Regulation impact statement

Background

How tax treaties operate

1.1 Tax treaties facilitate international investment by removing or reducing tax barriers to cross-border movement of people, capital or technology.

1.2 International taxation is based on concepts of residency and source. Countries generally tax their residents on their world wide income. Countries also seek to tax non-residents on the income that is earned (or sourced) within their borders.

1.3 Double taxation can therefore arise when the country of residence and the country where the income is sourced both seek to tax the same income.

1.4 Tax treaties reduce or eliminate double taxation by treaty partners agreeing in certain situations to limit taxing rights over various types of income. The respective countries also agree on methods of reducing double taxation where both countries exercise their right to tax. In the absence of rules to relieve the resulting double taxation, international commerce would be seriously inhibited.

1.5 In addition, tax treaties provide an agreed basis for determining the allocation of profits within a multinational company and whether the profits on related party dealings by members of a multinational group operating in both countries reflect the pricing that would be adopted by independent parties. Tax treaties are therefore an important tool in dealing with international profit shifting through transfer pricing.

1.6 To prevent fiscal evasion, tax treaties include provision for exchange of information held by the respective revenue authorities. Treaties may also provide for cross border collection of tax debts and may preclude certain types of tax discrimination. Taxpayers can also avail themselves of the mutual agreement procedures provided for in treaties which allow the two revenue authorities to consult with a view to developing a common interpretation and to resolving differences arising out of application of the treaty.

1.7 Australia seeks an appropriate balance between source and residence country taxing rights. Generally, the allocation of taxing rights

under Australian tax treaties is similar to international practice as set out in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model) (Australia being a member of the OECD and involved in the development of that Model). There are however, a few instances where Australian practice favours source country taxing rights rather than the residence approach of the OECD Model.

The New Zealand tax treaty

1.8 The existing Australia-New Zealand tax treaty was signed on 27 January 1995 and has been in effect in Australia since the income year commencing 1 July 1995 in respect of income taxes, and from 1 April 1995 for withholding taxes and fringe benefits tax. The 1995 treaty was amended in 2005 by insertion via a limited Protocol of additional integrity measures. However, the provisions of most interest to business and investors (including the rates of withholding tax applicable to dividends, interest and royalty payments) remained unchanged due to New Zealand undertaking an international tax review. New Zealand completed their internal review in December 2006.

1.9 On 28 January 2008, the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced the commencement of negotiations to revise the 1995 New Zealand tax treaty and its 2005 amending Protocol to enhance the mutual conduct of business.

1.10 The detriment to business from not modernising the existing New Zealand tax treaty and Protocol is difficult to assess and quantify. However, international consideration by such forums as the OECD and consultation with business has indicated that a modern tax treaty, including among other things reductions in withholding tax rates on payments to non-residents, provide a clear positive benefit to trade and investment relationships between the countries. Given the extent of Australia and New Zealand's trade and investment relationship it is important that these rate limits remain as up to date as possible with current treaty practice.

1.11 Taxpayers would also suffer from greater uncertainty in their tax affairs if other aspects of the tax treaty were not updated. For example, including provisions restricting the time in which transfer pricing adjustments and allowing taxpayers to have issues of fact resolved by arbitration in certain cases will provide greater certainty for taxpayers in their tax affairs. Both provisions would be included in a modernised New Zealand tax treaty.

1.12 Australian taxpayers would also suffer from having no protection from discrimination in the event New Zealand's tax system sought to impose more burdensome taxation on Australians, as the existing New Zealand treaty does not contain a *Non-discrimination* Article. A modernised treaty which incorporates a *Non-discrimination* Article would ensure Australian nationals and business are treated no less favourably than nationals and business of New Zealand in similar circumstances, and vice versa.

Australia's trade and investment relationship with New Zealand

Trade

1.13 New Zealand has been a major trading partner for many years. The economic and trade relationship between the two countries is shaped by the Australia New Zealand Closer Economic Relations Trade Agreement (known as CER), which came into effect in 1983. Since the CER came into effect, trade has increased at an average annual rate of nine per cent over the life of the agreement.

