International treaty examination of the Convention between New Zealand and Australia for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion

Report of the Finance and Expenditure Committee

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Recommendation

The Finance and Expenditure Committee recommends that the House take note of its report.

The Finance and Expenditure Committee has examined the Convention between New Zealand and Australia for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion. The National Interest Analysis for the treaty is appended to this report.

This convention will replace the earlier agreement on double taxation with Australia, which is now 14 years old. It will implement new withholding rates that reflect those recently agreed with the United States, and ensure that New Zealand's agreement with Australia is up-to-date in terms of treaty practice by including provisions for arbitration and non-discrimination. It will also correct specific trans-Tasman problems, such as the treatment of pensions (by ensuring that pension benefits are exempt in the country of residence to the extent that they would be exempt in the country of source) and the way income from employment is taxed where the employee is on a short-term secondment to an organisation in the other country (income from secondments that do not exceed 90 days will not be taxed in the country to which the person is seconded).

Appendix A

Committee procedure

The International treaty examination of the Convention between New Zealand and Australia for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion was referred to us by the Foreign Affairs, Defence and Trade Committee on 12 October 2009. We met on 18 and 25 November and 9 December 2009 to consider the convention, and heard evidence from the Inland Revenue Department.

Committee members

Craig Foss (Chairperson)
Amy Adams
David Bennett
John Boscawen
Brendon Burns
Charles Chauvel (to 18 November 2009)
Hon David Cunliffe
Aaron Gilmore
Raymond Huo (from 18 November 2009)
Rahui Katene
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Stuart Nash
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Appendix B

Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits

National Interest Analysis

Executive summary

The Convention between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits ("the new DTA") has been negotiated to replace an existing agreement with Australia ("the existing DTA") that dates back to 1995. The new DTA updates the existing DTA to reflect changes in each country's treaty policy and provides solutions to particular trans-Tasman taxation issues that have been identified. The new DTA will provide greater certainty in the taxation of cross-border investment income, reduce compliance costs and reduce withholding tax rates on dividends and royalties (the withholding tax rates are the same as those used in the recent *Protocol amending the Convention between New Zealand and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* ("the Protocol to amend the New Zealand/United States DTA")). Given the significance of the economic relationship between New Zealand and Australia, and the importance of trans-Tasman investment, it is essential that arrangements governing double taxation between New Zealand and Australia are kept up to date.

Accordingly, the new DTA commits both countries to consult each other at least once every five years with a view to determining if further revisions would be appropriate.

Date and nature of proposed binding treaty action

It is proposed that the new DTA be signed as soon as practicable after Cabinet authorisation is issued. Subsequent to signature and satisfactory completion of the Parliamentary treaty examination process, it is proposed that the new DTA be incorporated into domestic legislation through an Order in Council, and brought into force, in accordance with Article 30 of the new DTA, through an exchange of diplomatic notes that confirm completion of all necessary domestic procedures for entry into force in each country.

In the case of New Zealand, the provisions of the DTA that relate to withholding taxes will have effect from the first day of the second month following entry into force. Otherwise, the DTA will apply to income years beginning on or after 1 April following entry into force. (In the case of Australia, the date of effect for withholding taxes is the same as for New Zealand. However, the DTA provisions relating to fringe benefits have effect from 1 April following entry into force, and otherwise the DTA will have effect from 1 July following entry into force.)

As a provision of the new DTA comes into effect in accordance with Article 30(1), the equivalent provision of the existing DTA will cease to have effect. The existing DTA will terminate once all of its provisions cease to have effect.

Reasons for New Zealand becoming party to the treaty

New Zealand's DTAs are bilateral international treaties that are principally designed to encourage growth in economic ties between countries. They do this by reducing tax impediments to cross-border trade and investment. More specifically, they provide greater certainty of tax treatment, eliminate double taxation, reduce withholding taxes on cross-border investment returns and exempt certain short-term activities from income tax in the host state.

DTAs also enable the tax administrations of each country to assist each other in the detection and prevention of tax avoidance and evasion. DTAs do this primarily by establishing a mechanism for exchanging information between the two tax authorities.

New Zealand's existing DTA with Australia (concluded in 1995) is, in comparison with many of our other DTAs, relatively new. It is, however, New Zealand's most important tax treaty. Around half of all direct investment from New Zealand goes into Australia, as does about a quarter of total outbound investment. Similarly, about half of all direct investment into New Zealand, and almost a third of total inbound investment, comes from Australia.

