

Tax Brief

27 November 2009

Novelties in New Zealand Treaty

International Tax Agreements Amendment Bill (No 2) 2009 was introduced into Parliament on 25 November 2009 to give effect to the new tax treaty with New Zealand signed on 26 June 2009. This is Australia's fourth full tax treaty with New Zealand, the highest number with any country, reflecting our close relationship. As in the past the negotiators have taken the opportunity to experiment with a number of provisions not previously found in Australia's treaties. This Tax Brief explains the novelties, as well as indicating the main contours of the treaty. The Explanatory Memorandum (EM) to this treaty is particularly important as it spells out in detail the operation of some of the novelties, as well as recording many agreements between the countries on the meaning or operation of various provisions of the treaty.

Fiscally transparent entities

Article 1(2) provides that items of income derived by or through a fiscally transparent entity are entitled to treaty benefits to the extent that one of the states regards the income as derived by a resident. It is similar to a provision in the US 2006 Model treaty except that it refers to items of income. The provision is the subject of 12 pages of explanation in the EM which makes clear that it is intended to produce the same outcomes as the 1999 OECD Partnership Report.

The reason why the provision is included is that it goes further than the OECD Report in two respects. First, it extends the same result to other fiscally transparent entities, particularly trusts in the Australian context. Secondly, it is applied on an item of income basis. This again has particular relevance to trusts where, depending on whether beneficiaries are presently entitled to trust income, the trustee or beneficiary may be taxed. In cases where the trustee is taxed it is the trust which will claim treaty benefits (subject to the further comments under the next heading below). In cases where the beneficiary is taxed it is the beneficiary which will claim treaty benefits (subject to comments on managed investment trusts (MITs) below).

Hence if a partnership which has an Australian resident partner and a foreign resident partner derives royalty income from New Zealand, the Australian resident partner will be able to claim benefits under the new treaty to reduce NZ tax at source on its share of the partnership royalty income but the foreign resident partner will not. That partner will have to rely on any New Zealand treaty with the country of residence of the partner to get treaty benefits. This result obtains for the Australian resident partner even if New Zealand regards the partnership as a company for tax purposes

and treats it as deriving the royalty income. The same would apply if the royalty income is derived through a trust to the extent that there is an Australian resident beneficiary presently entitled to the income of the trust. In either case it does not matter if the entity is created or resident in Australia or a third country.

In other words it is the country of residence of the taxpayer that determines who is the relevant resident taxpayer (that is, which person is taxed on the income) for the purposes of claiming treaty benefits. The provision does not clearly give an answer if a New Zealand resident entity derives royalty income from New Zealand and New Zealand regards the entity as a non-transparent company while Australia regards it as a fiscally transparent entity. The EM records an agreement between the countries that the capacity of New Zealand to tax this income fully is not affected by the fact that Australia is taxing the members of the entity on the income. The relief of double taxation article of the treaty contains a complementary provision for this case to the effect that Australia must provide a foreign tax credit for the New Zealand tax even though it is levied in New Zealand on the entity and not the members. The EM notes that this result would follow in any event from the foreign income tax offset rules under Australian domestic law.

Trusts

In the case of trusts there are some additional provisions in the treaty. The definition of person expressly includes partnerships and trusts. This raises the continuing relevance under the new treaty of the ruling by the Australian Taxation Office (ATO) in TR 2005/14 that it is the residence of the trustee and not the residence of the trust that is relevant to treaty benefits under the current treaty with New Zealand. This change to the definition of person suggests that it would be the definitions of resident trust estate and resident trust for CGT purposes in Australian law that determine treaty residence under the new treaty on the Australian side. The EM is silent on this issue.

The treaty has the standard New Zealand treaty provision that where the trustee is taxed it is treated as a resident and the beneficial owner of dividends, interest and royalties for the purposes of the relevant articles of the treaty. The EM adds that the countries agreed that where a resident trust is taxed on income but that tax is subsequently refunded to a non-resident beneficiary as can happen in Australia, then the trust to that extent is not treated as the beneficial owner and hence does not obtain treaty benefits under these articles. The EM takes the same position where tax paid by the trustee is credited against the tax liability of a foreign resident beneficiary as can also happen under Australian law.

MITs

The treaty may be the first one internationally to draw on recently published work-in-progress by the OECD on treaty benefits for collective investment vehicles. It provides that an Australian MIT deriving income from New

Zealand will be treated as an individual and the beneficial owner of income derived by the MIT. The effect is that treaty benefits are obtained by the MIT under the new treaty and do not have to be claimed at the level of the investors in the MIT. The EM notes that this is designed to overcome the practical problem of multiple unitholders having to claim treaty benefits individually. This treatment is complete where either the MIT is listed or at least 80 per cent by value of the beneficial interests in the MIT are owned by Australian residents. If neither of these tests is satisfied, the MIT still gets treaty benefits but only to the extent that beneficial interests in the MIT are owned by Australian residents.