1.14 Based on trade in goods and services, New Zealand is now Australia's fifth largest market taking 5.2 per cent of our exports, and is the eighth largest source of imports for Australia. Australia is New Zealand's principal trading partner, providing 20.8 per cent of its merchandise imports and taking 22 per cent of its merchandise exports.

1.15 Two-way trade reached A$22.45 billion in 2007-08, with bilateral merchandise trade in 2007-08 accounting for approximately A$16.47 billion of this, with the balance of trade in Australia's favour. Two-way trade in services was valued at approximately $5.98 billion.

1.16 Total exports (goods and services) in 2007-08 were valued at A$12.9 billion. Key exports include refined petroleum, crude petroleum, passenger motor vehicles, and medicaments.

1.17 Total imports from New Zealand in 2007-08 were valued at A$9.5 billion. Imports comprised mainly of crude petroleum, gold, paper and paper board, and alcoholic beverages.

Investment

1.18 Two-way investment between Australia and New Zealand currently stands at over A$110 billion. New Zealand is Australia's sixth largest investor, with a total stock of investment worth A$32.4 billion at the end of 2006. New Zealand is the third largest market for Australian investment abroad, with Australia the largest investor in New Zealand. The total stock of Australian investment in New Zealand was worth

A$65.3 billion at the end of 2006. Over half of Australia's total investment in New Zealand is foreign direct investment, reflecting the high level of economic integration.

Policy objective

1.19 The objective of this measure is to:

- promote closer economic cooperation between Australia and New Zealand by further reducing taxation barriers to trade and investment between the two countries; and
- update the taxation arrangements between the two countries, including the insertion of provisions to prevent tax discrimination.

Implementation options

1.20 The implementation options for meeting the policy objectives specified above are:

- retain the existing Australia-New Zealand tax treaty; or
- conclude a second amending Protocol to amend certain aspects of the existing treaty and Protocol to reflect current policies; or
- conclude a new bilateral tax treaty.

Option 1: Retain the existing Australia-New Zealand tax treaty

1.21 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion, it has become outdated in many respects and no longer adequately reflects the current tax treaty policies and practice of Australia or New Zealand.

1.22 In particular, relying on the existing tax treaty means arrangements between Australia and New Zealand would not benefit from the move to lower withholding tax rate limits provided under Australia's most recent tax treaties. The existing treaty also does not contain other recent international developments, such as access to arbitration for taxpayers in certain circumstances where they have been taxed in a way that does not accord with the treaty. Relying on the existing treaty would

also mean there would be no protection for Australian nationals or business in the event of tax discrimination. Relying on the existing treaty would also mean that other barriers to conducting cross-border business activities would not be removed.

Option 2: A second limited amending Protocol — rely on the existing tax treaty and Protocol measures

1.23 This option would rely on the existing tax treaty and Protocol measures with an additional amending second Protocol covering both countries' desired changes. In view of the number of changes both partners wanted to make to update the existing treaty and Protocol to reflect the current tax treaty policies and practices of both countries, and the fact that the treaty already contained one amending Protocol, a second amending Protocol did not seem practicable in this instance.

Option 3: Conclude a new tax treaty

1.24 This option would replace the existing treaty and Protocol with a new bilateral tax treaty that reflects the current policies and practices of both countries.

1.25 A new tax treaty would be largely based on the current OECD Model, with some mutually agreed variations reflecting the economic, legal and cultural interests of the two countries.

