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Trans-Tasman Tax Reform: The Real Story

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Abstract

In 2003 the Australian and NZ governments

As a result of the amendment Australian companies can now pay dividends with NZ imputation credits attached. This legislative solution is often referred to as the pro rata allocation (PRA) model.

The new rules allow Australian and NZ companies to elect into a regime, which allocates to their Australian and NZ shareholders franking and imputation credits in proportion to their ownership in the parent company. However the Australian franking credits can only be utilised by Australian shareholders and NZ resident shareholders can only use the imputation credits.

The November 2003 legislation reflects the analysis and assumptions contained in the March 2002 Discussion Document.³ Prior to November 2003 the trans-Tasman taxation treatment of a triangular investment by a New Zealand shareholder resulted in an effective tax rate of 57.3%. The Discussion Document claimed that the PRA solution would reduce the effective tax rate to 43.6%. If that claim is true, the effective tax rate would have been reduced by 24%. This article examines:

(b) there is no Australian NRWT because the dividend is fully franked. In the case of column (d) the New Zealand Company receives a foreign shareholder tax credit (FITC) of \$12, which reduces the company tax from \$33 to \$21. The New Zealand Company passes on the credit to its non-resident Australian individual shareholder that is used to pay New Zealand NRWT of \$1

dividend. The Australian individual shareholder receives 100% of the dividends and 48.5% tax on Australian-sourced dividends and 48.5% tax on Australian-sourced dividends.

There are a number of important key points to provide an insight into the legislative so-called imputation credits are allocated according to the country. Secondly an individual shareholder can apply for a franking credit applicable in the shareholder's home country. One of the issues that arises from these two points is that there is an inevitable bias against trans-Tasman equity investment by ascertaining the percentage of individual shareholder's residence in each country.

The high rates of tax were comparable to the classical system of taxing dividends that exist in the absence of full dividend imputation.

Debt finance

The bias against trans-Tasman equity does not disappear when debt finance is used to finance investment. This is illustrated in Table 2.

TABLE TWO: SUMMARY OF CURRENT RULES

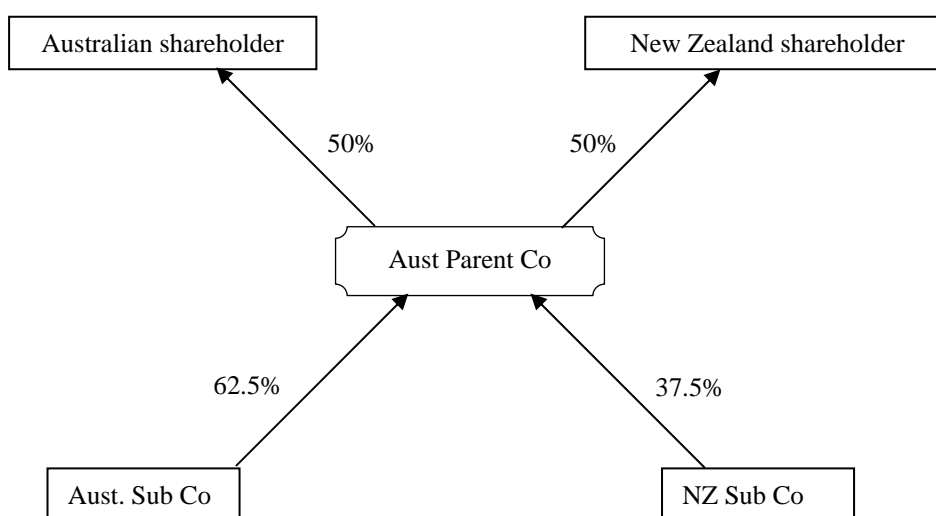
Parent Company	A NZ Parent Co NZ Bond Holder	B Australian Parent Co NZ Bond Holder	C Australian Co Australian Holder
Profit before interest	100	100	100
Interest expense	(100)	(100)	(100)