For this purpose MIT is defined by reference to the definition in the *Taxation Administration Act 1953* in relation to the recently introduced managed investment trust withholding tax. The EM provides helpful guidance on how to determine the extent of ownership of beneficial interests by Australian residents in MITs. It also records an agreement between the countries that if a New Zealand resident investor derives income through an Australian MIT sourced in New Zealand, then New Zealand can tax that investor in full under New Zealand tax law notwithstanding New Zealand source tax is limited because of the treaty benefits available to the MIT.

The EM also in relation to relief of double taxation makes clear that Australian resident investors in MITs deriving income from New Zealand can get foreign income tax offsets for New Zealand tax at source even though New Zealand reduces its the source tax rate based on the residence of the MIT in Australia rather than based on the investor's residence.

Permanent establishment

The new treaty also adopts the OECD services permanent establishment (PE) provision that was included in the OECD Commentary in 2008. Under this provision a PE will exist if services are preformed in a state by a resident of the other state for more than 183 days in a 12 month period on one or more connected projects.

A similar provision appears in the UN Model and in some other Australian treaties (for example, Indonesia). The OECD style provision is considerably more refined and caters for cases where the individual is the contractor or where a company is the contractor and various individual employees or contractors carry out the work on its behalf. The provision in the new treaty follows the OECD form. Unlike the OECD it does not count days for services performed by an individual on behalf of an enterprise if the individual is present for a period not exceeding five days unless the individual is regularly commuting to the other country for that purpose. The OECD Commentary has extensive analysis of the provision as does the EM.

Otherwise the PE rules follow the pattern in recent Australian treaties – see further below on substantial equipment.

Business profits and transfer pricing

What is most important about the new treaty is that it does *not* adopt the recently released draft revised version of the OECD business profits article designed to give full effect to the OECD work on Attribution of Profits to Permanent Establishments. New Zealand has already publicly indicated its disagreement with the approach in that work and the UN has moved in the same direction.

Australia typically wishes to tax income from land in the form of farming, mining etc as business profits whereas under the OECD Model that income is covered by the income from immovable (real property) article. In the new treaty the matter is dealt with by ensuring that income from real property derived in a business context is taxed in accordance with the net basis, arm's length principles applied to business profits generally even though the income from real property article is applicable to such income.

In common with the OECD Model and Australia's recent treaties, the new treaty does not include an income from independent personal services article, unlike the current treaty with New Zealand. Accordingly the profits of professional firms are dealt with by the business profits article.

The standard Australian provision for profits derived through a trust with a PE appears in the business profits article of the treaty and the EM provides (as has been common recently) that the same rule also applies to article 13(2) on alienation of property by a PE. This is simply inconsistent with article 7(5) providing that if profits include items of income dealt with separately in other articles then the provisions of those articles shall not be affected by the provisions of the business profits article (which must include the trust provision in that article). The EM statement would seem to be premised on a view that the trust provision simply clarifies what would be the position anyway. It is by no means evident that this is the case.

Transfer pricing adjustments under both the associated enterprises article and the business profits article have a 7 year time limit applied to them which overcomes the problems caused by the unlimited period for such adjustment under Australian domestic law. The lack of time limits in such cases is under review and the treaty may suggest that 7 years will become the Australian domestic norm. That seems to be an overly long period compared to the normal 4 year period for amendments. The recent Australia Japan treaty has a similar limit but only in the associated enterprises article.

Substantial equipment and international traffic

The new treaty follows Australia's recent norms for substantial equipment. The PE definition only applies to the (active) operation of equipment thus overcoming the issues with equipment leasing revealed in the *McDermott Industries* case, with time limits of 90 days in any 12 month period for natural resources and 183 days in any 12 month period for other cases. Because New Zealand wishes to make clear in the treaty its ability to tax exploitation of timber and fisheries, here and elsewhere where reference is

made to natural resources, a definition is provided which expressly covers them.

It is a little observed feature of past Australian treaties, though recently elaborated by the ATO in TR 2008/8, that the ships and aircraft article extends to operation of ships and aircraft and not just international transport so that dredging, exploration etc can also be covered by this article. The result effectively is to short circuit any time limits for substantial equipment PEs where ships or aircraft operating in Australia are involved. The new treaty removes this oddity and limits the article to transport cases in line with international norms.

