity

Another form of planning will be to avoid the characterisation of particular transactions as debt or equity. There are many potential ploys available here, as well as pitfalls for the unwary. There are simple ways of meeting the denial of deductions of foreign interest by avoiding that characterisation. For example, a borrowing in a low interest foreign currency combined with a hedging arrangement will have the same cost as paying interest in Australian dollars, but the hedging costs will be deductible

without limit as they will not be treated as interest. Similarly, cross guarantees of non-recourse debt by two unrelated foreign parents of their Australian subsidiaries' borrowings from the non-related parent will effectively avoid the legislation, as guarantees are not included.

So far as equity is concerned, the imputation system encourages non-residents to substitute interest from Australian residents in exchange for franked dividends as already noted. This can be easily achieved by a combination of a sale of shares in the subsidiary to unrelated Australian residents with the purchase price left outstanding as a debt and the right to recall the shares locked in by an appropriate option (there may be problems in avoiding the constructive control provisions of ITAA s.159GZJ when an option is used). So long as the interest in the company is taken below 15% then the purpose is achieved. There will be a similar form of planning with the accruals legislation to avoid the attributions of foreign income. For the non-resident in this case, if the foreign equity is reduced to nil the amount of in-house gearing that is possible then becomes infinite. In this case the incentives for the non-resident to restructure are produced by a number of features of the tax legislation.

4. Taxation of the Non-Resident and Double Tax Treaties

The effect of the disallowance of the interest deduction under the thin capitalisation is not to treat the payment as a dividend (although in substance that is what is occurring). The significance of this in Australia at least is that a higher withholding tax rate applies to dividends than to interest, both in the domestic legislation and under tax treaties - the interest withholding rate remains applicable.

So far as treaties are more generally concerned, a number of issues arise as to their impact on the legislation. These have been discussed recently by the OECD (1987). The upshot of the discussion is that the legislation is regarded as justified by the transfer pricing article between associated enterprises (OECD 1977 Article 9), though problems arise where the legislation operates as in the Australian case with a fixed ratio rather than a case by case approach. On the other hand, the non-discrimination article (OECD 1977 Article 24) will override such legislation where it is directed at non-residents as the Australian legislation is. Australia only has one non-discrimination article in its treaties (the US treaty Article 23) and it does not override reasonable anti-avoidance legislation, into which category the thin capitalisation has been put. The OECD document finds it necessary to stretch the language of the model treaty to accommodate thin capitalisation measures, and once again it is apparent that tax treaties do not adequately address the emerging problems in international taxation.

D Repatriations of Capital

Where a non-resident parent wishes to extract money from a domestic Australian or New Zealand subsidiary, the obvious way to proceed is to pay a dividend from the subsidiary. This will trigger loss of imputation credits where the franking account or

ICA is in credit and the dividend is franked, where otherwise the subsidiary may have been able to sell the credits to a resident. Moreover the payment of withholding tax will occur in New Zealand even if the dividend is franked and in Australia to the extent that the dividend is unfranked. It will therefore be to the tax advantage of the parent to seek to repatriate money from the subsidiary in a way that is not characterised as a dividend for Australian or New Zealand tax purposes.

One simple way to achieve this result is to make a loan from the subsidiary to the parent but this stratagem brings problems in its train. First, the transfer pricing legislation of Australia and New Zealand will (or should) require the charging of an arm's length interest rate by the subsidiary to the parent with the result that an on-going tax liability is generated by the loan. Secondly, both Australia and New Zealand have provisions whereby loans to shareholders are deemed to be dividends in certain circumstances which may well be applicable to this case (ITAA s.108, NZITA s.4(1)). Accordingly, the subsidiary will probably explore other possibilities.

A variation on this theme involves the use of an equity investment. If an Australian or New Zealand company invests in a foreign company by way of share capital, it seems self evident that the payment will not be treated as a dividend for tax purposes, but rather as an asset of the local company. It is possible to use this apparently simple step as a means of making moneys available to the parent since the company in which the money is invested can lend it to the parent or even pay it by way of dividend out of the foreign company (which will avoid dividend withholding tax since the dividend is paid by the foreign company). It will be more difficult to apply transfer pricing adjustments in this kind of case as there is no assumption that dividends will be received on equity investments: the use of transfer pricing laws to impute dividends would be beyond the normal kinds of adjustments made. Similarly it will be a problem under the legislation to treat the investment as a deemed dividend though the possibility cannot be overlooked.

1. Debt Creation in Company Restructures

More recently Australia has introduced legislation to deal with a more sophisticated means to the same end. In his Press Release of 30 April 1987 when the Australian Treasurer announced the thin capitalisation measures (Keating 1987), he also said:

> "The legislation will also prevent tax losses arising from, for example, interest-bearing debt either locally or to an overseas parent, associate or other foreign company without any change having taken place in the beneficial ownership of shares or assets of the group or fresh funds being introduced into the group by the owners".

