New Zealand's International Tax Review: An Update

Developing an active income exemption

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New Zealand's International Tax Review: An Update – developing an active income exemption
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1. INTRODUCTION

Process to date

1.1 The discussion document *New Zealand's International Tax Review: a direction for change* was released on 13 December 2006. It outlined the government's intention to introduce an exemption for offshore active income. Rather than make concrete proposals for the implementation of the exemption, it canvassed the various approaches taken in other countries and indicated the broad direction and approach of the proposed reform.

1.2 Officials then engaged in an extensive consultation process with businesses. Forty-eight written submissions on the ideas set out in the discussion document were also received. This consultation and feedback has been invaluable in enabling the government to assemble a balanced package of reforms that is appropriate for the New Zealand context.

Purpose of this document

1.3 This document aims to:

- provide an update of the government's in-principle policy decisions to date, setting out how the various components fit together as a balanced package;
- set out the areas on which further, detailed consultation, analysis and decisions are still required;
- indicate the potential reform proposals which the government has decided *not* to pursue; and
- explain the process and timelines for the second round of consultations.

1.4 It does not cover the possible changes to non-resident withholding tax (NRWT). As was noted in the discussion document, any changes to rates of NRWT are best done through bilateral treaty negotiation. Any proposals to change the foreign investor tax credit or the approved issuer levy rules will be considered in connection with this process.

Next steps

1.5 A series of technical papers will be released over the next few months. They will draw extensively on the submissions received in response to the discussion document and are likely to cover a range of topics, including:

- the active/passive boundary;
- the active business test;

- interest allocation rules for New Zealand companies investing offshore; and
- the possible extension of the active income exemption to branches and non-portfolio foreign investment funds.

1.6 Officials will begin consulting on the release of these papers, and written submissions will be invited on the technical issues raised in these documents. We are not expecting written submissions on this update.

1.7 Following the 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 early in 2008 (for application beginning from the 2009–10 income year).

2. BACKGROUND AND POLICY DECISIONS

Background and policy context

2.1 The review of New Zealand's international tax rules aims to improve our international competitiveness through promoting an enabling environment for globally connected firms to locate in New Zealand and expand into other countries from a New Zealand base. It fits within the government's Economic Transformation agenda, recognising that tax is one of a number of factors, including infrastructure, education and skills, and research and development, that influence firms' location decisions.

2.2 The central feature of this reform is the introduction of a tax exemption for active income. Examples of active businesses that will benefit from the exemption include:

- businesses that take advantage of multi-national manufacturing networks; and
- exporters that expand sales through international distribution networks.

2.3 An exemption for the offshore active income of New Zealand businesses constitutes a major policy change, and means that this income will no longer be taxed as it is earned. This will bring New Zealand into line with international norms and remove a current tax disincentive for globally connected firms to locate in New Zealand.

2.4 The following guiding principles have informed the design of the proposed package:

- First, the new rules should, as much as possible, allow firms to get on with legitimate business activity. This means the new rules:
  - should not discourage firms from undertaking expansion of business operations offshore to take advantage of market opportunities or gain production efficiencies; and
  - should take into account the legitimate business arrangements and methods of operation that New Zealand businesses use in their offshore operations.
- Second, the rules should, as much as possible, minimise compliance burdens.
- Third, the rules should maintain a level of protection for the domestic tax base.

