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Deloitte Touche Tohmatsu

30 October 2002

The International Taxation Project
Board of Taxation Secretariat
C / - The Treasury
Langton Crescent
Parkes ACT 2600
AUSTRALIA

Dear Sir/Madam

REVIEW OF INTERNATIONAL TAXATION ARRANGEMENTS

We make the following comments by way of submission on behalf of the New Zealand ("NZ") offices of Deloitte Touche Tohmatsu ("Deloitte NZ") on the consultative paper published by the Australian Treasury entitled Review of International Tax Arrangements ("the consultative paper").

As you will be aware, Deloitte is one of the world's leading professional services organisations. Deloitte has over 95,000 people in more than 140 countries and serves approximately one-fifth of the world's largest companies. Our NZ practise has over 900 people employed nationwide.

As at 31 March 2001, Australian enterprises had $17.2 billion of foreign direct investment ("FDI") in NZ enterprises. This is almost 35 per cent of the $49.3 billion total FDI in NZ. Australia is also the largest destination of NZ FDI abroad. At that time, NZ enterprises had $9.3 billion invested in Australia, representing 63 per cent of total FDI overseas by NZ enterprises. As it is NZ's major trading partner, any changes to the Australian international tax rules will have a significant effect on our businesses and therefore our clients.

EXECUTIVE SUMMARY

Our principal comments can be summarised as follows:

- We support the further consideration of the effect on Australian companies of the dividend imputation bias and exploring solutions to this problem. From a simplicity viewpoint, we favour the streaming option. (Option 2.1)
- All proposals to reduce the impact of the Australian controlled foreign company ("CFC") rules will be a positive advancement. (Options 3.1 – 3.4)
- We support the recent changes to the Australia/United States tax treaty and encourage its use as a basis of negotiation for future tax treaties, including NZ. (Option 3.5)

- We consider that the Review of Business Taxation proposal to apply capital gains tax ("CGT") to the sale by non-residents of non-resident interposed entities with underlying Australian assets should not be proceeded with. (Option 3.6)
- Deloitte NZ believes that the Australia/NZ tax treaty should be a priority for renegotiation given our close trade ties. (Option 3.7)
- We support providing conduit relief for Australian regional holding and joint venture companies. (Option 3.10)
- We support the replacement of the foreign dividend account with the introduction of a foreign income account to provide a withholding tax exemption for all conduit income an Australian company distributes. (Option 3.11)
- We support clarifying the residency test for companies and believe that this should be based on the place of incorporation. (Option 3.12)
- We believe that to exempt non-resident beneficiaries from Australian CGT on the sale of non-Australian assets is consistent with both residency-based and source-based taxation. (Option 4.6)

DETAILED ANALYSIS

We assume that Australian companies will canvas in detail the proposals purely relevant to domestic outbound investment and for that reason have restricted our comments to areas of relevance to international, and specifically NZ, investors.

We have not attempted to provide policy arguments for or against the options presented. Instead this submission represents the considered opinion of Deloitte NZ in its role as a leading advisory firm in NZ.

Attracting equity capital for offshore expansion

Option 2.1 Options for reducing a shareholder level tax bias against direct investment offshore

The consultative paper (page 16) states that a possible bias occurs at the shareholder level against direct investment offshore. When calculating the returns to the ultimate resident shareholders we believe that there is a tax bias against resident corporates investing outside their home jurisdiction under an imputation regime.

As noted above Australian direct investment in NZ represents almost 35% of the total received. As a net capital importer, it is in NZ's interests for this to grow, and accordingly, we support the move to remove bias against such investment.

Of the options presented, Deloitte NZ supports the streaming of dividends. This is the simplest option to implement. It encourages foreign investment, may reduce the cost of capital to Australian businesses and assists jurisdictions such as Australia in retaining its internationally focused companies.

