Business Tax Reform – international tax fact sheet

Less tax for New Zealand companies operating overseas

The introduction of a tax exemption for the active income of New Zealand businesses operating overseas will bring New Zealand into line with international norms. The exemption is designed to encourage businesses with international operations to remain in New Zealand and enable New Zealand businesses to be able to compete more effectively in foreign markets. Compliance costs will also be substantially reduced for many businesses.

At present, New Zealand taxes its residents on their worldwide income. That includes income earned by a foreign company that is controlled by New Zealand residents – referred to as a "controlled foreign company" – regardless of how it is earned. In contrast, many other countries distinguish between the active and passive income of controlled foreign companies – for example, distinguishing between income from manufacturing and income from investment such as interest, dividends and royalties. Those countries either delay taxing offshore active income until dividends are paid or exempt it altogether.

How will it work?

- ✓ Active income, such as income from manufacturing, earned by New Zealand-resident companies through their controlled foreign companies will be exempt from domestic tax. Only their passive income will be taxed.
- ✓ Dividends from controlled foreign companies to the New Zealand parent will be exempt from domestic tax.
- ✓ The government plans to develop a simple "active business" test that exempts all controlled foreign companies with less than 5 per cent passive income, no matter where they do business. The test will be designed to replace the current eight-country "grey list" exemption.
- ✓ Even if a controlled foreign company does not meet the active business test, only its passive income will be taxed back in New Zealand.
- ✓ Once the exemption is in place, interest allocation rules will limit the extent to which New Zealand businesses can deduct interest costs relating to offshore investments that are outside the New Zealand tax base.
- ✓ The rules on conduit taxation, which deal with the New Zealand tax liability on foreign income of the non-resident owners of New Zealand-resident companies, will be repealed.

Example of the benefits to a New Zealand company operating overseas

NZ Co, a New Zealand-resident company, has a manufacturing subsidiary in China, China Co, which earns profits of $100,000. If, for example, China Co qualifies for a special 10 per cent tax rate in China, it will pay $10,000 tax in China.

NZ Co will be taxed in New Zealand on China Co's profits of $100,000, with tax credits provided for the tax paid by China Co in China. Under the new 30 per cent company tax rate, NZ Co will pay $30,000 in tax: $20,000 paid to New Zealand, with credit for the $10,000 paid to China.

If the active income of its subsidiary is exempted from New Zealand tax, NZ Co can benefit from any low tax rate that China offers. The income of China Co will no longer be taxable to NZ Co. In other words, the only tax paid is the $10,000 to China.

The benefit to China Co from the low tax rate in China will be greater because dividends from controlled foreign companies will be exempt from New Zealand tax. If not, NZ Co would be required to pay $20,000 of New Zealand tax on China Co's profits when the profits are distributed.

Where to from here?

As part of the continuing review of New Zealand's international tax law, a second round of consultations will be undertaken to work through the detailed design and implementation of the active income exemption.

The goal is for legislation to be introduced early in 2008, with application beginning from the 2009/10 tax year.