Thus it appeared at first sight that the resulting legislation would consist of a thin capitalisation law together with relatively narrow anti-avoidance legislation. The need for the anti-avoidance legislation especially in the context of thin capitalisation seemed mainly to be to prevent non-residents whose debt to equity ratios in relation to Australian investments fall below the ratios permitted by the thin capitalisation

legislation using a corporate restructure to raise their debt to equity ratios to the permitted levels. This may seem to be a reasonable restriction but the legislation introduced in 1988 to give effect to the announcement in this area goes much further and catches many transactions which do not seem to be within the purpose just outlined. The wider scope of the legislation seems intended to prevent repatriation of capital to non-residents and its substitution by debt, as the overall effect of such transactions is to generate interest deductions on the debt while not collecting any tax on the repatriation of capital.

Again there are analogues in domestic law to the problem tackled by the legislation. There has been considerable debate in Australia about domestic company restructures that replace equity with debt, the most obvious example being debt financed takeovers. Strangely (in view of the attitude revealed in the legislation under consideration here), the Treasury stoutly maintained that there was no tax problem with takeovers of domestic companies by domestic entrepreneurs financed by foreign debt which usually was not subject even to any interest withholding tax because, for example, it was widely held debt under ITAA s.128F (Treasury Economic Paper No.12 1986). For others who saw a problem with takeovers, one solution suggested was to introduce limits on debt equity ratios for takeovers or for companies generally. There were also suggestions (regarded by Treasury as extreme) that the interest on the debt produced by the takeover should be denied deduction entirely. This latter solution is the one effectively adopted in relation to corporate restructures involving non-residents, but the legislation and arguments to Treasury that the result is extreme have apparently fallen on deaf ears. In New Zealand not dissimilar legislation on a domestic plane may be found in NZITA s.195 dealing with the issue of debentures in lieu of shares. In the case of corporate reconstructions, however, Australia seems to have gone far beyond any provisions existing or contemplated overseas.

The new legislation will deny interest deductions to company taxpayers (other than companies in the capacity of a trustee). The denial will be triggered where an asset is acquired by a company and the interest deduction relates to the acquisition, if there is a foreign controller of the taxpayer and the acquisition of the asset is effectively in-house. The potential breadth of application is reduced in a number of specific situations where it is considered that the legislation would impede normal commercial transactions. It is noteworthy that, like the thin capitalisation legislation, there is no intention element required to trigger the operation of the rules.

a) Foreign Controller

Under the legislation in ITAA Part III Division 16G, the rules apply in situations where there is a foreign controller. This term, which is also used in the thin capitalisation legislation, is differently defined for the purpose of the new rules under s.159GZZA. A foreign controller is a non-resident who, together with associated persons which are also non-residents, has a capital entitlement factor in a company of 50% or more. The capital entitlement factor under s.159GZZ refers to the percentage

of capital distributions to which a person is entitled when a company makes a capital distribution. The entitlement is to be traced through any interposed companies, trusts and partnerships.

It thus is possible to have more than one foreign controller in relation to a company (all associated persons will be foreign controllers where their collective interest is 50% or more). The legislation at first sight seems to give rise to the possibility of double counting of capital entitlements, for example, where a foreign company B has a wholly owned Australian subsidiary C and is in turn the wholly owned subsidiary of another foreign company A. Two controls deal with this possibility. First, the legislation applies only to the company which acquires the asset and the person from whom the asset is acquired. Thus if C in the example acquires an asset from B which was used by B in its Australian branch, then the fact that A is also a foreign controller of C simply does not have any impact under the legislation. If C acquires an asset that was equally owned by A and B, then there is a clear possibility of double counting but this is countered by s.159GZZD(6) which eliminates the problem.

The noteworthy differences from the thin capitalisation legislation relate to the percentage required for triggering of the legislation (50% as opposed to 15%) and the interests taken into account (capital, meaning, according to the Explanatory Memorandum, basically shareholder funds, as opposed to capital, income and voting power). Thus it would seem easier to deal with preference shares under this legislation. For example, if preference shares entitle the shareholder to a $10m priority return of capital and no other participation in capital, then the shareholder will be a foreign controller only if the net value of the company is $20m or less. Income tests are notoriously difficult to apply to preference shares but this problem is absent in the legislation.

b) Acquisition of an Asset

The debt creation rules apply where an amount of interest would be allowable as a deduction from the assessable income of a company taxpayer if the interest is in respect of an amount owing in connection with the acquisition of an asset by the taxpayer, with asset defined broadly in s.159GZY. Similarly acquisition is widely defined in s.159GZZB(a) to include the acquiring of an asset that was not in existence prior to the acquisition and the Explanatory Memorandum gives the examples of leases and options. As it is the relationship of the acquirer of the asset to the person which disposes of it that is of concern under the debt creation rules, s.159GZZB(b) spells out how to determine the seller of an asset in an asset creation situation in a way that generally relies on the consideration received by the parties disposing of the asset but prevents avoidance by manipulation of the consideration paid in the acquisition.