Dividends, Interest, Royalties

The new treaty generally follows the pattern for these articles originally established by the 2001 Australia US Protocol with a zero rate for inter-corporate dividends if certain tests are satisfied, an exemption from source tax for interest paid to financial institutions and a 5% tax on royalties at source (with the royalties definition not including equipment leasing). In addition there are some refinements to this pattern.

In relation to dividends the zero rate is extended to cases where the company receiving the dividend is wholly or partly owned by companies resident in third countries which would be entitled to equivalent treaty benefits if they received the dividend directly (that is, if there is a similar treaty between the country of source and the country of residence of that company). The EM gives an example of an Australian company owned 100% by a New Zealand company which in turn is owned 50% by a New Zealand listed company and 50% by a UK listed company. Because the Australian UK treaty gives similar benefits for UK listed companies, the result is that the dividend would not be taxable in Australia, assuming the other usual conditions are satisfied (80% voting power in the Australian company for at least 12 months).

A zero source tax rate is also provided for dividends received by or on behalf of governments if they hold no more than 10% of the voting power in the paying company, particularly for government investment funds. The EM records an agreement between the countries that the Future Fund (and some other funds) qualify under this provision. Until now this kind of exemption was only expressly granted by tax treaties in relation to interest. The treaty thus in effect recognises sovereign immunity in relation to dividends as well as interest. The OECD has just released a discussion draft on the treaty treatment of sovereign wealth funds, including a suggested treaty provision similar to the one adopted in the new treaty but without the 10% voting power limit. Domestic legislation is still awaited in Australia on sovereign immunity. The treaty may provide some indication in relation to dividends what form that legislation may take. The new treaty does not make clear if the Future Fund can obtain such an exemption if it derives dividend income through an MIT. It could be argued that the fiscally transparent entity provision applies in this case and is not excluded by the MIT provision. The EM does not clarify the matter.

The new treaty handles the issue of dual resident companies in relation to dividends differently from the usual Australian approach. It specifically provides that if a dual resident company derives profits from one of the countries, that country may tax dividends out of those profits at the rates permitted generally by the dividends article even though the treaty dual residence tie-breaker assigns the company to the other country. Otherwise a country cannot tax dividends paid by a company that is treaty resident in the other country even though out of profits derived in the first country.

The zero rate for interest paid by financial institutions is only available in New Zealand if the payer of the interest has paid NZ approved issuer levy. This levy in effect removes interest withholding tax under New Zealand domestic law. The treaty effectively limits the amount of such a levy to 2% (the current rate) and also provides that if New Zealand grants a zero rate on interest under another treaty without the condition of payment of the levy, then New Zealand will negotiate a similar rule with Australia. Otherwise the usual 10% treaty interest rate is applicable.

The dividends, interest and royalties articles all have the treaty shopping provision that has become common in recent Australian treaties to the effect that if it was the main purpose or one of the main purposes of the creation or assignment of the income or property giving rise to the income to obtain the benefits of those articles, then the rate limits in them do not apply. The provisions have the novelty among Australian treaties of requiring competent authority consultation before being applied.

Alienation of property

The alienation of property article generally follows the form that first appeared in the new Australia France treaty in 2006 after Australia had announced the reform of the international CGT rules in 2005. It thus prevents Australia levying CGT on sales by New Zealand residents of shares in Australian companies unless they are land rich.

The main novelty is that if an individual elects to defer taxation on losing Australian residence and becoming a New Zealand resident with respect to property other than taxable Australian property, then Australia may tax any alienation in that income year or the following six income years. Other recent treaties prevent the levy of Australian CGT in these circumstances. The EM suggests that this provision was regarded by Australia as necessary in the case of New Zealand as it does not have a general CGT.

Employment and pensions

The employment income article has two important variations from the usual form. The exemption from source taxation where the employee is not present in that state for 183 days in a 12 months period and is not an employee of a resident of that state or a PE in that state is extended to cover cases where the employer is a resident but the employee works for a PE in the other state. For example, if an Australian resident works for an Australian PE of a New Zealand resident company and goes to work in New

Zealand for less than 183 days, New Zealand will not be able to tax the salary referable to the work in New Zealand. In addition, there is an exemption if a person resident in one state is seconded to work in the other state for 90 days or less in a 12 month period. These extensions to exemption from source taxation presumably were considered important because employees commonly commute across the Tasman for short periods.

As with the current New Zealand treaty, fringe benefits tax is also covered by the new treaty (one of two Australian treaties to do so). The EM makes clear that the article on taxing rights over fringe benefits applies not only to employees covered by the general employment income article but also to those covered by the government services article. Presumably the same applies to entertainers and sportspersons who are employees. The article continues to confer exclusive taxing rights over fringe benefits on the country with the primary taxing right – the source country if source taxation of salary or wages is permitted under the relevant article, otherwise the residence country of the person subject to tax on the fringe benefits. The EM also makes clear that the article applies not only to benefits subject to FBT in the hands of the employer but also fringe benefits taxable to the employee.