The new DTA is intended to ensure that the arrangements governing double taxation between New Zealand and Australia are up-to-date and that they will provide the maximum possible levels of certainty and protection for tax residents of the two countries who choose to enter into cross-border transactions or who otherwise derive income from the other country. The new DTA also provides solutions to particular trans-Tasman taxation issues that have been identified. Finally, it includes lower withholding tax rates, mirroring those already agreed with the United States (in the Protocol to amend the New Zealand/United States DTA, signed on 1 December 2008).

Advantages and disadvantages to New Zealand of the treaty entering into force

There are several important ways in which the new DTA is different from the existing DTA:

- it includes some non-standard DTA provisions designed to provide solutions to particular trans-Tasman problems;
- it reduces withholding tax rates, mirroring those rates that New Zealand has already agreed with the United States;
- it limits source taxation and reduces compliance costs on certain short-term activities;
- it improves co-operation between tax authorities; and
- it deals with numerous technical issues to ensure the arrangements governing double taxation between New Zealand and Australia are up-to-date and provide certainty for taxpayers.

We consider that the overall package represents a definite improvement on the existing DTA. Further details on the advantages / disadvantages of specific changes are outlined below.

The new DTA is expected to reduce New Zealand tax revenues by around $10m per annum. This is largely attributable to the lower withholding tax rate on royalties.

The existing DTA currently provides adequate double taxation arrangements for New Zealand and one option could be to leave the existing DTA in place. However, there are a number of troublesome issues, such as double taxation of pensions (see below for more details), that exist under the existing DTA and are addressed in the new DTA. Furthermore, given the level of economic integration with Australia it is very desirable to ensure that double taxation arrangements between our two countries remain up-to-date so that they provide the maximum level of protection and certainty for investors. Otherwise New Zealanders who invest or carry out activities in Australia could face higher compliance costs or harsher tax treatment than comparable investors from other countries.

Solutions to trans-Tasman issues

Due to the close relationship with Australia, the new DTA text includes some non-standard DTA provisions designed to provide solutions to particular trans-Tasman problems – specifically the allocation of taxing rights for pension payments, income from secondments and income derived by sportspersons. In all of these areas New Zealand's high degree of labour mobility and economic integration with Australia can create compliance costs that are not commensurate with the risks to the tax base. The new DTA takes a more flexible approach on these issues in order to reduce these compliance costs.

Pensions (Article 18)

The new DTA includes a trans-Tasman tailored solution to the issue of double taxation of pension benefits.

Normally, New Zealand has a preference for residence taxation of pensions in DTA negotiations. If a resident of a DTA partner moves to New Zealand, we prefer to preserve our right to tax their pension under the DTA. The quid pro quo is that when a recipient of a New Zealand pension moves to the jurisdiction of a DTA partner, that country reserves its right to tax the New Zealand pension.

Accordingly, under the existing DTA, when a New Zealander moves to Australia, benefits received from a New Zealand pension scheme are subject to Australian tax. If, however, the person had stayed in New Zealand, no tax would be payable when they receive their pension benefit. This means that a person who has paid into a pension scheme in New Zealand and moves to Australia will be worse off than a person who stays in New Zealand. This amounts to double taxation (as New Zealand has already taxed the income as it accrued in the pension scheme) and Australian pensioners that move to New Zealand face the same problem. In recent years a number of groups that represent pensioners, as well as individual New Zealand pensioners resident in Australia, have argued that this result is unfair.

Because of the unique trans-Tasman relationship between New Zealand and Australia, it is particularly important to resolve this issue. The new DTA will resolve the economic double taxation of pensions by providing that pensions that would be exempt in the home country remain exempt in the country to which the recipient has retired. Lump sum pension benefits will be taxed only in the state where the pension is sourced, and not in the country to which the recipient has retired.

These new rules will ensure better outcomes for New Zealand and Australian pensioners who move across the Tasman. However, it is not intended to change our preferred DTA policy (residence taxation of pensions) more generally. While there may be some risk that the new DTA with Australia will create an adverse precedent for future DTA negotiations, we consider this to be manageable, partly because the trans-Tasman relationship is unique, and partly because the rule is most appropriate where both countries tax pensions on a similar basis (unlike New Zealand and Australia, many countries do not exempt pension benefits).

The new rules for pension benefits will also apply to ACC payments.

Secondments (Article 14(4) and (5))

The new DTA reduces compliance costs for short-term secondments.