1.26 Both countries have particular policy objectives to achieve in updating the tax treaty and the end result ultimately represents compromises necessary to achieve a mutually acceptable agreement. The key changes in a new treaty include:

- a reduction of the dividend withholding tax limit from 15 per cent to zero for dividends paid on portfolio investment by government bodies, and for intercorporate dividends on non-portfolio holdings of more than 80 per cent subject to certain conditions; five per cent dividend withholding tax limit for other intercorporate non portfolio holdings and 15 per cent dividend withholding tax limit for all other dividends;

- a reduction in the interest withholding tax limit from ten per cent to zero where interest is paid to:

  – government bodies and central banks; or

  - financial institutions, provided that in the case of interest paid from New Zealand, the New Zealand two per cent Approved Issuer Levy has been paid. A most-favoured-nation provision applies if New Zealand subsequently provides better treatment in respect of such interest in another treaty;

- a reduction in the maximum royalty withholding tax rate limit from ten per cent to five per cent;

- extending the meaning of 'royalties' to include spectrum licences. Leasing of industrial, commercial or scientific equipment will no longer constitute a royalty;

- clarifying the residence status of Australian managed investment trusts and entities participating in dual listed company arrangements to ensure these entities can access the treaty's benefits where appropriate;

- providing for profits from the provision of services performed in a country to be taxed by that country in certain circumstances;

- ensuring that profits derived from the operation of ships and aircraft in international traffic are generally taxed only in the country of residence of the operator;

- updating rules governing the taxation of income, profits or gains from the alienation of real property, and other capital gains;

- ensuring that employees' remuneration during certain short visits on secondment to one country are not taxed by the country visited;

- providing that pensions will not be subject to tax in the residence country when they are exempt from tax in the country from which they are sourced. Lump sum payments will only be taxed in the country in which they are sourced;

- providing certainty to taxpayers by restricting transfer pricing adjustments to within a seven year period except where an audit has been initiated or where there is fraud, gross negligence or wilful neglect;

- providing certainty to taxpayers by giving them access to arbitration where issues of fact resulting in taxation not in

accordance with the treaty cannot be resolved by the Australian and New Zealand tax authorities within two years; and

- providing new rules to protect nationals and businesses from tax discrimination in the other country.

Assessment of impacts

Difficulties in quantifying the impacts of tax treaties

1.27 Only a partial analysis of costs and benefits can be provided because all of the impacts of tax treaties cannot be quantified. While the direct cost to Australian revenue of withholding tax changes can be quantified relatively easily, other cost impacts such as compliance costs are inherently difficult to quantify. There are also efficiency and growth gains and losses to Australia that provide estimation problems. Analysis has been conducted to establish plausible impacts on Australian economic activity and consequent tax revenue flowing from implementation of the tax treaty. The tax revenue estimates are subject to more uncertainty than the estimates of costs but are best estimates given the technology of estimation, the availability of estimates of behavioural responses, and data.

1.28 Benefits that flow to business are generally equally difficult to quantify. The evidence from international consideration (for example, by the OECD) and from consultation with business strongly indicates, however, that while the quantum of benefits is very difficult to assess, a modern tax treaty provides a clear positive benefit to trade and investment relationships. Tax treaties provide increased certainty and reduce complexity and compliance costs for business.

Impact group identification

1.29 A revised tax treaty with New Zealand is likely to have an impact on:

- Australian residents doing business with New Zealand, including principally:
  - Australian residents investing directly in New Zealand (either by way of a subsidiary or a branch);
  - Australian residents investing indirectly in New Zealand;

- Australian banks and the other specified Australian institutions lending to New Zealand borrowers;
- Australians borrowing from New Zealand banks;
- Australian residents using technology and know how supplied by New Zealand residents;
- Australian residents supplying services to New Zealand and vice versa; and
- Australian residents exporting to New Zealand;

- Australian employees working in New Zealand;
- Australian residents receiving pensions from New Zealand;
- Australian residents who receive income that is exempt in New Zealand because they are transitional residents of New Zealand;
- the Australian Government; and
- the Australian Taxation Office (ATO).

Assessment of benefits

Renegotiation provides a better outcome for all stakeholders

1.30 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion since coming into force, it has become outdated and no longer adequately reflects both partners' desired positions, given Australia and New Zealand's close economic relationship and the desire of both countries to continue to enhance this relationship.