A JOINTLY OWNED COMPANY

The hypothetical trans-Tasman company

Table 1 assumes that individual shareholders own the parent company resident in the other jurisdiction. Secondly, there is only one operating subsidiary, which is taxed in the other jurisdiction. A more realistic scenario is illustrated in Diagram one, which formed the basis of the analysis, contained in the Discussion Document.⁵

DIAGRAM ONE: A TYPICAL TRANS-TASMAN CORPORATE OWNERSHIP STRUCTURE:



A hypothetical example of a New Zealand trans-Tasman shareholder company

The common theme which underlines Diagram one is the unique nature of trans-Tasman investment. Shareholders on both sides of the Tasman own a parent company. Secondly, the parent company owns an operating subsidiary on the other side of the Tasman. Thirdly, the operating subsidiary is paying full local corporate tax. Fourthly, the dividend paid by the subsidiary to its parent company is usually not effectively subject to non-resident withholding tax (NRWT). Finally, the dividend derived by both groups of shareholders does not contain a tax credit for the corporate tax paid by the operating subsidiary. Prior to the adoption of the PRA solution it was one of the ironies of the closer economic relations (CER) agreement that any “local” parent company that wished to become an Australasian player would reward its shareholders with a punitive tax bill, which was totally inconsistent with CER.

The seriousness of the pre PRA problem is illustrated by the case of a hypothetical New Zealand brewer who expands into Australia. Let us assume that Lager Limited is a company paying New Zealand Company tax at 33% and that it pays a fully imputed dividend to, inter alia, its individual New Zealand shareholders. Assume that Lager Limited is also producing beer for export into a highly competitive global market. The company identifies an opportunity in the Australian market. It merges with an

⁵ Op cit, footnote 2 p. 19.

established Australian beer manufacturer to exploit that opportunity. To fund the merger a new parent company (Super Lager) is formed which is listed on the Australian and New Zealand stock exchanges. As is so often the case, the parent company is based in Australia and the original New Zealand shareholders now hold shares in Super Lager. Despite the fact that the merger was fundamental to the long-term viability of both the pre-merger companies and despite the clear benefits to the respective national economies, the New Zealand shareholders were rewarded with an increased tax liability from 39% to 59%. This occurred despite the fact that the same amount of New Zealand company tax was still paid and the New Zealand shareholding remained intact. Clearly something was wrong with both countries' tax systems.

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

Why was a 50-50 shareholding structure chosen?

The Discussion Document states that the PRA solution will reduce an individual New Zealand shareholder's effective tax rate by 24%.⁶ This saving is based on the hypothetical group structure illustrated in Diagram One.

The shareholding of the hypothetical Australian parent company that was used in the Discussion Document disclosed that 50% of

DIAGRAM TWO: THE DISCUSSION DOCUMENT EXAMPLE OF TAX P

TABLE THREE: THE DISCUSSION DOCUMENT EXAMPLE OF THE TAX SAVINGS

NZ Shareholder	Before reform \$AU	Pro rata allocation \$AU
Cash dividend	700	700
Imputation credits	Nil	225
Franking credit	Nil	300
Gross income	700	925
Tax due @ 39%	273	361
Less imputation credit	Nil	(225)
Franking credit	Nil	Nil
Tax payable	273	136
Net dividend	427	564
Effective tax rate	57.3% ¹	43.6% ²

¹. $[273 + 300 \text{ (uncredited underlying corporate tax)} / 1000]$

². $[361 + 75 \text{ (uncredited underlying corporate tax)} / 1000]$

Reaction to the February 2003 announcement

The professional advisers to trans-Tasman companies and the business community did not share the Minister's euphoria. For example, the National Business Review reported:⁷

This is certainly not the breakthrough it is being portrayed as, Ernst & Young tax partner Michael Stanley said ... only a very small minority of shareholders are going to be affected by this. For a real breakthrough there would have to be full recognition of the tax paid.