Under the existing DTA salaries and wages from secondments are taxable in the country in which the service is performed. There are large numbers of short-term secondments across the Tasman, in both directions. Imposing source taxation on these secondments creates significant compliance costs for Australian and New Zealand businesses while producing little net revenue for either country.

The new DTA will address this issue by providing that secondments that do not exceed 90 days in a twelve month period will not be taxed in the country to which the person is seconded.

Sportspersons (Article 17)

Sportspersons can earn large amounts of income in very short periods of time. Accordingly, tax treaties typically provide that such income always remains taxable in the country in which the service is performed. To reduce compliance costs this rule does not currently apply to trans-Tasman sporting leagues such as the National Rugby League. The new DTA extends this exclusion to Australian and New Zealand teams participating in competitions that also involve teams from outside Australia and New Zealand (such as the Super 14 Rugby competition).

The exclusion does not apply to national representative teams competing in international competitions such as the rugby world cup. Existing domestic law provisions exempt foreign national representative teams competing in New Zealand.

Reductions in withholding tax rates (Articles 10, 11 and 12)

The new DTA introduces reductions in withholding taxes, consistent with the broader strategy on treaty withholding tax rates. The main objective of that strategy is to reduce withholding taxes on foreign non-portfolio dividends received by New Zealand residents.

This will reduce tax barriers for New Zealand businesses with direct investments offshore, making it less costly to repatriate foreign profits back to New Zealand where they can be reinvested or distributed to shareholders.

Lower rates for foreign withholding tax on inbound dividends will complement the proposed international tax reforms, which are also intended to facilitate offshore investment by New Zealand businesses. Those reforms include exempting the active income of foreign companies controlled by New Zealand residents and exempting most foreign dividends received by New Zealand companies. Together, these changes will bring New Zealand's domestic law and treaty network more closely into line with international norms. This will help New Zealand firms to compete on more equal terms in foreign markets. It will also improve the competitiveness of the New Zealand tax system, reducing incentives for firms to migrate to other jurisdictions.

The standard withholding tax rate on dividends remains at 15% in the new DTA. However, this rate is reduced from 15% to 5% if the investor is a company that has at least a 10% shareholding in the company paying the dividend, and from 15% to 0% if the investor is a company that has an 80% or higher shareholding and satisfies certain other requirements.

The new DTA also lowers withholding tax rates for interest paid to financial institutions and for royalties. This is less attractive from New Zealand's perspective since these taxes provide some protection against companies shifting their profits out of New Zealand in order to reduce their tax liabilities. However, some lowering of these rates is acceptable as part of the wider package. The potential impact on the New Zealand tax base is mitigated by two factors. First, a positive rate (5%) has been retained for withholding tax on royalties. Second, the new DTA allows New Zealand to retain its approved issuer levy for borrowers paying interest to an Australian financial institution - although this does effectively "lock in" the approved issuer levy and cap it at 2% with respect to Australian financial institutions.

The new DTA amends the definition of royalties so that it now excludes payments for leased equipment. This means that New Zealand would no longer be able to tax lease payments for Australian-owned equipment used in New Zealand unless the lessor has a permanent establishment in New Zealand. This change limits New Zealand's ability to tax equipment lease payments, but is not unprecedented and is acceptable in the context of the wider package. Again, the change is reciprocal.

Limits on source taxation to reduce compliance costs

Compared to the existing DTA, the new DTA reduces New Zealand's ability to tax income earned by Australians which carry out certain short-term activities here. This will reduce business compliance costs but may have a small revenue cost at the margins. Because the changes are reciprocal there may be some offsetting savings to the extent to which New Zealand businesses perform short-term activities in Australia. The fiscal impact either way is not expected to be significant.

Deemed Permanent Establishments (Article 5)

In line with international norms, our double tax agreements only allow us to tax activities carried on in New Zealand by an enterprise of the other Contracting State if that enterprise has a "permanent establishment" here. (This principle applies reciprocally.)

Typically, certain activities are deemed to give rise to a permanent establishment (assuming one does not already exist) – including the exploration for or exploitation of natural resources and the operation of substantial equipment. Under the existing DTA such activities were deemed to be permanent from the first day of an enterprise's operation. The new DTA with Australia introduces minimum time periods that must pass before a permanent establishment is deemed to exist. In future, the exploration for or exploitation of natural resources or standing timber will only give rise to a deemed permanent establishment if activities are carried on for more than 90 days. The operation of substantial equipment will only give rise to a deemed permanent establishment if carried on for more than 183 days.