Back to back acquisitions are dealt with in s.159GZZC so that an asset sold to an independent third party and then acquired by a company related to the seller of the asset to the third party will be treated as an acquisition by the company from the original seller. In cases involving assets of a fungible kind (such as shares in a listed

company), it would be possible to avoid the operation of this provision by selling one asset to the third party and then for the related company to acquire from that third party or another a different but identical asset to that sold. The Explanatory Memorandum indicates that general anti-avoidance provisions will be applied in this kind of case.

c) Interest Deductions

The new Division operates to deny interest deductions and for this purpose interest is defined by s.159GZY to mean interest within the meaning of s.128A(1). The use of the withholding tax definition leaves open all the well known questions about whether bill discounts and payments pursuant to guarantees are caught. It is also reasonably clear that foreign currency hedging payments and swap payments are not caught by the definition of interest in the usual case even though they may be functionally equivalent to interest in financial terms.

The interest is potentially subject to denial as a deduction where it is paid in respect of an amount owing in connection with the acquisition of an asset by the taxpayer (s.159GGZE(1)(b)) and where the interest deduction is only partly in respect of such an amount, s.159GZZE applies to the deduction to a corresponding extent (subsection (5)). This is clearly a tracing type approach to the relation of interest deductions to assets and the usual problems of such tracing are present - is it actual tracing of funds that is in question or a tracing of purposes?

The Explanatory Memorandum makes clear that where borrowed money is used for one purpose and then is used in relation to the purchase of an asset, it will be within the provision as the words "in connection with" are of the widest import. Nonetheless, where it can be so arranged that borrowings are made for purposes that immediately consume the borrowed money (such as the payment of wages), it would seem that no further tracing is possible even though the borrowing may free up other internal funds for the purchase of the asset.

d) Denial of Deductions for In-house Transactions

If the conditions set out above apply, then s.159GZZE(1)(c) provides for three specific situations where interest deductions will be denied. Firstly, where the seller of the asset was a foreign controller of the taxpayer company immediately after the acquisition. Secondly, where the taxpayer company was a foreign controller of the seller of the asset immediately after the acquisition. Thirdly, where neither of the previous cases applies and a person (called a common foreign controller) was a foreign controller of the seller immediately before the acquisition and a foreign controller of the taxpayer company buyer immediately after the acquisition. There are anti-avoidance provisions to ensure that transactions are caught where persons cease to be foreign controllers some time before, or become foreign controllers only some time after the transactions occur rather than immediately before or immediately after as the case may be.

Where the conditions referred to above are fulfilled, the interest deduction that

would otherwise be available on the monies borrowed to acquire the asset is reduced by an amount depending on the "asset ownership factor" and the "capital entitlement factor". The formula provided is as follows:

Reduction in interest allowable deduction =
Deduction otherwise allowable x
Asset ownership factor x
Capital entitlement factor.

The asset ownership factor is the seller's interest in the asset immediately before the acquisition, expressed as a proportion of the total interests in the asset. The capital entitlement factor varies depending on which of the three basic situations set out above for the application of the Division is in question. For the first it is the capital entitlement of the seller in the taxpayer immediately after the acquisition; for the second it is the capital entitlement factor of the taxpayer in the seller immediately before the acquisition; and for the third, it is the lesser of the capital entitlement factors of the common foreign controller in the seller immediately before the sale or in the taxpayer immediately after the acquisition.

For example, if a foreign controller owns 50% of an Australian company which purchases an asset from the foreign controller in exchange for debt, the interest deduction will be denied as to half. If the foreign controller owns only a half interest in the asset before the acquisition, the other half is owned by an unrelated third party and the Australian company acquires all interests in the asset in exchange for debt, then the interest deduction will be denied as to one quarter.

The consequences of this denial of interest deductions by Division 16G are far reaching and it is important to note various aspects of its general scope and to compare it to the thin capitalisation provisions. First, the new Division applies only to company taxpayers whereas the thin capitalisation measures apply to individuals, partnerships and trusts as well. It should be noted that the company in question may be an Australian or foreign company. It seems to be too simple to avoid the operation of the Division by the transfer of the asset to a trustee for the company or to a partnership where a third party has a small interest in addition to the company, but it is difficult to see how the denial provision could be interpreted to cover the trust or partnership situation. This is reinforced by a comparison of s.159GZZ which contemplates tracing through companies, partnerships and trusts with s.159GZZE(1)(a) which is quite clear that the denial operates only in respect of an interest deduction claimed directly by a company. Once again general anti-avoidance provisions will need to be considered in the particular case but there will be many normal commercial transactions that will use partnerships or trusts. Although the taxpayer in question must be a company, the seller or common foreign controller may be any person or entity and still be caught by the provisions.