1.31 A new bilateral tax treaty would comprehensively modernise and update the existing treaty and Protocol. As well as revising the allocation of taxing rights between the two countries and the withholding tax rate limits prescribed in the treaty, Australia would also be able to achieve improved certainty for taxpayers by restricting the time in which transfer pricing adjustments may be made and allowing taxpayers to have issues of fact resolved by arbitration in cases where they cannot be resolved by the Australian and New Zealand tax authorities within two years.

1.32 A new tax treaty would provide benefits to Australian business and to the Australian revenue by ensuring certainty of legislative outcomes based on the treaty. It would be another step forward in providing Australian business with an internationally competitive tax treaty network and business tax system.

1.33 A renegotiated treaty will provide a better outcome than the existing treaty for a large majority of stakeholders. Given the long term nature of such arrangements, a revised tax treaty is expected to promote greater certainty than the existing tax treaty. It would also contribute to the updating of Australia's ageing treaty network.

Economic benefits

Withholding tax reductions

1.34 A new bilateral tax treaty would address businesses' desire to improve the competitiveness of Australia's tax treaty network with business particularly seeking reductions in withholding tax rates.

1.35 Under its domestic tax law, Australia imposes a final withholding tax on interest, royalty and unfranked dividend payments to non-residents at the rates of 10, 30 and 30 per cent of the gross payment respectively. However, Australia generally agrees to limit these withholding tax rates, on a reciprocal basis, in its bilateral tax treaties. In the existing New Zealand treaty, the withholding tax rates for interest, royalty payments, and dividends are limited to 10, 10 and 15 per cent of the gross payments respectively.

1.36 Withholding tax reductions below the rates reflected in the existing New Zealand tax treaty were first included in the 2001 Protocol amending the Convention with the United States (US). Similar reductions have generally been agreed in Australia's subsequent tax treaties. Providing for similar treatment in the New Zealand treaty aligns treatment, where possible, with Australia's recent tax treaties, maintains the integrity of Australia's treaty network and discourages treaty shopping (and the consequent degradation of the tax base of countries where the costs of capital and intellectual property are higher under their treaties as a result of the higher withholding tax rates).

1.37 While a reduction in maximum withholding tax rates will involve a cost to revenue, there are expected to be benefits to the revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

Dividends

1.38 An outcome such as that provided in the US and United Kingdom (UK) treaties (that is, no withholding tax on dividends paid to a company with an 80 per cent or greater voting interest in a listed company in the other jurisdiction, and 5 per cent withholding tax where the interest is at least 10 per cent of the voting power) would remove distortions in the raising of capital for direct investment that results from the more favourable terms that currently apply bilaterally in the case of the US and the UK. The existing treaty only has a 15 per cent rate for all dividends and therefore would not remove these distortions.

1.39 The new treaty would also include an exemption for dividends derived in respect of portfolio holdings by the Governments of either country (including their political subdivisions, local authorities and government investment funds).

Interest

1.40 A zero Australian interest withholding tax rate on interest arising in Australia and paid to unrelated New Zealand financial institutions consistent with Australia's current treaty practice recognises that a 10 per cent interest withholding tax rate on gross interest derived by financial institutions may be excessive given their cost of funds. It should accordingly lower the costs of borrowing in those cases where the financial institution can pass the cost represented by the withholding tax on to the Australian borrower. The existing treaty does not provide an exemption for unrelated financial institutions, and therefore in the absence of updating the existing treaty in this respect Australian borrowers often pay the cost of the withholding tax.

1.41 In the case of interest arising in New Zealand and paid to an Australian financial institution, the exemption from withholding tax will only apply where the Approved Issuer Levy (if applicable) has been paid. Due to the nature of New Zealand's banking sector it was necessary for New Zealand to maintain payment of this levy in order for a zero withholding tax rate to apply. New Zealand payers of interest to non-residents lenders can elect (if they meet the required conditions) to pay the Approved Issuer Levy instead of non-resident withholding tax. The treaty provides that if New Zealand repeals their Approved Issuer Levy regime, or increases it beyond the current two per cent, then this condition will no longer need to be satisfied for the zero rate to apply.