Similar time limits are already a standard feature of our other tax treaties and help to minimise compliance costs for firms by ensuring that short-term or transitory activities in another country do not trigger a taxable presence there.

Personal Services (Article 14(2))

The new DTA also reduces the circumstances in which New Zealand can tax services performed by a visiting Australian individual. The existing DTA allows a State to tax personal services if an individual from the other State is present there for more than 183 days in a 12 month period, regardless of whether they have a "permanent establishment" there. The new DTA only allows the State to tax personal services if the 183 limit is exceeded *and* certain other requirements are met, namely that either:

- more than 50 per cent of revenue from the business activities of the enterprise are from the services performed in the State through the individual, or
- the services are performed for the same or connected projects through one or more individuals present in the other State.

There is an exception to the provisions governing tax on personal services in the new DTA which applies to irregular, infrequent periods of presence of not more than 5 days. This is designed to reduce compliance costs for trans-Tasman businesses. These irregular, infrequent periods will not count towards the 183 day limit.

Non-discrimination (Article 24)

The new DTA includes a non-discrimination article (Article 24) that prohibits discrimination on the grounds of nationality, situs of an enterprise, ownership of capital, and (in limited circumstances) residence. The existing DTA has a more limited non-discrimination article based on an alternative provision, preferred by New Zealand, which only requires that non-residents are treated in a comparable manner to other non-residents, rather than as New Zealand residents.

Compared to the existing DTA, the new DTA provides greater certainty for foreign investors that they will not be treated more harshly than other taxpayers. However, the increased certainty for foreign investors comes with an increased risk to the New Zealand government of legal challenge for an alleged breach of the non-discrimination provision of the new DTA. The risk of legal proceedings under the non-discrimination article is minimised by carve outs for:

- Laws designed to prevent the avoidance or evasion of taxes (including rules preventing thin capitalisation and dividend stripping, plus transfer pricing, controlled foreign company and foreign investment fund rules);
- Specific regimes covering the transfer of assets offshore, consolidation rules for companies, transfers of losses within group companies, tax rebates, credits in relation to dividends and research and development expenditure deductions; and
- Anything otherwise agreed by the Contracting States.

These carve-outs are broad enough to protect our existing tax regimes, while also allowing some flexibility for future policy-making and base protection measures. They provide significant protection against the risk of legal challenge for an alleged breach of the non-discrimination provision of the new DTA .

Improves co-operation between Tax Authorities

The new DTA will improve the already strong working relationship between Australian and New Zealand tax authorities by:

- allowing tax information from the other country to be used for any important purpose authorised by domestic law (such as, for example, data matching with other Government agencies) (Article 26);
- allowing taxpayers to request arbitration in cases brought under the DTA where New Zealand and Australian tax authorities have been unable to reach an agreement to resolve the case within two years of the case being presented to the competent authorities (the competent authority for New Zealand is the Commissioner of Inland Revenue, although the role is usually delegated) under the mutual agreement procedure (Article 25); and
- requiring both countries to consult each other at least once every 5 years, with a view to ensuring that the DTA remains up to date (Article 29).

Further detail on these changes is outlined below.

Exchange of Information (Article 26)

Article 26 on the Exchange of Information enables tax authorities of the two countries to exchange certain types of information for the purpose of detecting and preventing tax avoidance and evasion.

An additional paragraph has been added that potentially extends the purposes for which exchanged information can be used. The paragraph provides that information can be used for such other purposes as are permitted under the laws of both States if (and only if) the competent authority of the supplying State authorises such use.

This paragraph is an optional provision suggested by the OECD. New Zealand does not usually include this paragraph in its tax treaties. However, given the particularly close relationship with Australia, it was considered appropriate in this case. The paragraph will allow tax authorities to use information exchanged under the new DTA for any important purpose authorised by domestic law (such as, for example, data matching with other Government agencies), but in each case will be required to obtain specific approval from the competent authority of the country that supplied the information.

Arbitration (Article 25(6) and (7))

The new DTA is the first DTA for either country to include an arbitration provision. The provision will allow taxpayers to request arbitration in cases brought under the DTA where New Zealand and Australian tax authorities have been unable to reach an agreement to resolve the case within two years from the presentation of the case to both competent authorities under the mutual agreement procedure. The provision prevents a case being submitted to arbitration if a decision on the issue has already been reserved or rendered by a tribunal of either Contacting State. In practice, given the strong working relationship between the Australian and New Zealand tax authorities, and the carve outs from the non-discrimination Article, arbitration is unlikely to be required very often, if at all.