The problem, which Michael Stanley was alluding to, is the fact that the PRA method allocates the available imputation and franking credits according to the respective shareholding in each country. Secondly, the shareholder can only utilise the appropriate imputation or franking credit which in the case of an individual Australian shareholder is the franking credit but not the New Zealand sourced imputation credit. It therefore follows that a parent company with a small shareholder presence in the other jurisdiction would find it difficult to justify the compliance and administrative costs of implementing a regime, which only provided a small benefit to a minority group of non-resident shareholders. The only type of Trans-Tasman Company minorit

shareholding. However, the following Table demonstrates that the Discussion Document example is not a reliable indicator of a representative company.

TABLE FOUR: THE SHAREHOLDING COMPOSITION OF TRANS-TASMAN COMPANIES

Source: Company Annual Reports

Company	Year Ending	New Zealand Shareholding	Australian Shareholding
Australian Gas Light Company	2003	1.66%	97.71%
AXA	2003	2.95%	97.05%
Goodman Fielder Wattie	2003	4.64%	94.86%
National Australia Bank	2002	0.64%	98.58%
Telstra	2002	0.50%	93.20%
The Warehouse Group*	2003	97.02%	2.47%
Tower*	2003	78.81%	20.64%
Westpac	2003	3.34%	95.15%

* A New Zealand company

The New Zealand shareholding in this sample of Australian parent companies is less than 5%. In the case of Westpac, the approximately 95% Australian shareholders will gain no advantage from the PRA solution, and only approximately 4% of the total tax paid by the New Zealand group will be passed on as an imputation credit to the small minority of New Zealand shareholders. It is perhaps not surprising that as at 1 January 2005, no major trans-Tasman public company has announced that it will implement the PRA solution.

A more realistic example

DIAGRAM THREE: THE PRO RATA ALLOCATION REGIME

95% shareholding

5% shareholding

Dividend \$2,380

Divide

(5%), which is only an 8% reduction in the effective tax rate. This is significantly less than the 24% benefit referred to in the Discussion Document. The difference b

ALTERNATIVE SOLUTIONS

The optimal solution

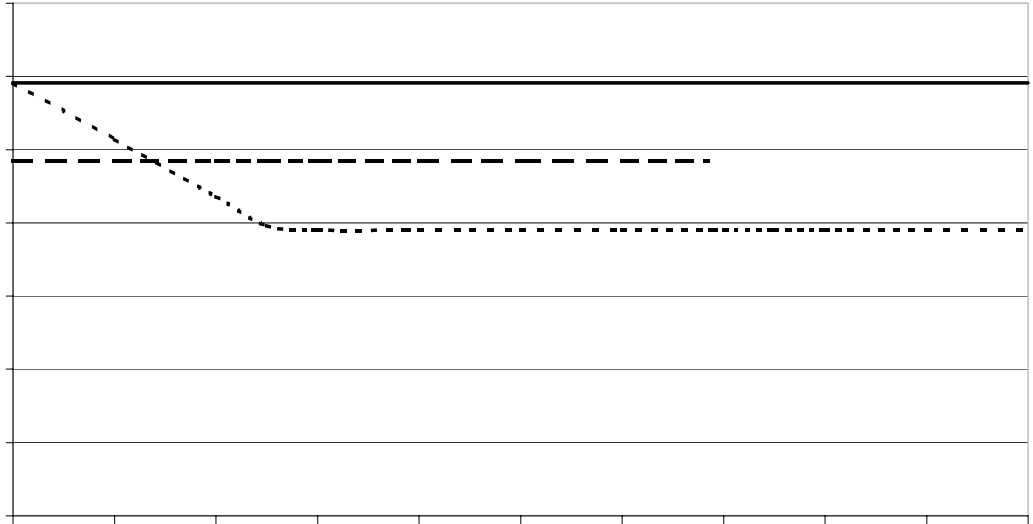
The pro rata model is not the optimal tax solution. From a company and shareholder perspective, the streaming of tax credits would provide significant additional benefits that are not available under the pro rata allocation method. If this alternative were adopted, then the Australian parent company and its New Zealand subsidiary would