1.42 A most-favoured-nation provision applies to interest derived by financial institutions so that if New Zealand subsequently provides better treatment in respect of such interest, they must notify Australia and enter

into negotiations with Australia with a view to providing the same treatment.

1.43 As is the case in Australia's other recent tax treaties, the new treaty would include an exemption for interest derived by the Governments of either country (including their political subdivisions, local authorities and government investment funds), and the countries' central banks.

Royalties

1.44 Australian residents required to meet the cost of Australian royalty withholding tax on royalty payments made to New Zealand residents would benefit from the reduced royalty withholding tax rate of five per cent. Commercial practice indicates that, as with interest, the cost represented by the royalty withholding tax is commonly passed on to the payer of the royalty. This means that the Australian payer may bear the cost of higher rates of withholding tax if the existing treaty rate of ten per cent is maintained, which would place them at a competitive disadvantage in competing with businesses from other countries with lower rates. The effect of lowering the withholding tax rate is a lowering of the cost of new technology and intellectual property, which may encourage the development of Australia's economy through use of the most up to date technology and processes. Additionally it may encourage New Zealand residents to use Australian technology and intellectual property.

Managed Investments Trusts

1.45 Inclusion of provisions to provide treaty benefits in respect of income derived through Australian managed investment trusts (MITs) is of benefit to the managed funds industry and investors. Under the existing treaty, as MITs are considered to be fiscally transparent (where the income flows through the entity and is taxed in the hands of the participants as opposed to taxation at the entity level), Australian investors would need to be able to identify amounts derived by the MIT from New Zealand, and the character of each item of income, in order to be able to claim treaty benefits in New Zealand (such as reduced withholding tax rates).

1.46 The new provisions provide that the MIT will be entitled to treaty benefits if they are listed on an Australian stock exchange, or more than 80 per cent of the interests in the MIT are held by Australian residents. By treating the MIT as an Australian resident for treaty purposes, the MIT is able to claim treaty benefits in respect of items of income flowing from New Zealand to Australia.

1.47 If the MIT does not meet the listing requirement or the 80 per cent resident ownership threshold, the proposed treaty nevertheless allows it to claim treaty benefits to the extent that Australian residents own the income.

1.48 These provisions remove the need for each individual investor in a MIT to claim treaty benefits from New Zealand on their own behalf as is required under the existing treaty, which significantly reduces compliance complexity and costs for Australian investors. This will help promote Australia as a funds management hub in the Asia-Pacific region.

Alienation of property

1.49 Updating the *Alienation of Property* Article will better align the treaty with Australia's domestic law treatment and international treaty practice by providing for taxation of certain capital gains only in the alienator's country of residence. The existing treaty maintains the domestic tax law treatment where the taxation treatment of the income, profit or gain from the disposal of property is not subject to specific rules in the treaty. The treatment under the existing treaty is not consistent with recent treaty practice and does not align with OECD practice.

1.50 Updating the *Alienation of Property* Article will encourage investment in Australia and result in generally lower compliance costs. Australia's source country taxing rights over capital gains on real property, land rich companies and assets which form the business property of a permanent establishment in Australia would be retained.

1.51 Inclusion of a special provision to permit Australia to continue to tax capital gains of its former residents for up to six years was necessary to prevent the creation of double non-taxation, since New Zealand does not have a general capital gains tax regime.

Income from employment

1.52 Inclusion of special provisions in the *Income from Employment* Article will ensure that an employee's remuneration during their short term visits on secondment to one country is taxable only in the country of residence of the employee. These provisions will facilitate cross border secondments within an enterprise or company group and will simplify the taxation affairs of the receiving enterprise and the employee. These provisions will reduce compliance burdens significantly. The existing treaty does not provide special rules for such short term visits on secondment, resulting in non-residents being burdened with the need to comply with a foreign country's tax system, even though they are only there for a short period.