Arbitration is taxpayer favourable. It provides certainty for business that any cases of double taxation will be resolved in a timely and efficient manner. It takes place at the taxpayer's request. If a person directly affected does not agree with the outcome, it does not prevent them from pursuing domestic legal remedies.

Arbitration also has certain benefits from a government perspective. It provides an independent mechanism for ensuring tax on cross-border transactions is shared fairly between relevant jurisdictions. This is likely to favour countries, such as New Zealand, that already seek to apply best international practice in the application of their tax treaties.

There are potential costs to the government from including arbitration in the new DTA – although, in practice, these are not expected to be significant. These include:

- The administrative cost of arbitration proceedings. Such costs are likely to be modest since very few cases are likely to go to arbitration. In New Zealand's experience, only a small number of mutual agreement cases have been brought by taxpayers under our DTAs (11 in the last 3 years[1]), and the average time to resolve a case was less than six months, well within the two years that must elapse before a case can be sent to arbitration.

- The revenue cost of adverse decisions. Arbitration might produce a decision on a specific case that was unfavourable to New Zealand, at a fiscal cost. Taxpayers are already able to seek legal redress against Inland Revenue through the courts. The fiscal risks here are analogous.

[1] Statistics were not kept prior to 2006, but there were no outstanding cases at the beginning of 2006.

Opportunity to update the DTA every 5 years (Article 29)

Given the significance of the economic relationship between New Zealand and Australia, and the importance of trans-Tasman investment, it is essential that arrangements governing double taxation between New Zealand and Australia are kept up to date. Accordingly, the new DTA commits both countries to consult each other at least once every five years with a view to determining if further revisions would be appropriate (Article 29(1)).

Technical Clarifications

The new DTA clarifies numerous technical aspects to ensure the arrangements governing double taxation between New Zealand and Australia are up-to-date and provide certainty for taxpayers. The main technical changes are explained below.

Fiscally Transparent Entities (Articles 1(2) and 23(3))

The new DTA includes new provisions clarifying its application to fiscally transparent entities. Similar provisions were also included in the Protocol to amend the New Zealand/United States DTA.

A fiscally transparent entity is one that is disregarded for tax purposes, with tax imposed directly on the owners or shareholders, as happens with general partnerships. The appropriate treatment of such entities under a double tax agreement is not always obvious, particularly when the two Contracting States classify them differently for domestic law purposes. New Zealand's policy is to deal with such entities in accordance with international norms as laid down by the OECD in its 1999 report, *The application of the OECD model tax convention to partnerships*. Articles 1(2) and 23(3) of the new DTA are consistent with the policy in that report.

Residence (Articles 1(1) and 4)

Article 1 provides that the treaty only applies to persons who are residents of one or both of the Contracting States. Entitlement to benefits under the new DTA therefore depends on being resident in at least one country. Residence is determined in accordance with rules set out in Article 4 of the new DTA. Those rules have been modernised to make them more relevant to the current business environment and also to clarify that political entities are entitled to benefits under the new DTA.

The application of the rules for determining residence can result in a person being a resident of both countries. In such cases, Article 4 contains additional rules for determining how to "break the tie". (That is, for determining sole residence to one or other of the two countries.) There are separate tie-breaker rules for individuals and for non-individuals.

The tie-breaker rules for individuals have been modernised, although the basic tests remain the same. There are four tests, each of which is to be applied in turn until one is found that is determinative. The tests look successively at where the person has their permanent home, centre of vital interests, habitual abode and, finally, citizenship. In our DTAs with other countries, dual-residence is usually resolved within the first two tests, and the third test, habitual abode, is seldom reached. In the New Zealand-Australia context (with freedom of movement across the Tasman), the habitual abode test is more relevant. However, this can be problematic as there are no clear guidelines as to what "habitual abode" means. In the negotiations, officials agreed in principle that the better interpretation of "habitual" is "normal" rather than "more usual". That is, the place a person comes back to out of choice rather than where they spend the bulk of their time (which can be dictated by factors such as work requirements.) It was also agreed that, in the unlikely event that dual-residence of individuals remains unresolved after the application of all four steps, it remains open to the two sides to settle the issue by mutual agreement under the Mutual Agreement Procedure Article of the new DTA (Article 25).