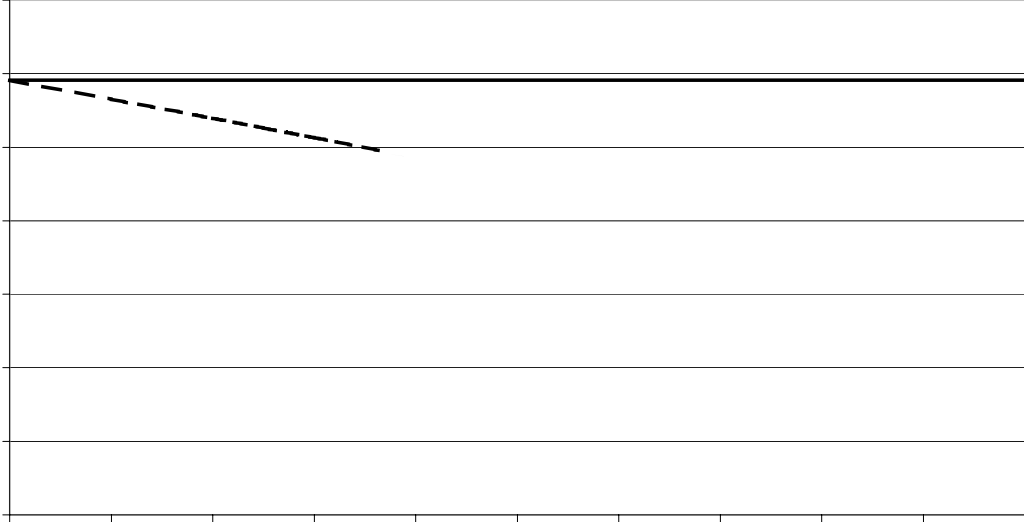
concerns was that shareholders in either country

THE DETERMINANTS OF EFFECTIVE TAX RATES UNDER PRO RATA ALLOCATION

The relationship between income distribution policy and income earned in a jurisdiction

A dividend will always be partially imputed (or franked) if the proportion of income derived in New Zealand (or Australia) is less than the percentage





Finally Graph Two emphasises that regardless of the distribution policy, the Australian shareholders marginal rates of tax are the same prior to and after the enactment of the PRA solution. The foreign tax credits attached to their dividend cannot be used to reduce their domestic tax liability. Constructing the graphs to reflect a New Zealand company would also demonstrate that a New Zealand shareholder's tax rates under pro rata allocation reflect those under the current regime.

Graphs Three, Four, Five, and Six illustrate the effective tax rates for New Zealand and Australian shareholders of an Australian parent company. The only variable, which has been altered, is the percentage of the available profit which is distributed. These four graphs will assist trans-Tasman companies to calculate the income and dividend payments, which would be necessary to provide their shareholders with a fully imputed dividend.

Graph Three demonstrates that a 25% distribution policy will provide fully im

DIAGRAM FOUR: THE FULL STREAMING MODEL

Australian Shareholder	
Cash dividend	\$1,596
Franking Credit ⁺	\$684
Imputation Credit	\$0

95% shareholding

New Zealand Shareholder	
Cash dividend	\$84
Franking Credit	\$0
Imputation Credit [~]	\$36

5% shareholding

Dividend t 10.02 98.16344.2220 0 10.02 569.47101 637.

TABLE SIX: THE FULL STREAMING MODEL (AUSTRALIAN PARENT)

New Zealand shareholder	\$AU	Australian shareholder	\$AU
Cash dividend	84	Cash Dividend	1,596
Imputation credit	36	Imputation Credit	0
Franking credit	0	Franking credit	684
Taxable income	120	Taxable income	2,280
Tax due @ 39%	47	Tax due @ 48.5%	1,106
Less imputation credit	36	Less imputation credit	0
Less franking credit	0	Less franking credit	684
Tax payable	11	Tax payable	422
Net dividend	73	Net dividend	1,174
Effective tax rate	39.00%	Effective tax rate	48.50%
Pre-tax cash dividend	120	Pre-tax cash dividend	2,280
Company tax	36	Company tax	684

WHY WAS FULL STREAMING REJECTED?**Introduction**

The Discussion Document summarises¹⁸ the three primary reasons why both governments have rejected the streaming alternative.