Pensions

1.53 Inclusion of a new provision which provides that pensions will be exempt in the country of residence of the recipient to the extent they would not be subject to tax if the recipient were resident in the source country, will encourage the free movement of workers between Australia and New Zealand. In line with the objectives under the CER, encouraging the free movement of people between Australia and New Zealand in this way removes some of the 'behind-the-border' impediments to trade. Australia and New Zealand residents are regularly caught up in both countries' superannuation systems. Each country's domestic law treatment of foreign pension payments means cross-border pension payments are often taxed more heavily than if the payment was received by a resident recipient. This pension provision, unlike the provision in the existing treaty removes impediments to working and accumulating superannuation benefits in both countries.

Arbitration

1.54 Inclusion of an arbitration provision giving taxpayers access to arbitration where issues of fact in relation to taxation not in accordance with the treaty cannot be resolved by the Australian and New Zealand tax authorities within two years, will provide certainty to taxpayers. The arbitration provision also provides businesses with a mechanism for the timely resolution of disputes regarding the application of the tax treaty to issues of fact. The existing treaty does not allow taxpayers to seek arbitration.

Non-Discrimination

1.55 Inclusion of a *Non-Discrimination* Article will prevent tax discrimination against Australian nationals and businesses operating in New Zealand and vice versa. The existing treaty does not provide any such protection.

Other benefits

1.56 Where Australians carry on business activities in New Zealand, the existing treaty prevents New Zealand from taxing the business profits of an Australian resident unless that Australian resident carries on business through a permanent establishment (such as a branch) in New Zealand. A new tax treaty would further refine the concept of when a permanent establishment would be taken to exist and the level of activity that would constitute a permanent establishment. This principle also applies where a New Zealand enterprise carries on business activities in Australia.

1.57 The refined permanent establishment concept will include a services provision, which allows Australia to tax a New Zealand resident entity on income it derives from the provision of services performed through one or more individuals present in Australia for more than 183 days in a year. It allows New Zealand to tax the Australian resident's income in the reverse situation.

1.58 The 2008 OECD Model Commentary includes an optional provision providing for source country taxation of services. The new treaty provision is based on the OECD Commentary provision, but incorporates modifications designed to minimise compliance costs for business to the greatest extent possible.

1.59 While the existing New Zealand treaty already has a services provision in that it permit a country to tax professional services in the country where they are performed where the individual is present for a period of 183 days in any twelve months (in the *Independent Personal Services* Article), it does not provide an exemption for short term stays of five days or less. Further, it only applies to self-employed individuals performing professional services, while the new provision would apply to services provided by individuals or companies.

Other benefits also include:

- the clarification of the residency rules. Under the existing treaty the residency status of certain entities, for instance entities participating in dual listed company arrangements, is left uncertain;
- clarifying that treaty relief is not available on certain income, profits or gains that are exempt in New Zealand because the recipient is a transitional resident of that country, which the existing treaty does not provide, creating uncertainty for these individuals;
- clarifying the treatment of income derived through trusts, which the existing treaty leaves uncertain;
- ensuring that income from real property, including natural resource royalties, may be taxed in full by the country in which the property is situated;
- providing new time limits for transfer pricing adjustments, giving taxpayers greater certainty; and
- ensuring that profits derived from the operation of ships and aircraft in international traffic are generally taxed only in the

country of residence of the operator, as opposed to source taxation of profits from all domestic shipping and airline activities, as occurs under the existing treaty. This change will provide closer alignment with the OECD Model and more consistent treatment for similar activities;

- requiring Australia and New Zealand to consult with each other every five years to ensure the treaty continues to operate effectively. This will ensure the treaty is reviewed at regular intervals, unlike the existing treaty which does not provide for a review period.

Revenue benefits

1.60 New treaty arrangements with New Zealand would represent another step in facilitating a competitive and modern treaty network for Australian companies and would help to maintain Australia's status as an attractive place for business and investment, helping to better position Australia as a regional headquarters for multinational companies and as a regional financial hub. While a reduction in maximum withholding tax rates and the pensions exemption will involve a cost to revenue, there are expected to be benefits to revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

Compliance and administrative cost reduction benefits

1.61 Tax exemptions in respect of withholding taxes, and exclusive taxation of income from employment in the employee's resident state in respect of short term secondments to another country, are likely to reduce compliance and administration costs associated with remitting and claiming credits for such tax.