Secondly, the in-house aspect of Division 16G is also different from Division 16F. In the latter the debt must be in-house in the sense that it is owed directly or indirectly

to a foreign controller whereas under the former, arm's length debt from third parties will be caught if it relates to an in-house acquisition of an asset. It will be apparent that both Divisions 16F and 16G could be applicable to the same transaction, in which event the priority is that Division 16G is applied first and then Division 16F to any interest that survives the former. This follows from s.159GZZE(1)(a) which refers to interest deductions that are allowable apart from Divisions 16F and 16G.

e) Specific Exceptions for Normal Commercial Transactions

On its own, s.159GZZE would deny interest deductions in many cases involving normal commercial transactions and accordingly exceptions to the operation of the provision are created by s.159GZZF. The first exception makes clear that s.159GZZE does not apply where the asset acquired is cash and the acquisition is not part of the sale of a business. Thus where there is a foreign controller and one company simply lends money to a company taxpayer, there will be no denial of interest deductions. The third exception which deals with a similar problem relates to the allotment of shares in a company. Such an allotment will be an acquisition and if the allottee has borrowed the subscription moneys, s.159GZZE may be applicable but s.159GZZF(3) makes clear that it does not apply.

The second exception relates to trading stock. It is not uncommon for a foreign parent to sell trading stock to an Australian subsidiary which acts as distributor and to charge interest on the outstanding sale price after a period of say 90 days (the subsidiary will not be expected to pay for the stock until it in turn has sold it which may occur much later). Such interest will not be caught by the new Division if the acquisition of the stock is not part of the acquisition of a business.

The fourth exception in s.159GZZF(4) relates to assets that are outside the Australian tax net before the acquisition and are brought into that net by the acquisition. For example, a foreign parent may sell equipment which it has used in its home country to produce income not subject to Australian tax to an Australian subsidiary, and the equipment is then shipped to Australia and used by the subsidiary in its income earning operations. If the subsidiary borrows to purchase the equipment, the interest will not be subject to s.159GZZE. The reason for this exception is that the purpose of Division 16G is to prevent erosion of the Australian tax base by converting equity into debt by asset sales. If the asset in question has not been involved in producing income subject to Australian tax then there is no erosion of the Australian tax base by a debt financed acquisition of the asset.

The final exception has a similar reason to the previous one. If, for example, an Australian subsidiary of a foreign parent holds an asset that is financed by debt and the asset is sold to another Australian subsidiary and financed by an equivalent amount of debt, there is apparently no prejudice to the Australian tax base as a similar level of interest deductions will be claimed as previously. Thus s.159GZZF(5) provides an exception where there is no overall increase in the level of indebtedness of the group and no increase in the ability of the seller or its associates to make a distribution to its

foreign controller or its associates that will not be subject to Australian tax on dividends (either under s.44(1) or s.128B). If in the example, the original loan was owed to the foreign controller and the replacement loan to a third party, it would seem that the repayment of the loan to the foreign controller will fail to satisfy the second of these conditions.

f) Problems

Despite the exceptions just outlined, problems remain. Where a takeover occurs in a foreign jurisdiction of a company based in that jurisdiction which has Australian subsidiaries, then any reorganisation of the target group after the takeover, for example, by transferring the Australian subsidiaries to the acquirer in the acquisition, will give rise to problems where such transfers involve debt. The same applies where a foreign based company with Australian interests undergoes other kinds of restructuring whether for insolvency or otherwise. In these latter kinds of cases, problems can be caused by the tax and corporate law requirements of the foreign jurisdiction where the takeover or reconstruction is occurring. That jurisdiction may require that interest be charged on debt created where assets are transferred within the group, for example, under transfer pricing provisions. These kinds of activities are quite common across the Tasman Sea and so the legislation will have a great impact on the Australian New Zealand case.

It is also unclear how the new legislation relates to Australia's tax treaties. Because of its similarity to the thin capitalisation legislation, similar considerations may apply. It is more difficult, however, to justify the denial of the interest deduction as a transfer pricing adjustment under Article 9 of the model treaty (OECD 1977) as compared to thin capitalisation, and it seems more likely that the model non-discrimination article will be applicable if it is ever adopted by Australia in its treaties. Again this legislation demonstrates how far treaty practice lags behind current international tax developments.

It may be questioned whether such legislation is an appropriate response to the repatriation of capital problem. The possibility of avoidance of the effect of the legislation seems strong, while it creates difficulties for many transactions that are not tax motivated.

5 Transfer Pricing

Transfer pricing is a method by which the return on equity investment can escape taxation in a particular country because of the pricing practices adopted between related parties which generate high deductions or low income in that country. The techniques for transfer pricing by both residents and non-residents are well enough known not to require elaboration here. The incentives to engage in the practice are more often assumed than examined. For example, as already noted, a reason advanced both in Australia and New Zealand for the introduction of the accruals taxation of foreign income of residents is to minimise transfer pricing by residents. This justification assumes that the transfer pricing incentive is for residents to shift income out of Australia and New Zealand to a suitable tax haven, and that the accruals taxation of foreign income will bring the income back onshore.