The perception that the streaming model provides tax benefits that are disproportionate to the individual shareholder's interest in the company.

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

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

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

Disproportionate benefits*The Discussion Document*

The governments' concern was

Streaming would see all tax paid in New Zealand available to provide imputation credits solely to New Zealand shareholders. Such a m

“might also signal that streaming of credits more generally is now acceptable. Both governments wish to avoid such a result, as it is still both countries policy that imputation credits should not be streamed and should be allocated across all shareholders.”²¹

It is clear that the streaming model is not inconsistent with the impu

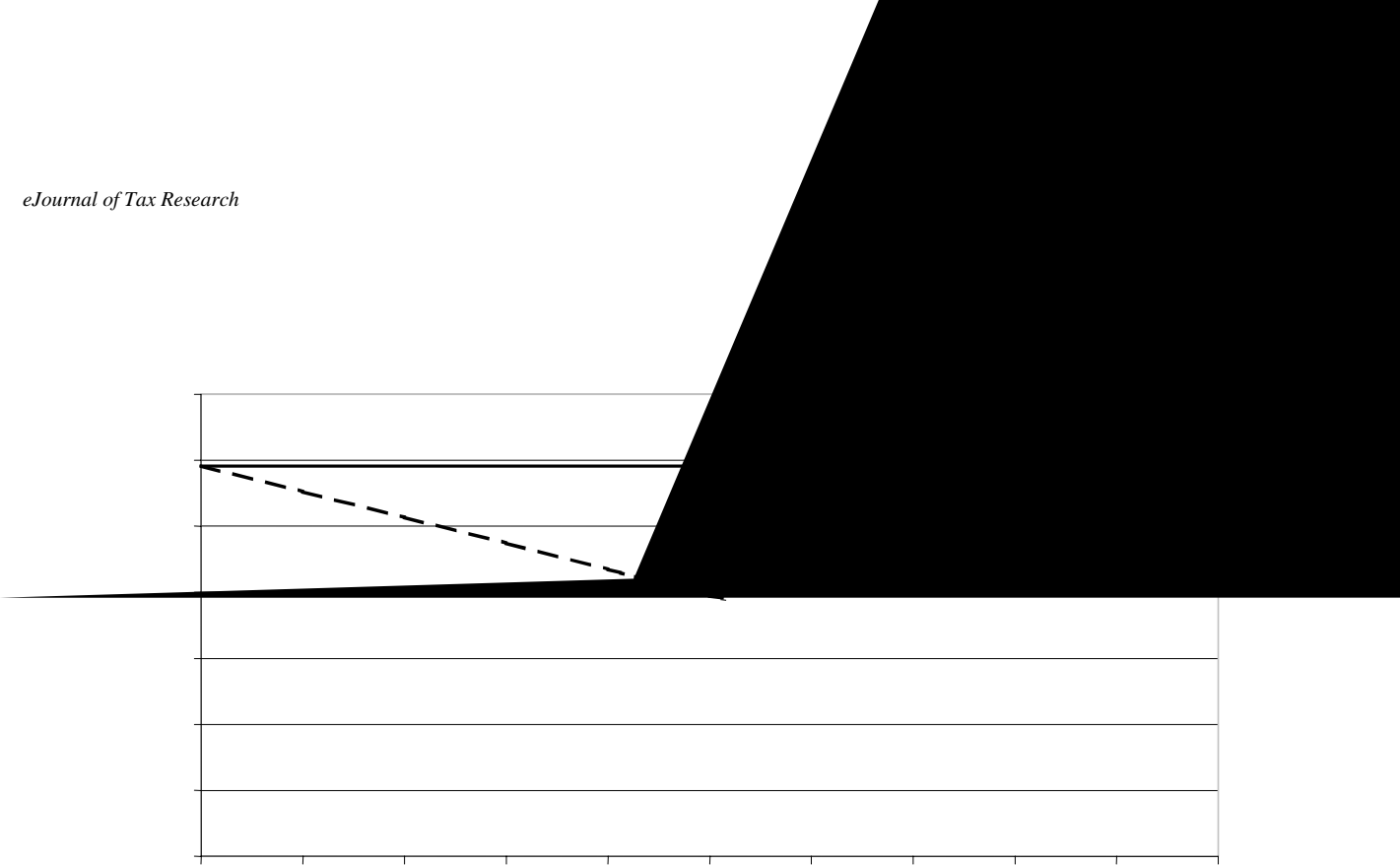
New Zealand's anti-avoidance rule

There are a number of significant provisions in New Zealand domestic law that would prevent the inappropriate use of the streaming model thereby alleviating the above concerns:

The current imputation regime has numerous provisions that are designed to prevent streaming. The first is a restriction against attaching imputation credits to dividends that exceed the maximum imputation ratio (i.e. 33/67). This rule ensures that a company cannot attach imputation credits to a dividend that exceeds the company tax paid or payable in respect of funds in which the dividend was sourced. Furthermore, the benchmark dividend rule ensures that the same imputation ratio (subject to a ratio change declaration) applies to all distributions.

A continuity of shareholding test. A company cannot carry forward an imputation credit balance where there is a greater than 33% change in shareholding. In other words, a company must maintain at least a 66% continuity of shareholding.

Specific rules that prohibit the trading of shares where a purpose (not being an incidental p