1.62 The closer alignment with more recent Australian and international treaty practice would generally be expected to reduce compliance costs.

1.63 Clarifying other areas of uncertainty, such as tax treaty tests of 'residency' (including for MITs), the time periods for transfer pricing adjustments, and allowing taxpayers access to arbitration on issues of fact should also decrease compliance costs and uncertainty.

Improved international relationships

1.64 New treaty arrangements with New Zealand will also assist the bilateral relationship by updating an important treaty in the existing network of commercial treaties between the two countries. It would also

promote closer economic relations through the provisions aimed at improving the free movement of employees between the countries and by preventing tax discrimination against Australian nationals and businesses operating in New Zealand and vice versa.

1.65 Updating the tax treaty to take account of changes to the OECD Model as far as possible (for instance, the inclusion of a limited arbitration provision) would also help to maintain Australia's status as an active OECD member, which in turn would maintain Australia's position in the international tax community.

Assessment of costs — types of costs

Revenue costs

1.66 Treasury has estimated the impact of the first round effects on forward estimates as unquantifiable. Identifiable costs to revenue associated with reductions in the rates of withholding tax and the change to taxing rights for pensions have been estimated as $142 million over the forward estimates. Estimating the revenue benefits to Australia flowing from reductions in New Zealand withholding taxes is problematic. Reductions in New Zealand withholding taxes can be expected to result in an increase in the amount of Australian tax revenue through reduced Foreign Income Tax Offsets and increases in Australian taxable income. Given the bilateral flows between Australia and New Zealand, the current features of the Australian and New Zealand tax systems, and the impact of the changes in the arrangements under the Convention, the revenue costs are likely to be broadly offset by revenue gains.

Administration costs

1.67 The administrative impacts on the ATO from the changes made by any new treaty arrangements are considered to be minimal. Some formal interpretive advice may be required, for example private binding rulings, concerning the application of the treaty. Staff from the ATO, clients and tax professionals will need to be made aware of the entry into force and changes from the previous treaty. Therefore a number of ATO information products will need to be updated. Further, the insertion of a new arbitration provision may have some minimal administration impacts in setting up the mode of application (MOA) of the provision, and once the provision and MOA are in effect, facilitating arbitration where it is sought.

1.68 The cost of negotiation and enactment of new tax treaty arrangements with New Zealand is minimal and have mostly been borne by Treasury and the ATO. There will also be an unquantifiable but small

cost in terms of parliamentary time and drafting resources in enacting the proposed new tax treaty arrangements.

1.69 There are also 'maintenance' costs to the ATO associated with tax treaties and mutual agreement procedures (including advance pricing arrangements). These costs also apply to the existing arrangements. By bringing the New Zealand treaty into basic conformity with modern treaty practice these costs would be reduced. However, as treaties are deals struck between the two countries that reflect specific features of the bilateral relationship, some level of differential treatment or wording between treaties, which may require interpretation or explanation by the ATO, is inevitable.

Other costs

1.70 Government policy flexibility in relation to taxation of New Zealand residents would be further constrained by changes to treaty obligations, for example with respect to exemption from taxation of New Zealand pensions where those pensions are exempt in New Zealand. However, such constraints are also placed on New Zealand law makers, providing long term certainty to taxpayers. As such, the cost of such constraints is outweighed by the benefits. Ultimately, the tax treaty could be terminated if it became out of step with Government policy. Such termination is very rare in international tax treaty practice, however, and could be expected to be resisted by the business community and others who benefit from the treaty.

1.71 The impact of new tax treaty arrangements on tax policy flexibility is generally quite minimal as tax treaties are based on broad and generally accepted taxation principles. Australia's closer economic relations with New Zealand through the CER, has meant that some provisions in the new treaty have been negotiated with this particular relationship in mind. Australia can justify these particular provisions within this context, and therefore it is likely that any impact on tax policy flexibility is minimal.