However, it is also acknowledged that depending on various mixes of domestic versus. foreign income, the results may be more or less beneficial to domestic shareholders. We agree that this base of shareholders is very important for the Australian equity markets and accordingly we support further consideration of either an exemption model or a shareholder tax credit model which could work in tandem with the streaming of dividends.

Promoting Australia as a location for internationally focussed companies

Better targeting the controlled foreign company rules

The CFC rules are obviously targeted at outbound investment, and we have therefore limited our comments to the impact they have on decisions of NZ companies to invest through Australia.

While at first glance, NZ companies are attracted by the active business test exemption, complexities surround the exceptions to this test and it involves significant ongoing compliance costs. This acts as a deterrent for NZ companies to invest directly through Australia even when this makes commercial sense from the way the business is managed.

We therefore support all proposals to reduce the impact of the Australian CFC rules for foreign investors who invest into an Australian conduit. This will increase the likelihood that, following a successful takeover of Australian resident multinationals, Australia will continue to be used as a headquarters or interposed conduit country. Currently there is a real incentive to restructure acquisitions of Australian corporates to streamline tax structures. Clearly any such proposals also have implications on the retention of Australian resident multinationals and attractiveness of using Australia as a regional headquarter.

Option 3.5 Australia's future tax treaty practice

We support the direction of the recently negotiated protocol to the Australia/United States tax treaty. We recommend that all future Australian tax treaties be reconsidered in this light.

Option 3.6 The application of CGT rules to the sale of non resident interposed entities with underlying Australian assets

We do not agree with the Review of Business Taxation proposal to apply Australian CGT to the sale by a non resident of non resident interposed entities with underlying Australian assets.

We believe that imposing such an additional tax would detract from Australia as a location for international investment from NZ.

The imposition of this is contrary to the trend by various Governments (including Australia) to reduce taxes on foreign investment (as an example, the recent changes to the Australia/United States tax treaty). It is generally accepted that reductions in taxes for foreign investors reduce the cost of capital to resident entities, and improve the economic welfare of the home jurisdiction. The proposed change is contrary to this and can only result in foreign investors increasing their expected returns to take into account this additional layer of tax.

In order for non-resident investors not to be inappropriately taxed, the measures would need to be carefully targeted. Given the various situations that would need to be separately addressed, this would almost certainly result in the measures being extremely complex.

It is unclear how the proposed rules would apply to non-wholly owned groups. For example:

- An upstream non-resident may choose to sell its investment leaving the interposed entities or possibly a resident shareholder exposed to the tax, notwithstanding that they had no control over the decision.
- There may be a tax liability triggered without the knowledge of the interposed entities due to changes further up the chain.
- When an Australian tax liability has crystallised in respect of a part holding how the cost base of the investment would be determined.

It is also unclear from the paper which taxpayer would be liable for the Australian tax, for example, the entity that is sold, the vendor of the entity that is sold, or the entity that actually holds the Australian investment. All these options raise practical issues such as determining when the tax liability arises and who must return the taxable income.

Situations may arise where the ultimate taxed entity may face an Australian tax liability for which no credit can be obtained in the foreign jurisdiction. For example where gains are reduced by foreign exchange losses and other holding costs, the ultimate vendor may have no overall gain and therefore no income against which to utilise the tax credit. Such imposition of double tax would be undesirable.

We note that rules need to encompass the costs to the acquirers of the interposed foreign holding vehicles. That is, if the sale of an interposed foreign holding vehicle is to trigger an Australian tax liability, the rules need to allow for the cost of that interposed foreign holding vehicle. If this is not addressed double Australian tax will arise as discussed above.

Taxing gains made on interposed foreign holding vehicles is merely a timing difference as the original cost base of the underlying Australian tax asset remains. While in theory it may be possible to keep an interposed structure in place ad infinitum, thus permanently deferring the CGT liability, this is not usually feasible in the commercial world. In drafting the rules, care will therefore need to be taken to ensure that double Australian tax does not result, firstly from the sale of the interposed foreign holding vehicle and secondly if that holding vehicle directly disposes its Australian investment(s).

