A special report by the Policy Advice Division of Inland Revenue

21 March 2005

Proposed tax rules for migrating companies

Introduction

The government has announced it will introduce legislation to ensure that a migrating company pays tax on its worldwide income earned while it was a New Zealand resident company. The change is intended to remove incentives for companies to migrate for tax reasons and, once enacted, will be effective from the date of announcement, 21 March 2005.

The new rules will be similar to those relating to companies that liquidate. Thus, for tax purposes, migrating companies will be deemed to have liquidated and paid a dividend to shareholders.

This special report describes the proposed tax treatment.

What is corporate migration?

A company has migrated from New Zealand if it is no longer a resident company for New Zealand tax purposes. This is generally achieved by companies transferring their place of incorporation overseas.

For New Zealand tax purposes, a non-resident company:

- is not incorporated in New Zealand;
- does not have its head office in New Zealand;
- does not have its centre of management in New Zealand; and
- is not controlled by its directors in New Zealand.

Key features of the proposed rules

On a company's migration from New Zealand, the company will be deemed to have liquidated and paid a dividend to its shareholders.

This will mean that the existing tax rules that apply on the liquidation of a New Zealand company will also apply in the event of a company ceasing to be a New Zealand-resident.

The company will first be deemed to have disposed of all assets and liabilities and realised them at market value immediately before it ceases to be a New Zealand-resident. Under existing legislation, certain proceeds (such as gains in the value of revenue account property) will be subject to tax.

The company will then be deemed to have distributed all shareholder funds (which will include the deemed disposal proceeds) to its shareholders by way of a dividend.

A migrating company will be required to "withhold" tax from the dividend immediately before it ceased to be a New Zealand-resident company, under the resident withholding tax (RWT) or non-resident withholding tax (NRWT) rules, as appropriate.

Under the RWT rules, RWT on dividends applies at the rate of 33%. A deemed dividend "paid" to a resident shareholder will then be taxed at the shareholder's personal marginal tax rate, less imputation credits attached by the company.

A deemed dividend "paid" to a non-resident shareholder will be taxed at 30% if the shareholder is a resident of a non-treaty country and the dividend is not fully imputed or credited with dividend withholding payments. NRWT at 15% will apply to a deemed dividend "paid" to a shareholder of a treaty country or a non-treaty country if the dividend is fully imputed or credited.

While realised capital reserves will generally be excluded from the deemed distribution, for consistency with the liquidation rules, they will be included for non-resident related company shareholders.

The amount of the deemed dividend will therefore vary between certain shareholders as shown in the following table.

Resident shareholder	**Non-related non-resident shareholder**	**Related non-resident company shareholder**
Dividend subject to RWT = shareholder funds, less available subscribed capital and realised capital reserves.	Dividend subject to NRWT = shareholder funds, less available subscribed capital and realised capital reserves.	Dividend subject to NRWT = shareholder funds, less available subscribed capital.

Property that continues to be subject to tax in New Zealand after a company's migration (for example, standing timber) because it is located in New Zealand, could be treated as re-acquired by the company at the same market value for which it was deemed to have been disposed of at the time of migration. This will establish a new cost base to apply in the event of a subsequent realisation.

To remove potential double taxation in the event that a migrating company pays a dividend to its shareholders, the amount of the deemed distribution to a migrating company's shareholders could be treated by the company as an additional amount of tax paid share capital or available subscribed capital (ASC).

Example: Migration of a New Zealand company

S Ltd was incorporated in New Zealand in 1995 and issued 140,000 ordinary shares at $2 each to resident shareholders and 60,000 ordinary shares at $2 each to non-resident shareholders (40,000 of those shares are held by related non-resident companies).

The shareholders resolve to transfer S Ltd's place of incorporation and its directorial and managerial functions offshore. S Ltd has a realised capital profit of $150,000 and revenue reserves of $300,000. S Ltd also owns shares held on revenue account in a company that owns commercial rental property in Wellington. The market value of these shares is $500,000. They were purchased for $450,000. S Ltd also owns a New Zealand-registered patent worth $250,000. The cost of the patent was $200,000, and depreciation deductions of $50,000 have been claimed.

S Ltd's imputation credit account has a credit balance of $100,000.[1]

Deemed disposal rules

S Ltd will be deemed to have disposed of all of its assets and liabilities at market value immediately before it ceases to be a New Zealand resident.

The taxable amount from the deemed disposal of the patent is $100,000 (market value less cost (reduced by the amount of depreciation already claimed)).[2] The taxable amount from the deemed disposal of the shares is $50,000 (market value less cost).[3] S Ltd's tax liability on the deemed disposal of its revenue account property is therefore $49,500, and the tax paid is credited to S Ltd's imputation credit account.