While there is some force in this argument it does overlook the new system of incentives introduced by imputation. It has already been noted on more than one occasion in this paper that the imputation system in both Australia and New Zealand renders the method of relieving international double taxation relatively unimportant as the failure to give imputation credits for foreign taxes means that the system operates as a foreign tax deduction system at the shareholder level. To put the point another way, there is within limits, an incentive for Australian and New Zealand companies to minimise foreign tax payments so as to maximise domestic company tax payments (and hence imputation credits to shareholders). One way to achieve this result for Australian and New Zealand companies is to engage in transfer pricing which reduces the foreign tax base and increases the domestic tax base, that is, transfer pricing into rather than out of Australia and New Zealand.

Hence the preoccupation with transfer pricing by residents that seems evident in Australia and New Zealand may be to some degree misplaced, since the real incentives to engage in the practice rest with non-residents. They not only will want to move profits to a convenient tax haven and so reduce their overall taxes but also, if their home country has an imputation system similar to Australia's and New Zealand's, will want to move profits to their home country for the same reasons as Australian and New Zealand companies.

As the problem of transfer pricing has come to the fore internationally (again partly as a result of the work of the OECD (1979, 1984), it has been realised in Australia and New Zealand that our legislative and administrative responses leave much to be desired. It can be argued convincingly that the arm's length criterion that has come

to be accepted internationally as the standard for making transfer pricing adjustments is fatally flawed and needs to be replaced by some acceptable formula , but until that happens both Australia and New Zealand need to play by the current rules, which means putting in place effective legislation and then administering it competently.

A Legislation

Prior to 1981, Australia's transfer pricing control was contained in ITTAA s.136 which read:

"Where any business carried on in Australia -

(a) is controlled principally by non-residents;

(b) is carried on by a company a majority of shares in which is held by or on behalf of non-residents; or

(c) is carried on by a company which holds or on behalf of which other persons hold a majority of the shares in a non-resident company, and it appears to the Commissioner that the business produces either no taxable income or less than the amount of taxable income which might be expected to arise from that business, the person carrying on that business in Australia shall...be liable to pay income tax on a taxable income of such amount of the taxable receipts... of the business as the Commissioner determines".

This apparently straightforward section contained a host of defects that were exposed by the Asprey Committee (Taxation Review Committee 1975, pp 266-269) and the High Court of Australia in *Commonwealth Aluminium Corporation Limited* (1980) 143 C.L.R. 646. Briefly some of the defects were:

1. the section was limited to the case where a business was carried on in Australia and therefore did not cover passive income (so that recharacterisation of income was a means of avoiding the operation of the section);
2. where the transfer pricing consists in depressing the receipts of the taxpayer, the limitation of the adjustment to the receipts of the business meant that this type of pricing was difficult to attack;
3. clause (a) could be avoided by having Australian residents forming a majority of directors even though the shareholders were non-residents (because the directors and not the shareholders control the business of the company);
4. clauses (b) and (c) could be avoided by interposing a resident company between the company engaged in transfer pricing and the non-resident shareholders (because the shares in the relevant company would then not be held by non-residents; and
5. the section was mainly directed at transfer pricing by non-residents and had only limited application to transfer pricing by residents.

While these problems were dealt with in comprehensive new transfer pricing legislation in Australia in 1981, it is important to recall the problems of ITAA s.136

since the New Zealand equivalent (NZITA s22(3))is in similar terms. It reads:

"Where any business carried on in New Zealand -

(a) is controlled exclusively or principally by persons not resident in New Zealand;

(b) is carried on by a company not resident in New Zealand, or by a company which is under the control of persons not resident in New Zealand; or

(c) is carried on by persons having control of a company not resident in New Zealand, and it appears from the returns made to the Commissioner that the business produces no taxable income or less than the amount of taxable income which in the opinion of the Commissioner might be expected to arise from that business, the person carrying on that business in New Zealand shall ... be assessable for and liable to pay income tax on a taxable income of such amount as the Commissioner determines, being at the option of the Commissioner either such proportion as he determines of the total receipts ... of the business or such proportion as he determines of the total purchase money paid or payable ... in the conduct of the business".

Despite the closeness in wording, some of the defects of the former Australian provision are absent from this provision.The problem raised in point 1 above is partly dealt with by NZITA s.22(1), which extends considerably the meaning of business to include any profession, trade, manufacture or undertaking which is carried on in New Zealand; whether this covers passive income may still be doubted. The limitation raised in point 2 still seems to be present, though at least the problem of increasing losses by transfer pricing is covered by NZITA s.22(4). The limitation in point 3 also seems to be present. Although NZITA s.22(2)(a) provides a test for control of a company by reference to s.7, it does not seem to cover the control of a business, which is the matter dealt with in clause (a). Whether point 4 has been dealt with by the concept of control in NZITA s.7 is also unclear but it certainly seems that the section is directed at non-residents or New Zealand companies controlled by non-residents, rather than transfer pricing for the benefit of residents.

It is therefore suggested that the current New Zealand provision should be replaced with more comprehensive transfer pricing legislation in order to avoid problems at the legislative level.