The tie-breaker rules for non-individuals (that is, for entities such as companies) have been updated, both for additional clarity and also to address concerns that dual residence can be manipulated for tax avoidance purposes. The general test of determining where the entity has their place of effective management remains the same. However, as this is not always determinative, recourse to a second step of resolving the matter by mutual agreement has been added. Where either country is concerned that difficulties in resolving dual-residence arise from deliberate attempts to manipulate residence in order to gain a tax advantage, the two sides may fail to reach mutual agreement. In such a case, the new DTA specifically provides that the entity is not entitled to any benefits under the new DTA.

Dual listed companies (Article 4(6))

The new DTA includes a separate provision for settling the residence of companies which are listed on the stock exchanges of both companies ("dual-listed companies"). Rather than applying the ordinary "tie-breaker" rules referred to above, dual-listed companies are deemed to be resident in the country in which they are incorporated (so long as they have a primary stock exchange listing in that country). This clarification will provide more certainty for dual-listed companies.

Transitional Residents (Article 4(4))

Under New Zealand domestic law, transitional residents (i.e. new migrants) are exempt from tax for four years on certain income that they earn offshore. The new DTA clarifies that transitional residents will not get relief from Australian tax in respect of this exempt income.

Australia has a similar exemption for individuals on temporary residence visas. However, New Zealand does not have the same DTA policy of denying treaty protection in this circumstance. Accordingly, the provision in the new DTA is unilateral.

Managed Investment Trusts (Article 4(7))

Article 4 is amended so that Australian managed investment trusts (MITs) are treated as "individual" residents of Australia for the purposes of the new DTA. This amendment clarifies that, subjection to meeting certain ownership conditions, an Australian MIT will qualify for protection under the new DTA in respect of its investments in New Zealand. However, it has the status of an individual resident in Australia. Accordingly, it only qualifies for the same benefits of an Australian resident individual. This is important for determining the relevant rate of non-resident withholding tax (NRWT) that New Zealand is entitled to withhold under Article 10 of the new DTA.

MITs are widely-held 'flow-through' vehicles that distribute virtually all their income at regular intervals to their investors, with distributions being taxable only in the hands of individual investors and not at the entity level. Without this amendment, it is not clear that MITs would be entitled to the benefits provided by the new DTA. While individual Australian investors would be entitled to claim these benefits, there are major practical difficulties in any individual investors claiming benefits under the new DTA in relation to their underlying investments in New Zealand entities made through the MIT.

The extension of benefits to MITs under the new DTA is in line with emerging OECD treaty guidance on the treatment of collective investment vehicles which recognises the difficulty that individual residents face in claiming tax treaty benefits and suggests that there is often a good case for these to be claimed at the entity level. Making it explicit that only MITs that are at least 80% Australian-owned are entitled to treaty benefits provides the New Zealand tax base with a reasonable level of protection against treaty shopping.

The amendment to Article 4 deals only with Australian MITs. There is no equivalent flow through collective investment vehicles in New Zealand. Providing symmetrical treatment would have caused confusion about the scope of the provision. It is expected that Australia would agree to make the provision reciprocal if New Zealand did introduce widely held flow through investment vehicles like Australia's MITs.

Income from real property (Article 6)

New Zealand tax treaty practice generally follows Article 6 of the OECD Model by allocating taxing rights to all income derived from real property to the state in which the property is situated (i.e. the source state).

Australia has a long-standing tax treaty policy of not following the OECD Model with respect to business income from real property. Australia's standard tax treaty practice is to make business income from real property subject to the principles of Article 5 (permanent establishment) and Article 7 (business profits) of the new DTA, not comprehensive source taxation under Article 6 of the OECD Model.

Article 6 of the new DTA reflects a compromise between the New Zealand and Australia positions. Under the new provision, source taxation will apply to all income from real property earned by an enterprise of the other Contracting State. In particular, Article 6 is consistent with New Zealand's tax treaty preferences in that business income from fishing, agriculture and forestry are within its scope. Also important to New Zealand, both naturally-occurring forests and plantation timber are subject to source-based taxation.

However, in line with Australian tax treaty policy the new Article provides that certain principles relating to business profits under Article 7 are also applicable. These principles are that the enterprise's profits from real property will be calculated on an arm's length approach (as if it were separate from the enterprise's other operations) and that taxation will be on a net basis. In practice, it is unlikely that these deviations from the OECD Model will make a significant difference to how income from real property is currently taxed.

There is a risk that this departure from our usual tax treaty practice will create a precedent going forward. However, this risk is manageable given that Australia's position on the treatment of income earned from real property is a departure from the OECD Model. We also note in this regard that the text of Article 6 of the existing DTA with Australia also differed from the OECD Model provision. Yet virtually all of our other treaties are consistent with the OECD Model (the other exception is the 1998 DTA with Thailand).

