International tax review: questions and answers

1 What are the major features of the international tax reform package?

The central feature of the reform is the introduction of a tax exemption for active income (such as manufacturing) of a controlled foreign company (CFC). This constitutes a major policy change, and means that the offshore active income of New Zealand business will no longer be taxed as it is earned, but will instead be exempt from New Zealand tax.

As part of a package of proposals for the implementation of an active income exemption, the following additional in-principle policy decisions have been made:

- Ordinary dividends from CFCs to the New Zealand parent will be exempt from domestic tax.
- A simple "active business" test will be developed to exempt all CFCs with less than five percent 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 CFC does not meet the active business test, only its passive income will be taxed back in New Zealand.
- A relatively limited definition of passive income, that would include dividends, interest, royalties and certain rents, will be developed.
- A limited set of "base company" rules for services will be adopted.
- 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- The conduit rules will be repealed.

2 What are these changes intended to achieve?

The international tax reform package is aimed at improving New Zealand's international competitiveness through promoting an environment for globally connected firms to locate in and expand from a New Zealand base. The reform fits within the government's Economic Transformation agenda, recognising that tax is one of a number of factors that influence firms' location decisions. With an increasingly borderless global economy, New Zealand must be able to attract and retain capital and our businesses must be able to compete effectively in foreign markets.

New Zealand's current CFC rules tax offshore income more comprehensively than other countries, which generally exempt active income earned offshore or defer tax until that income is returned in the form of dividends. Australia, in particular, has an extensive active income exemption in its CFC rules.

An exemption of offshore active income will bring New Zealand into line with international norms. This will put New Zealand companies on a more equal footing internationally by removing an additional tax cost not faced by firms based in comparable jurisdictions, enabling them to expand into new markets from a New Zealand base.

3 Who will benefit from the active income exemption?

New Zealand businesses will not have to pay New Zealand tax on the active income earned by their CFCs. Firms with active CFCs in non-grey list countries will be relieved of both tax and compliance burdens. As a result, New Zealand firms will be better able to expand their business overseas and compete more effectively in foreign markets.

4 How do these changes compare with the Australian system?

New Zealand has had the opportunity to learn from the Australian system in developing our rules. Australia uses a comparable framework for its taxation of CFCs, although some key features differ. For example, Australia has retained a "listed country" exemption. On the other hand, we propose a narrower definition of passive income, to minimise compliance costs and avoid getting in the way of the legitimate business arrangements of New Zealand firms operating offshore.

5 Why replace the grey list?

The new system needs to be looked at as a whole. The proposed rules exempt dividends from CFCs and allow considerable margin in the application of the interest allocation rules. In that context, taxation of passive income, no matter where it occurs, forms a cornerstone in protecting the domestic tax base from tax-eroding strategies.

The grey list exemption is based on the assumption that eight listed countries have tax systems that are comparable to New Zealand. In reality, however, there can be no guarantee that passive income will be comparably taxed in those countries. Non-taxation of passive income may occur from the architecture of the other country's tax system, or as a result of tax arbitrage, exploiting technical differences between tax systems.

6 What are the implications for firms' compliance costs?

Compliance costs will be minimised through the adoption of a simple "active business" test, which will exempt all CFCs with less than five percent passive income, no matter where they do business. Combined with a narrow definition of passive income, and narrow base company rules, it is anticipated that most substantially active CFCs will not need to attribute any income at all.

Other aspects of the system will also help to minimise compliance costs by comparison with other countries' regimes. For example, New Zealand will have no base company rules for goods and will exempt dividends from CFCs.

7 Why repeal conduit relief?

Conduit tax relief is currently available for the CFCs to the extent that the parent company is owned by non-residents.

Conduit relief will become redundant for active income once the proposed reforms are in place. The case for continuing to provide conduit relief for passive income is weak and would involve on-going risk to the tax base. In particular, it can encourage non-residents to re-characterise New Zealand source income as foreign income.

8 Why extend our interest allocation rules to New Zealand firms with CFCs?

The introduction of an active income exemption will create an incentive for New Zealand companies with outbound investment to over-allocate their global interest costs against their New Zealand income. As such, there is a strong case in principle for extending our existing interest allocation rules on inbound investment to New Zealand firms with CFCs with the introduction of an exemption for active income earned by CFCs.

To ensure that the rules do not unduly affect most New Zealand business, the government proposes to maintain the current thresholds, including a 75 per cent safe harbour. This will result in New Zealand having rules which are similar to Australia's.

9 What about Non-Resident Withholding Tax?

The Budget announcement focuses on the design of an active income exemption. Changes to NRWT will be taken forward through bilateral treaty negotiation. Associated changes to the Foreign Investor Tax Credit and the Approved Issuer Levy are also best considered as part of that process.

10 What are the next steps?

An update on the international tax review has been released with Budget materials. It provides a stock-take of the package of proposals discussed here and sets out the areas of which further detailed consultation, analysis and decisions are still required.

Over the next few months, officials will release a series of technical papers covering in greater depth the topics requiring further consultation and analysis. Officials will then consult on the topics covered in the papers, and written submissions will be invited.

Following this second round of consultation, the government expects to consider the detailed proposals and finalise the reform package later this year, with a view to introducing legislation in early 2008 (for application beginning the 2009/10 tax year).

In order to develop a workable and robust reform package, it is critical that supporting and consequential details are carefully considered. For this reason, the determination of a finalised policy package is conditional on the outcomes of a secondary round of detailed work and consultations.