B Administration

There are many problems in the way of effective administration of transfer pricing legislation. No better demonstration of the difficulties can be found than in the report of the Australian Audit Office on *International Profit Shifting* (1987). The first matter is to obtain preliminary information to enable an assessment to be made of the likelihood of transfer pricing by a taxpayer. Until very recently both Australia and

New Zealand did not take even this elementary step. Now Australia has a special Schedule 25A to company tax returns designed to supply information on international transactions engaged in by the taxpayer. Similarly New Zealand has enacted a special procedure for the obtaining of information under NZITA s.21A in relation to off-shore payments under threat of the disallowance of deductions. While this power is useful, more systematic collection of information from large companies would seem to be justified.

Having obtained this preliminary information it is necessary to be able to assess it, for which purpose a database on pricing in general and comparable information from similarly placed taxpayers (for example, by industry type) is necessary. In Australia, the setting up of such a database has proved problematic so that much of the information collected went to waste and obvious targets for investigation were missed. The database and a set of audit criteria for transfer pricing should select taxpayers for detailed audit in the transfer pricing area. Having identified the target taxpayers, the audit team should develop a strategy and timetable for the audit in much the same way as for other audits. In Australia this certainly was not occurring until very recently with the result that many investigations dragged on for many years to the point where they must certainly have gone stale.

Finally, since transfer pricing adjustments are inherently controversial, the revenue needs to be fully prepared for protracted negotiations with taxpayers, including the use of industry and other outside experts. Again in Australia this was not occurring until recently with the result, in the opinion of the Audit Office, that taxpayers were getting the better of the Australian Taxation Office in negotiations. Although these measures seem simple enough, they are not easy to implement as they require sophisticated technology and highly trained taxation officers, both of which have been lacking in Australia (and probably in New Zealand).

It is clear from experience around the world that transfer pricing will become an increasingly important issue in Australia and New Zealand. To date the efforts in the area in each country seem to have been fairly ineffectual. However, increased enforcement activities will bring their own problems. Most importantly, in many cases it is not possible to define clearly the 'correct' price and taxpayers should not be penalised simply because they disagree on pricing with the tax authorities. This is an area that calls out for industry guidelines to be settled in advance by co-operative endeavours.

6 Interaction of the Australian and New Zealand Tax Systems

The introduction of reforms for the taxation of equity investment in Australia and New Zealand, both at the domestic level and on the international plane, means that the relationship of the two tax systems needs to be reassessed. Most attention will focus on the effect of reform on company structures where both Australian and New Zealand elements are involved (which is the case for virtually every substantial company in either country).

A The Complex Web We Weave

In making this assessment it is helpful to consider the various factual combinations that are possible. On the basis of the normal criteria for international tax jurisdiction, namely source of income and residence of taxpayer, six variations can be produced that have to be handled by the imputation and international tax system depending on the residence of the company, the residence of the shareholder and the source of income from which a dividend is paid:

1. Resident shareholder of resident company with foreign source income.
2. Resident shareholder of non-resident company with foreign source income.
3. Resident shareholder of non-resident company with Australian source income.
4. Non-resident shareholder of resident company with foreign source income.
5. Non-resident shareholder of resident company with Australian source income.
6. Non-resident share holder of non-resident company with Australian source income.

In the case of Australia and New Zealand, as their economies become increasingly integrated, it is likely that each of these combinations will occcur not uncommonly. Variation 1 involves the system for relief of international double taxation and the imputation system and has been elaborated at a number of points above. So far as the income has been taxed in the country of source, it will give rise to relief against Australian or New Zealand company tax liability by a foreign tax credit or exemption. When a dividend is paid to a resident shareholder out of the foreign source income, the imputation system in both countries will provide an imputation credit only to the extent that domestic company tax has been paid and that tax will be nil or at least less than the nominal tax rate so long as some foreign tax has been paid on the income.

Variations 2 and 3 can be taken together. The Australian or New Zealand imputation system simply will not apply to them because the companies are non-residents so that they will not be liable to keep a franking account or ICA, and the resident shareholder will not in the normal case gross up the dividend or receive an

imputation credit though the net dividend will be included in assessable income (assuming that the shareholder is not a company). So far as the company has foreign source income, the controlled foreign company regime in New Zealand or proposed accruals system for foreign income in Australia may be applicable to the shareholder to tax the income of the foreign company on a current basis, but this will not apply in the usual case where the only countries involved are Australia and New Zealand. If these regimes are not applicable and the company has foreign income which is taxed in the country of source, no foreign tax credit or other relief will be given in Australia or New Zealand, but this will not usually be a problem as neither country would claim jurisdiction to tax the income. However, if the Australian or New Zealand shareholder is a company, when that company comes to pay a dividend out of the dividend it has received from the non-resident, the problem of imputation raised in relation to variation 1 will be present.