The definition of fringe benefit is thus of crucial importance to the scope of the article but it is a non-definition – a fringe benefit includes a benefit! The definition makes clear that options over shares arising under an employee share scheme are excluded which suggests that shares acquired under an employee share scheme are a fringe benefit. There are many conundrums as to the extent of operation of the article but they have been there since 1995.

Prior to the effective repeal of the foreign services income exemption in Australia in 2009, the international operation of the FBT and income tax generally marched in step in Australia in that if New Zealand as the source country had the right to tax wages it had the exclusive right to tax fringe benefits and the foreign services exemption applied to the wages so that no Australian tax was payable. Now the interaction of the income tax on wages and FBT will be more complicated.

Footballers and other sportsperson playing in Trans-Tasman leagues will be pleased that the current league exemption continues and has been expanded to cover the Super 14 (it is no longer confined to leagues operating only in Australia and New Zealand).

And pensioners will be glad that Australia and New Zealand have mutually recognised their exemptions of most pensions from tax. The EM provides an elaborate discussion of how this will operate but in general an Australian with a tax exempt private pension in Australia can now happily retire to New Zealand. The countries did agree, however, that financial products in the form of annuities are more appropriately treated as giving rise to interest and the interest article will apply to the interest element of the annuity. Lump sums paid in consequence of retirement etc are taxable only at source (the

country where the paying fund is established) so that if the source country levies no tax they also are totally tax free between the two countries.

Administrative cooperation and arbitration

In 2005 Australia and New Zealand signed a Protocol introducing the latest OECD standards on exchange of information and assistance in collection. Not surprisingly these changes are continued in the new treaty in identical form.

In addition for the first time in an Australian treaty, there is a provision for arbitration if the competent authorities cannot settle certain matters under the mutual agreement procedure. The OECD introduced arbitration into the Model in 2008 and the new treaty follows suit though it falls short of the OECD standard. For the time being the procedure will be limited to “issues of fact” though there is power to extend it to other matters by exchange of diplomatic notes. Moreover the provision will only commence following an exchange of diplomatic notes for that purpose, rather than when the rest of the treaty commences.

The OECD 2008 Commentary contains an extended analysis of this provision together with a standard mutual agreement to be used for establishing the arbitration procedure etc. The EM indicates that agreement on procedures will be part of the process of exchanging notes to start up the arbitration provision. Once it starts arbitration will be available to any case that meets the necessary conditions for any mutual agreement *commenced under the new treaty*. This effectively means at least a two year delay before an arbitration can occur as arbitration only becomes available after two years from commencing a competent authority proceeding.

Transition and consultation

Because the Bill has been introduced at the end of the 2009 Parliamentary sittings in Australia and Parliament does not commence again until February 2010, getting the treaty up and fully operative in 2010 is going to be a close run thing.

It will be necessary for all Parliamentary and other procedures in each country to be completed and diplomatic notes exchanged confirming the completion of such processes before 1 April 2010. Then the treaty would commence for New Zealand tax by assessment for the year starting on 1 April 2010 as well as for the Australian FBT year starting then. If this timeline is achieved then for Australian tax by assessment the new treaty will commence for income years starting on or after 1 July 2010. If procedures are completed after 31 March but before 1 July 2010 then it will be an April 2011 start date for New Zealand tax by assessment and Australian FBT.

As usual withholding tax changes that arise under the treaty start on the first day of the second month next following the date on which diplomatic notes have been exchanged indicating that each country has completed its

internal processes. If such exchange occurs in March 2010 the withholding tax changes will start on 1 May 2010.

The new treaty contains the five year consultation provision that was also included in the 2003 UK treaty. Hence it can be expected that a Protocol for the new treaty will be forthcoming around 2015 to deal with emerging issues.

Australia's new treaty policy?

In January 2008 the then Assistant Treasurer announced a review of Australia's treaty policy. In June 2008 he announced some new directions (which were largely already occurring in treaties in the period up to the announcement) promising further details in due course. Now some 17 months later it seems likely that no announcement will be forthcoming and we will be left to deduce Australia's new treaty policies from actual treaties as they emerge. The difficulty in this process is that it is not always easy to tell whether the policy novelty comes from Australia or the other country.

Compared to other recent Australian treaties, the New Zealand treaty has the most novelties since the 2001 US Protocol and may indeed signal several new policy directions in Australian tax treaties. Only time will tell.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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