Assessment of costs

Taxpayer costs

1.72 No material additional costs to taxpayers have been identified as likely to arise from the renegotiation of the New Zealand tax treaty.

1.73 Businesses that collect withholding taxes would need to make small system changes to change the rate at which they withhold to reflect the new treaty withholding tax rate limits. Previous experience and

anecdotal evidence suggests that these changes will be straight forward and easily accommodated.

1.74 Businesses with New Zealand resident employees or with employees or professionals performing services in New Zealand may need to make business system changes to calculate days during which services are provided in the other country, as under the new treaty very short periods of service (five days or less) will be disregarded and other provisions to moderate compliance costs are provided. Under the existing treaty, businesses already have to calculate days of service in the other country for self-employed persons performing independent personal services (under the *Independent Personal Services* Article).

1.75 Most businesses that have dealings with New Zealand would already understand their tax obligations under the existing tax treaty and Protocol, accordingly changes are likely to give only a minor compliance cost as businesses adjust to the new treaty.

1.76 No costs for the community or other parties have been identified.

Administration costs

1.77 The costs to the ATO with respect to arbitration are expected to be minor, and only arise when taxpayers seek arbitration.

Consultation

1.78 The Assistant Treasurer and Minister for Competition Policy and Consumer Affairs' Press Release No. 4 of 28 January 2008 invited submissions from stakeholders and the wider community on Australia's future tax treaty policy and in particular issues that might arise during negotiations with New Zealand. Treasury has also sought comments from the business community through the Tax Treaties Advisory Panel.

1.79 In general, business and industry groups support the general approaches taken in Australia's recent treaties. They also favour a more residence-based taxation treaty policy, lower withholding taxes, time limits on transfer pricing audits and the inclusion of arbitration clauses.

1.80 The state and territory governments have been consulted through the Commonwealth/State Standing Committee on Treaties. Information on the negotiation of this treaty was included in the Schedules of treaties to state and territory representatives from early March 2009.

1.81 The proposed treaty arrangements will be considered by the Commonwealth Joint Standing Committee on Treaties, which provides for public consultation in its hearings.

Conclusion and recommended option

1.82 While the existing tax treaty and its amending Protocol have provided a good measure of protection against double taxation and prevention of fiscal evasion since coming into force, in the context of the closer economic relationship that Australia and New Zealand share, the treaty has become outdated and no longer adequately reflects current tax treaty policies and practices of either Australia or New Zealand, nor modern international norms.

1.83 A new bilateral tax treaty would respond to businesses' desire for greater certainty and more competitive withholding tax rate limits in Australia's tax treaty network.

1.84 Developments in both countries' domestic law, commercial practices, and treaty policies and practices support a full revision of the treaty. This also provides an opportunity to update the text in accordance with modern OECD practice, which a second limited amending Protocol would not permit.

1.85 The proposed new treaty arrangements with New Zealand are consistent with Australia's recent move towards a more residence-based tax treaty policy. It would bring Australia's arrangements with New Zealand more into line with international norms, as set out in the OECD Model and would provide outcomes similar to Australia's recent treaties.

1.86 There is a direct cost to revenue, largely due to reduced withholding tax collections and the limited exemption provided for pensions. On balance, the benefits of concluding a new treaty outweigh the cost to revenue.

1.87 A new bilateral tax treaty is therefore recommended.

Implementation and review

1.88 A new tax treaty with New Zealand would be implemented by amending the *International Tax Agreements Act 1953* to include the treaty as a Schedule to that Act, giving the treaty the force of law in Australia. Like all other tax treaties it will be administered by the ATO. Since the

ATO already administers the existing New Zealand treaty, implementing and administering the new treaty is not expected to require extra resources, and only result in minor costs from updating information products.

1.89 The new treaty will make provision for review of the treaty. Review will take place no later than five years after the treaty enters into force, by both countries consulting with each other in regard to the operation and application of the treaty with a view to ensuring that it continues to serve its purposes of avoiding double taxation and preventing fiscal evasion.