So far as the non-resident company has Australian or New Zealand source income, it will generally be subject to the company tax rate but will not share the disadvantage under Australian or New Zealand tax law of the resident company which takes advantage of tax preferences and so reduces imputation credits available to its shareholders because it is not subject to the imputation system. Any relief from the double tax of the classical system will have to be found under the tax law of the non-resident company's country of residence. If that country operates a classical system then there will be no relief and the same result follows under imputation systems because of the usual limitation of tax credits to residents of the imputation country.

There are two exceptions in the case of imputation countries: the possible but unusual case of the shareholder being a dual resident of Australia/New Zealand and the foreign country and much more importantly the effect of double tax treaties allowing imputation credit to non-residents. Where imputation credits are available to Australian/New Zealand resident shareholders and the imputation country in question has a foreign tax credit system in operation, then the same problem with the interaction of the foreign tax credit system and the imputation system as will occur in Australia and New Zealand is raised in the foreign country. The notable case is the UK which grants its imputation credit to Australian and New Zealand resident individuals who beneficially own dividends received from UK companies.

Variation 4 represents the worst of all possible worlds at least so far as the resident company has significant levels of foreign source profits and pays dividends out of them, since the resident company seems to have unnecessarily intruded into the income flow between the source and the shareholder, both of which are outside Australia/New Zealand. Variation 5 in the case of Australia and New Zealand with their large volume of foreign direct investment through subsidiary companies will probably be the most common case involving international elements. The effect of the imputation system in this case is quite clear but liable to create controversy in tax treaty negotiations.

Variation 6 does not involve the imputation system directly and is similar in effect

to Variation 3. There is no dividend withholding tax in this case as that tax is limited to dividends paid by resident companies. The non-resident will no doubt be taxable in his country of residence and may receive foreign tax credits in respect of the Australian or New Zealand tax paid by the company, but tax havens may be interposed to the benefit of the non-resident shareholder which cut out or reduce this tax burden—indeed, were it not for the controlled foreign company regime in New Zealand and the proposed accruals system in Australia, residents would probably find it beneficial to invest in non-resident companies with Australian or New Zealand source income via non-resident entities operating out of tax havens.

B Australia-New Zealand Takeovers and Mergers

How does this analysis affect the Australian/New Zealand situation? Suppose an Australian company (with all its assets and shareholders in Australia) takes over a New Zealand company (with all its assets and shareholders in New Zealand), and the New Zealand shareholders receive shares in the Australian company. Prior to the takeover both the Australian and New Zealand companies avoided the complexities discussed above in relation to variations 1 to 6 since (from an Australian viewpoint) the situation of the Australian company was wholly domestic and the situation of the New Zealand company wholly foreign (and vice versa from a New Zealand viewpoint).

As a result of the takeover, however, variation 1 is produced so far as the Australian shareholders of the Australian company are concerned. The result will be a reduction in the imputation credits available to Australian shareholders as the Australian company will receive part of its income by way of dividends from its (now) New Zealand subsidiary, and the exemption of the dividends from Australian tax under the new accruals regime will reduce Australian tax payments. Variations 4 and 5 will be present so far as the New Zealand shareholders are concerned (the former with respect to the New Zealand income of the Australian company and the latter with respect to the Australian income). These shareholders will gain no advantage from the Australian imputation system since they are non-residents except that franked dividends will not be subject to withholding tax (but the presence of New Zealand source income will reduce the availability of franked dividends as already explained).

If the takeover had been in the reverse direction (New Zealand company takes over Australian company with Australian shareholders receiving shares in New Zealand company), then so far as the Australian shareholders are concerned, variations 2 and 3 have been produced, while for the New Zealand shareholders variation 6 is relevant from the Australian perspective. The Australian shareholders will have sacrificed the possibility of receiving franked dividends since they now hold shares in a non-resident company and they will suffer Australian and New Zealand company tax on the New Zealand holding company's profits and New Zealand withholding tax on dividends received.

The position of the New Zealand shareholders from an Australian perspective is not as important in this case as their tax treatment in New Zealand. It seems that Australia and New Zealand are headed in the same direction with respect to their company and international tax regimes so that from a New Zealand perspective the outcome will be similar to the outcome for Australian shareholders under Australian tax law where the Australian company takes over the New Zealand company.

In all circumstances the shareholders are likely to be worse off from a tax point of view as a result of the takeover, other things being equal. The adverse tax effects of a potential cross border takeover or merger may thus prevent the takeover proceeding unless ways can be found to eliminate the tax problems. From the point of view of economic efficiency these tax obstacles can prevent takeovers that are desirable on all other criteria and so the tax planning used to remove the obstacles should not necessarily be regarded adversely by governments.

Two types of structures that are currently being explored in this context are staples shares and dividend trusts. The purpose of each structure is the same. In the example of a takeover by an Australian company of a New Zealand company, the purpose would be to so stream dividend payments that dividends paid by the New Zealand subsidiary find their way into the hands of the New Zealand shareholders of the Australian parent company without actually passing through the parent. The Australian shareholders would receive fully franked dividends from the Australian company out of Australian fully taxed profits (since the New Zealand profits are being streamed off the New Zealand shareholders, the problem caused by the foreign tax credit is effectively eliminated). Despite the strictness that is applied to the streaming of imputation credits in New Zealand it is not immediately clear that this case would fall foul of the New Zealand rules in all situations.