The company that owns the commercial property will remain in New Zealand, and the patent is registered in New Zealand. Therefore future income derived from the shares and the patent will continue to be subject to New Zealand tax.[4] S Ltd will be deemed to have re-acquired the shares at $500,000 and the patent at $250,000, which will establish new cost bases for those assets.

Deemed liquidation rules

S Ltd will be deemed to have liquidated and made a distribution to shareholders immediately before it ceases to be a New Zealand resident. The total amount "received" by each shareholder is $4.75 per share.[5]

In calculating the amount of the taxable dividend deemed to have been paid by S Ltd it is first necessary to exclude capital amounts from total funds. For these purposes, capital amounts comprise the amount of "ASC per share cancelled" and, for shareholders that are not related non-resident companies, the "excess return amount" per share – essentially a shareholder's share of capital assets and realised capital gains.

Applying the formulae in the legislation, ASC per share cancelled is calculated as $2, and the excess return amount is 75 cents. Therefore the tax-free capital component of the amount distributed by S Ltd in respect of each share is $2.75, and the remaining $2 per share (representing revenue reserves) is taxable to each shareholder as a dividend.

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[1] A company could make use of the foreign investor tax credit rules by paying a fully imputed dividend and a supplementary dividend to its non-resident shareholders before it ceases to be a New Zealand-resident company. The company will not be able to obtain credits in relation to deemed dividends to its non–resident shareholders on its migration.
[2] See section EN 2.
[3] See section CD 3.
[4] Assuming that there are no DTA implications.
[5] (400,000 + 150,000 +300,000 +150,000 - 49,500)/200,000. Note that all figures in this example have been rounded to two decimal places.

S Ltd may attach imputation credits of 70 cents per share[6] to dividends paid to resident shareholders.

Resident shareholders

The total amount received per share distributed to resident shareholders on S Ltd's migration is $4.75, of which $2.75 (being $2 + $0.75) is tax-free. The remaining $2 per share is taxable to each shareholder as a dividend. Imputation credits of 70 cents per share could be attached for offset against the shareholder's personal tax liability.

S Ltd is required to withhold RWT from the dividends paid to resident shareholders. S Ltd's RWT cost per share is 19 cents.[7] S Ltd's total RWT cost is $26,600.[8]

The amount of the deemed distribution, less RWT and NRWT, becomes ASC and in the event of S Ltd paying a dividend to resident shareholders, could be returned to those shareholders tax-free.

Non-related non-resident shareholders

The total amount received per share distributed to non-related non-resident shareholders on S Ltd's migration is $4.75, of which $2.75 (being $2 + $0.75) is tax-free. The remaining $2 per share is taxable to each shareholder as a dividend.

S Ltd is required to withhold NRWT from dividends paid to non-related non-resident shareholders. S Ltd's NRWT cost per share held by these shareholders is 30 cents.[9] S Ltd's total NRWT cost in relation to these shareholders is $6,000.[10]

Related company non-resident shareholders

The amount of the dividend to the related non-resident company shareholder subject to NRWT is that amount which would arise as a dividend if the excess return amount (that is, the share of capital assets and realised capital gains) were nil.

The total amount received by related non-resident company shareholders on S Ltd's migration is $4.75, of which $2 (being $2 + nil) is tax-free. The remaining $2.75 (representing revenue reserves and capital profits) is taxable to the company shareholder as a dividend subject to NRWT. S Ltd's NRWT cost per share held by these shareholders is 41 cents.[11] S Ltd's total NRWT cost in relation to these shareholders is $16,400.[12]

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[6] Existing imputation credit rules require the same imputation credit ratio to apply to all distributions within an income year. Applying this rule to the total imputation credit account balance of 149,500 allows dividends to resident shareholders to receive 70 cents per share of imputation credits.

[7] ((2+.70) x .33) - .70

[8] .19 x 140,000

[9] .15 x 2 (assuming that the standard NRWT treaty rate of 15% applies).

[10] .3 x 20,000

[11] .15 x 2.75

[12] .41 x 40,000

These calculations per share for the various shareholders are summarised in the following table.

Summary of tax calculations

	Resident shareholder	Non-related non-resident shareholder	Related non-resident company shareholder
Deemed distribution	$4.75	$4.75	$4.75
ASC "cancelled"	$2.00	$2.00	$2.00
Excess return amount	$0.75	$0.75	$0.75
Taxable amount	$2.00	$2.00	$2.75
Imputation credits	$0.70	–	–
RWT	$0.19	–	–
NRWT	–	$0.30	$0.41