Shipping and Air Transport (Article 8)

The wording of Article 8 has been modernised in the new DTA, and clarification has been added to provide greater certainty in respect of certain leasing arrangements and the use of containers. However, in substantive effect the Article is unchanged.

Obligations which would be imposed on New Zealand by the treaty action, the position for reservations to the treaty, and an outline of any dispute settlement mechanisms

DTAs do not impose requirements on taxpayers. The obligations they impose are on the Contracting States. The obligations that will be imposed on New Zealand by the new DTA with Australia are in substance the same as under the existing DTA. These are:

- to limit taxing rights, on a reciprocal basis with Australia, in accordance with the rules set out in the DTA;
- in cases where the DTA permits both countries to impose tax, to relieve double taxation by means of a foreign tax credit mechanism, in accordance with the rules set out in the DTA;
- to provide assistance to the Australian Taxation Office, on a reciprocal basis, by exchanging tax related information and collecting unpaid taxes from absconding taxpayers;
- to enter into consultation with the Australian Taxation Office, as appropriate, with a view to attempting to resolve disputes;
- to agree to arbitration where disputes cannot be mutually resolved by the two tax administrations (but only in relation to issues of fact or other issues specified in an exchange of diplomatic notes between the two countries).

The new DTA will not (and cannot) require the imposition of a tax that is not already imposed under domestic law. That is, where the DTA allocates New Zealand a taxing right, New Zealand needs to have a corresponding taxing provision under domestic law before it can take up that taxing right. A DTA can therefore only restrict taxing rights. It cannot extend them.

When income is derived from one country ("the country of source") by a tax resident of the other country ("the country of residence") the country of residence generally always retains taxing rights. The main impact of a DTA is to restrict the ability of the country of source to tax the income in certain circumstances. Where both countries are permitted to tax the income, a DTA requires the country of residence to provide a credit for the tax imposed by the country of source. With the exception of the new withholding tax rates, the rules for allocating taxing rights under the new DTA are substantively unchanged from the existing DTA. They provide as follows:

Income from real property will generally be taxed in the country where the property is situated (Article 6 refers);

Business profits will generally be taxable only in the country where the business is resident. However, the profit attributable to a permanent establishment situated in the other country may be taxed in that country. A permanent establishment generally exists in the country in question when there is a fixed place of business where the business of an enterprise is carried on (Articles 5 and 7 refer);

Profits of an enterprise of a country from the operation of ships or aircraft shall be taxable only in that country, subject to various rules applicable in specific situations (Articles 7 and 8 refer);

Dividends, interest and royalty payments made between New Zealand and Australia may generally be taxed in both countries. However, the country from which the payment originates cannot impose tax at a rate exceeding an agreed withholding tax rate which differs depending on whether the payment is a dividend, interest or royalty. The other country, where the payment is received, must reduce its own tax on the payment to compensate for any withholding tax imposed on the payment in the payment's country of origin. This enables both countries to tax the payment, whilst ensuring the payment is not excessively taxed.

- The maximum withholding tax rate that each country can impose on **dividends** received by a resident of the other country is:
  - 0% if it is paid to a company in the other country that owns (directly or indirectly) 80% or more of the shares in the company paying the dividend and meets certain other requirements;
  - 5% if paid to a company in the other country that owns (directly or indirectly) 10% or more of the shares in the company paying the dividend;
  - 15% in all other cases. (Article 10 refers);
- The maximum withholding tax rate that each country can impose on **interest** received by a resident of the other country is:
  - 0% if the interest is paid to a lending or finance business, provided in the case of interest that originates in New Zealand that the 2% approved issuer levy is paid;
  - 10% in all other cases. (Article 11 refers);
- The maximum withholding tax rate that each country can impose on **royalties** received by a resident of the other country is 5% (Article 12 refers);

Specific rules apply to the taxation of income, **profits or gains derived from the sale of property**. In the case of real property the profits are taxable where the property is situated (Article 13 refers);

Income from employment will be taxable only in the country where the employee is resident, unless the employment is performed in the other country. In this case, the country where the employment is performed may also tax the income, if the employee is present for at least 183 days and various conditions are met. Specific exemptions apply for short-term secondments (Article 14 refers);

Directors' fees may be taxed in the country where the relevant company is resident (Article 15 refers);