In the case of staples shares this outcome would be sought to be achieved by issuing to all shareholders in the Australian company shares in the New Zealand company. The rights attached to the shares in the New Zealand company would probably be restricted and the Australian company would maintain effective control of the New Zealand company. In addition it would be provided that the shares in the New Zealand company held by the shareholders in the Australian company could not be disposed of independently of the shares in the Australian company and vice versa. The shareholders would then have the right to elect on which shares they received dividends—the Australian company could be expected to be elected by the Australian resident shareholders and the New Zealand company by the New Zealand resident shareholders. This mechanism seems to work in Australia but not in New Zealand for reasons that have been explored in earlier discussion. As it is necessary for the proposal to be effective in both countries, staples shares do not seem to provide a solution to the problem.

In the case of a dividend trust, a dividend access share in the New Zealand company would be issued to a trust set up by the Australian company with the beneficiaries being the shareholders in the Australian company. Again there would be a right of

election in the shareholders to receive either dividends from the Australian company or distributions from the trust out of dividends received from the New Zealand company on the access share. Shareholders could be expected to elect to produce the same type of outcome as for stapled shares. Whether this structure will experience difficulties under the New Zealand system is more problematic, but in view of the stern stance against streaming of credits in New Zealand, it is doubtful whether the device will be tolerated.

The strictness of the New Zealand imputation system as compared to the Australian system may be one factor that will influence the use of an Australian company as the holding company in trans-Tasman business. In this way the New Zealand problem is quarantined from the rest of the group, so that for example if there are also UK operations, staples shares or other streaming techniques can be used as between Australian and UK shareholders. Depending on the outcome of the Australian accruals proposals for the taxation of foreign source income, the relative strictness of the international tax regimes in each country may also be a factor. To judge by past experience, the Australian system is likely to turn out to be less stringent than the New Zealand system despite the considerable modifications that have been made to the latter.

C The Australia-New Zealand Double Tax Treaty

It might be thought that the Australia/New Zealand double tax treaty is the ideal vehicle to solve the kinds of problems illustrated under the previous heading. In fact the treaty in its current form will have virtually no impact on the matters discussed in this paper. The position of treaties generally in relation to the new international tax rules in Australia and New Zealand has been discussed at a number of points above where the general conclusion has been that current treaties have little to say on the issues.

There are major international constraints on how far one particular tax treaty can be modified without the results flowing over into other tax treaties. For example, if Australia and New Zealand were to agree to exchange imputation credits for their respective residents by means of the tax treaty (that is, New Zealand companies would extend imputation credits to Australian shareholders and vice versa), there would be demands from other countries, particularly the US, for similar treatment for its residents even though it does not have an imputation system (Vann 1985). The Consultative Committee was fully alive to this problem in New Zealand (1988d, pp 9-10) but left the matter to the government for decision. It will indeed be unfortunate if Australia and New Zealand are required to remain separate islands for tax purposes by the constraints of tax treaties when their economies are in the process of becoming a common market.

Footnotes

1. The May 1988 Economic Statement announced that a 39% company tax rate would be introduced for the year of income commencing on 1 July 1988 in lieu of the 49% rate, but because companies are taxed on a preceding year basis, the rate cut will not be felt in tax payments until after 30 June 1989.

2. The author has criticised the use commonly made by economists of this model in a previous Occasional Paper for the Institute of Policy Studies, *Eliminating the Double Taxation of Dividends: Legal and Practical Issues* (Vann 1985). As a starting point for the analysis in the long term of the different systems of dealing with the taxation of foreign income of residents in respect of direct investment overseas as opposed to portfolio investment, it would seem reasonable to adopt this simplifying assumption.

3. Both Australia and New Zealand come into this category and so their treaties with the US have no tie breaker regarding dual resident companies; compare, for example, the tie breaker provision for dual resident companies in Article 3(4) of the Australia-New Zealand Agreement. The US, in its source rules for dividends and interest paid by corporations (Internal Revenue Code 1986 s.861), does to some extent seek to modify the consequences of the mechanical nature of the residence test, but the modifications in turn gave rise to avoidance activities and the source rules were tightened up considerably in 1986.

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The purpose of this book is to explore the taxation of income flows in the business area with particular reference to the international tax treatment of equity investments (company shares) in Australia and New Zealand. The focus is on tax policy as viewed from a tax planning perspective, i.e. the likely responses of taxpayers to tax changes already made and in progress are investigated to see whether the changes are likely to achieve their purpose and, if they do, whether the costs are too high.

The book looks at the Australian and New Zealand dimensions of:

* Tax planning and tax reform
* Imputation
* Foreign income of residents
* The domestic income of non-residents
* Transfer pricing
* Interaction of the Australian and New Zealand tax systems.

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