This is NOT a comprehensive of profit

DIAGRAM FIVE: THE WESTPAC SOLUTION TO TRIANGULAR TAXATION

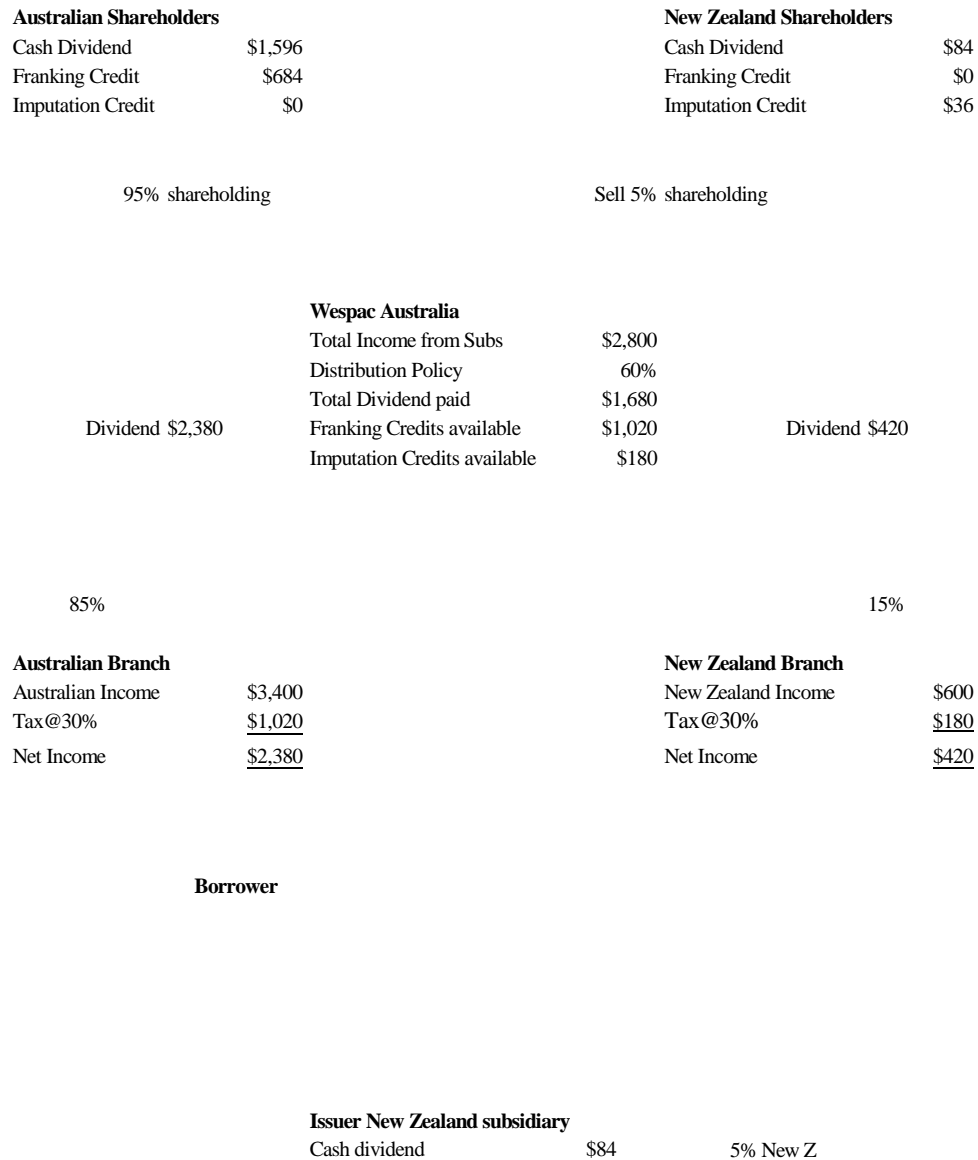
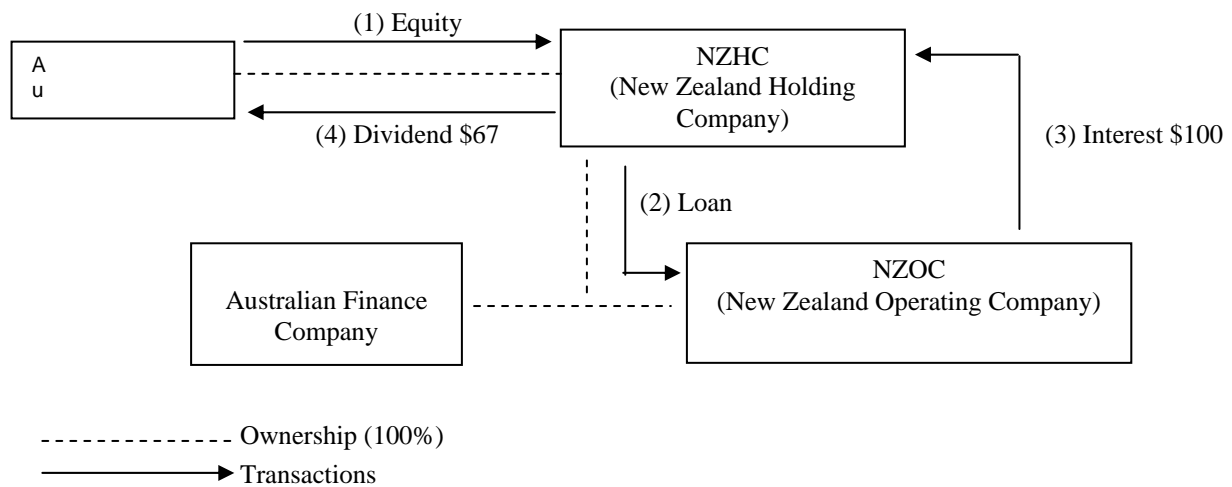


DIAGRAM SIX: CURRENT STRUCTURE



A more tax efficient alternative: hybrid instruments

The following more complex diagram is designed to reduce the amount New Zealand tax and create a corresponding increase in the dividend paid to the Australian parent company. Under a conventional funding arrangement, an after tax dividend of \$67 is paid to the Australian parent company. Under the following rearrangement, the net after tax New Zealand sourced dividend is increased from \$67 to \$90.