Entertainers and sportspersons may be taxed in the country in which the activities of the sportsperson or entertainer take place (Article 16 refers);

Pensions are taxable in the country where the recipient is resident. An exemption applies to pensions that would have been exempt in the country where the pension is sourced. Alimony or maintenance payments are only taxable in the country where the payment was made. Lump sums will only be taxable in the source country (Article 17 refers);

Salaries and wages for services to a Government of one country are generally exempt from tax in the other country (Article 18 refers);

Students are generally not taxed on payments received from outside the country when those payments are for the maintenance and education of the student (Article 19 refers);

Measures which the Government could or should adopt to implement the treaty action, including specific reference to implementing legislation

Section BH 1 of the Income Tax Act 2007 enables DTAs to be given effect by Order in Council. Section BH 1 provides that DTAs will then override the Inland Revenue Acts, the Official Information Act 1982, the Privacy Act 1993, although generally only in relation to income tax. (The only exceptions are for exchange of information and collection assistance, which may relate to taxes other than income tax.) The override of the Inland Revenue Acts is necessary to give effect to the terms of a DTA, given that the Australian DTA requires New Zealand to forego some taxing rights imposed under those Acts. The Official Information Act is overridden to ensure that communications with other states during DTA negotiations are not disclosed. The Privacy Act is overridden to ensure that information can be exchanged regarding natural persons under the exchange of information provisions of the new DTA.

Subject to satisfactory completion of Parliamentary treaty examination, the Order in Council will be promulgated and will come into effect 28 days after being published in the Gazette.

Economic, social, cultural and environmental costs and effects of the treaty entering into force and the treaty not entering into force

The main economic effect of the new DTA will be to increase certainty of tax treatment and reduce compliance costs for New Zealand businesses that operate in Australia and vice versa. The new DTA will also reduce withholding taxes on dividends and royalties. This will increase New Zealand's attractiveness as a location for internationally-focused firms.

No social, cultural or environmental effects are anticipated.

Were the new DTA not to enter into force, the existing DTA would remain in place and the status quo position would be maintained.

Costs to New Zealand of compliance with the treaty

The new DTA is expected to reduce New Zealand tax revenues by around $10 million per annum.

This cost is largely attributable to the lower withholding tax rate on royalties. Based on 2005 to 2008 data, the static fiscal cost of halving the rate of withholding tax on royalties is estimated at $8 million.

Other fiscal impacts, which cannot be quantified precisely, are:

- the increased incentive for companies with non-resident shareholders to use deductible royalty payments to shift profits offshore. We expect a modest behavioural response, with some impact on the company tax base;
- the amended definition of royalties (that means that payments for leased equipment will no longer face royalty withholding tax).
- some reduction in revenue from changes that limit source taxation on certain short-term activities.
- the potential administrative and revenue costs from any proceedings brought under the new non-discrimination article or the new arbitration provision. These costs are not expected to be significant as very few mutual agreement procedure cases are likely to go to arbitration and the carve-outs to the non-discrimination article mean there is only a very remote risk of legal proceedings.

The new DTA also reduces the rates of withholding tax on non-portfolio dividends and interest paid to financial institutions. The fiscal cost associated with those changes is expected to be negligible because equivalent relief is already available under domestic law.

Completed or proposed consultation with the community and parties interested in the treaty action

Submissions were sought prior to negotiating the new DTA. 29 Submissions were received. These were taken into account when negotiating the new DTA.

The Treasury and the Ministry of Foreign Affairs and Trade have been consulted on and agree with the proposed treaty action.

Subsequent protocols and/or amendments to the treaty and their likely effects

The new DTA includes a treaty obligation for both countries to consult at least once every 5 years, with a view to ensuring that the DTA remains up to date. At this stage, no specific future amendments are anticipated. If the need to amend the new DTA arises, this can be achieved by means of a Protocol. New Zealand would consider proposed amendments on a case-by-case basis and any decision to accept an amendment would be subject to the normal domestic approvals and procedures.

Withdrawal or denunciation provision in the treaty

Article 31 of the new DTA provides that, after the expiration of a period of five years from the date of entry into force, either New Zealand or Australia may terminate the DTA. Notice of termination is to be made through diplomatic channels and must be given at least six months before the end of the calendar year in which it is made.

Adequacy statement

Inland Revenue has prepared this extended NIA and has assessed it as adequate in accordance with the Code of Good Regulatory Practice.

Prepared by: Inland Revenue

Date: the 15th of May 2009