As a final note, if the Australian investment's assets are predominately outside Australia, then taxing non resident shareholders on the sale of any interposed foreign holding vehicles is effectively taxing non resident investors on non Australian sourced income. This is being addressed in the consultative paper in terms of Option 3.10. If the above proposal (Option 3.6) is implemented we believe that the relief being considered under "Option 3.10" needs to be expanded.

We strongly submit that this proposal is not implemented, but recommend that in the event it does proceed that a comprehensive consultation process be undertaken.

Option 3.7 Countries that should be given priority for tax treaty negotiations

We understand that the recent tax treaty between Australia and the United States will trigger most favoured nation clauses in a number of existing Australian tax treaties once the protocol

takes effect. Notwithstanding that NZ does not have a most favoured nation clause in its tax treaty with Australia, Deloitte NZ submits that the tax treaty with NZ should be a priority for renegotiation. We note Table 2.3 of the consultative paper states that NZ is the third highest source for Australian direct investment and this is the largest component of NZ FDI.

Although not considered in the consultative paper, Deloitte also submits that, where possible, Australia should negotiate its tax treaties in conjunction with the NZ Government. We believe that this approach is in keeping with the Closer Economic Relations agreement and may have advantages and efficiencies for both countries

Option 3.10 Conduit relief for Australian regional holding and joint venture companies

We believe it is not correct to seek to tax non-residents on income which is not sourced in Australia.

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

Further, we believe that Australia should consider expanding the proposals by implementing a conduit tax relief regime similar to NZ's conduit tax relief regime. Broadly this regime does not tax CFC income of NZ resident companies to the extent that the NZ company is owned by non-residents of NZ. This is in line with the policy objective of not taxing foreign income derived by non-resident investors. We consider providing conduit relief in respect of all CFC income (i.e. not limited to capital gains) may assist in the retention of Australian resident corporates.

Option 3.11 Foreign income accounts

Deloitte NZ supports the Review of Business Taxation's recommendation to expand the foreign dividend account to provide a withholding tax exemption for all conduit income an Australian company distributes. As chains of companies are common, especially in large groups, we believe that this will encourage, retain and facilitate the use of Australia as a place for foreign investment.

Option 3.12 Clarifying the residency test for companies

In determining residency, we support a move to either:

- An exclusive use of the place of incorporation, or
- A greater emphasis on the place of incorporation.

This should assist in simplifying the resolution of residency issues between Australia and NZ particularly as the management of many NZ companies report through to Australian regional offices. Moving to a more objective test will also serve to reduce uncertainty and therefore compliance costs.

Deloitte
Touche
Tohmatsu

Chapter 4 Promoting Australia as a global financial services centre

Option 4.6 Exempt non-resident beneficiaries from Australian CGT on the sale of non-Australian assets

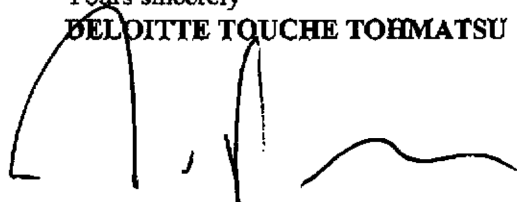
We believe that this approach is consistent with both residency-based and source-based taxation. The objective should be to tax residents on their worldwide income and non-residents only on their Australian sourced income (although for a capital importing country even this latter point is debatable). It is incorrect from a policy perspective to seek to tax non-residents on income that is not sourced in Australia.

We note that if (despite our submission above) Australia did proceed to tax the sale of interposed companies with Australian assets it would be necessary to extend this principle to ensure that no tax was levied in relation to the proportion of the assets of the interposed entity that were not Australian based. This might require looking through a number of tiers of companies.

CONCLUSION

Thank you for the opportunity to comment on this consultative paper. We believe that many of the proposals are very positive initiatives by the Australian Treasury and look forward to the outcome of the consultation process.

Yours sincerely
DELOITTE TOUCHE TOHMATSU



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