For the purposes of illustration only the underlying assumption is that the structure will be used to refinance the existing NZ group. The concepts are equally applicable to financing an expansion of the NZ group associated with for example a merger or acquisition. The “anti avoidance” risks and implications have been ignored.

The initial rearrangement (steps 1 to 5) is designed to replace the NZ group’s original equity (which created the tax consequences described in section 7.2) with a more tax effective alternative.

-Step one: The Australian Parent Company subscribes for equity issued by the NZHC. The proceeds from that transaction are ultimately returned to the Australian Parent

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-Step three: The New Zealand branch of Australian Finance Company leads the proceeds (raised from issuing the *hybrid instrument* to NZHC) to the NZOC. For New Zealand tax purposes this is a transaction between two resident entities and therefore the non-resident withholding tax provisions are not applicable.

-Step four: The NZOC uses the loan finance to repay the original loan shown as step 2 in Diagram 6. From the NZOC perspective it has simply replaced its current creditor (NZHC) with a new creditor (the New Zealand branch of Australian Finance Company), which means that everything else been equal the new arrangement will have no impact on its current business activities.

-Step five: NZHC will use the loan repayment (from NZOC) to return the original equity obtained from the Australian Parent Company. One tax effective method of unwinding the original transaction would be for NZHC to repurchase the original shares from Australian Parent Company. Provi

Parent Company's after tax return from its investment in the NZHC. The Australian Parent Company invest the additional \$23 in a manner that will increase the franking credits, which can be distributed to, inter alia, its Australian shareholders.

(1) Periodic cash flow (a). NZOC pays interest to the New Zealand branch of Australian Finance Company. The interest is deductible to NZOC, and forms part of the New Zealand branch's gross income. In other words, this transaction is tax neutral from a New Zealand perspective. Secondly, there are no NRWT implications because this transaction is between two New Zealand tax residents.

TABLE SIX: THE TAX SAVING ASSOCIATED WITH A HYBRID INSTRUMENT

(a) Interest NZOC to Aus Finance Co (NZ Branch)ABLE

payment by NZHC of a dividend to the Australian Parent Company the conduit tax relief (CTR) provisions apply. This is the key feature of the entire transaction which eliminates all of the New Zealand company tax and New Zealand NRWT associated with the original “plain vanilla” financing. However, it would be fair to say that the CTR provisions contained in the ITA94 were never meant to be used in this way.

(3) Periodic cash flow (d). The final transaction is the payment of a dividend by NZHC to Australian Parent Company. This transaction is linked to the periodic cash flow (b) / (c) because it is the second stage of the CTR. The original purpose of the CTR provisions were to reduce the amount of New Zealand company tax, and NRWT which is payable associated with International Paper (Inc)’s investment in Carter Holt Harvey Limited who in turn owned forestry investments in Chile and Canada. However, there is nothing in the CTR regime, which prevents the relief from New Zealand tax applying to trans-Tasman companies.

The tax saving associated with a hybrid instrument

Table Six summarises the New Zealand tax consequences of the periodic cash flows described above in section 7.4. The main purpose of Table 6 is to demonstrate that the original after tax dividend of \$67 (paid by NZHC to Australian Parent Company) has increased to \$90, as discussed in section 7.4. This represents an increase of \$23 or 34% in the after New Zealand tax return of the Australian Parent Company. This only occurs because the CTR regime effectively enables the New Zealand group to more efficiently utilise the underlying New Zealand company tax (imputation credits) paid by the NZOC associated with the commercial activities that were originally financed by the Australian Parent Company.

CONCLUSION

Prior to the enactment of the PRA solution there were no logical reasons why the hypothetical trans-Tasman group of companies outlined in the Discussion Document (and reproduced as Diagram One) would wish to pay New Zealand company tax. All of the imputation credits created by the Ne

Alternatively, Australian public companies may simply ignore the PRA solution to the detriment of their New Zealand shareholders.