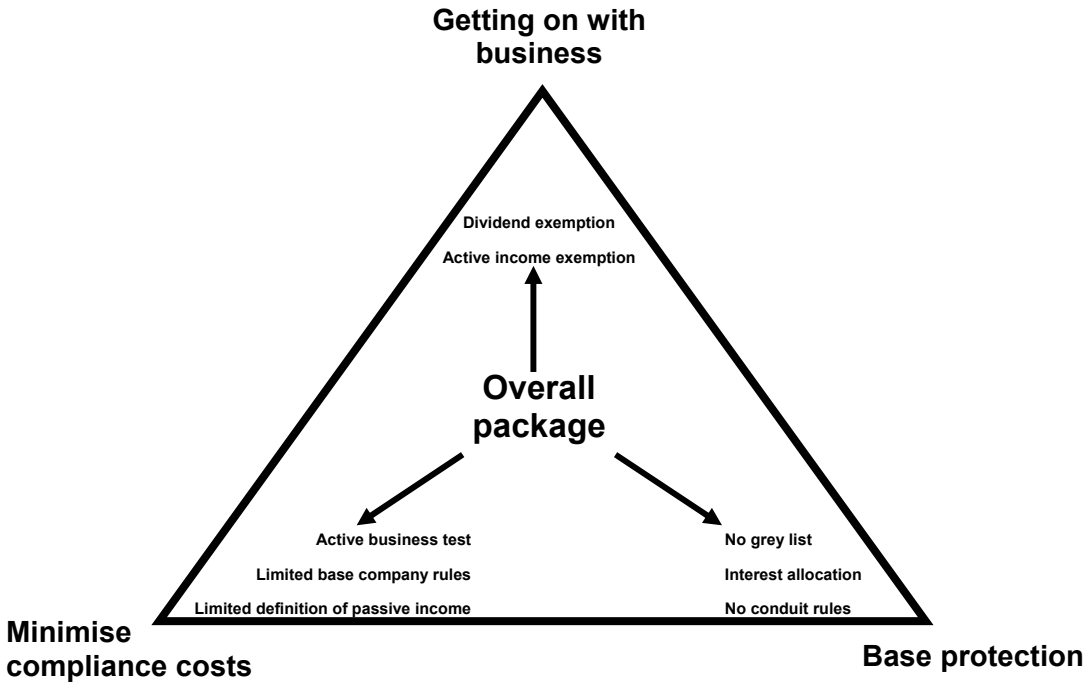
A balanced package

2.5 Bearing these principles in mind, the government has taken the following in-principle policy decisions:

- A tax exemption for the active income of a controlled foreign company (CFC) will be introduced.
- 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.[1]
- Even if a CFC does not meet the active business test, only its passive income will be taxed 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 developed.
- 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.
- The conduit rules will be repealed.

2.6 The changes are summarised in figure 1. Together, they represent a balanced package:

FIGURE 1: Summary of the package



[1] The income from CFCs resident in eight "grey list" countries is exempt from New Zealand tax. The grey list countries are considered to have tax systems similar to New Zealand's. The eight grey list countries are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.

2.7 The proposals allow companies room to go about their ordinary business, while constraining the risk of significant base erosion from tax planning strategies.

2.8 The active income exemption will remove the current barrier to investments outside the grey list countries and greatly reduce the compliance burden imposed on such investments. Exempting dividends received from offshore CFCs will enhance these benefits. The absence of base company rules on goods will be of particular benefit to New Zealand firms that export through international distribution networks.

2.9 Compliance costs are minimised by the introduction of the active business test and use of safe harbours, a relatively limited definition of what is passive income and the avoidance of many of the technically complicated base protection rules used in other countries.

2.10 Protection of the domestic tax base is achieved through accrual taxation of passive income above the threshold (including in grey list countries) and the extension of interest allocation rules to firms making offshore investments. Taxing passive income prevents the avoidance of domestic tax merely by shifting the location of the investment and inhibits tax minimising strategies. The interest allocation rules protect the domestic tax base from erosion by preventing an over-allocation of global interest costs against New Zealand operations.

2.11 In order to develop a workable and robust reform package, it is critical that supporting and consequential details are carefully considered. The final policy package depends on a satisfactory outcome from a second round of detailed work and consultations. The design of the active business test will be particularly important in minimising compliance costs faced by firms under the proposed package. The government plans to develop a simple test that exempts 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.

The key design features

2.12 Table 1 outlines the key features of the proposals for the technical implementation of the policy and signals those areas where further policy development is required.

TABLE 1: KEY FEATURES OF THE PROPOSAL

The main features of the package include:

Exemption for active income

An exemption for active income will consist of:

- the introduction of an active income exemption under New Zealand's CFC rules;
- the exemption of all dividends received by the New Zealand parent company from ordinary shares in CFCs.

Further work will explore extending the active income exemption to offshore branches and non-portfolio foreign investment funds (FIFs).

Limited definition of passive income

A relatively limited definition of passive income will include dividends, interest, royalties and certain rental income and be restricted to exclude:

- income earned by a holding company or a financing subsidiary from related active CFCs in the same jurisdiction; and
- rental income from real property in the same jurisdiction as the CFC.

Further work will explore:

- whether further narrowing of the definition of passive income with respect to royalty income and foreign exchange gains to the extent that they relate to an active business is appropriate and practicable; and
- the scope of base company rules for certain services.

Active business test

The active income exemption will be implemented through the adoption of an active business test for CFCs – based on the CFC earning less than five percent passive income. Characteristics of the active business test will include:

- No income will be attributed for a CFC that passed the test.
- Only passive income will be attributed for those CFCs that failed the test.
- It is intended that the test will be based on the International Financial Reporting Standards (IFRS) compatible accounts of the CFC, with adjustments as appropriate.
- The test will apply for all jurisdictions, replacing the current grey list of eight countries.

Further work will explore whether it is possible to use the consolidated accounts of a group of CFCs in a jurisdiction in applying the active business test.

Associated key base maintenance measures

The grey list of eight countries will be replaced with a simple active business test that applies for all CFCs in all countries.

The interest allocation rules will be extended to New Zealand firms with outbound investment in CFCs.

Further work will explore:

- whether certain preference shares should be treated as liabilities;
- whether alignment of the definition of liabilities for the worldwide test and the definition of New Zealand liabilities can be achieved; and
- the treatment of financial institutions under the interest allocation rules.

The conduit rules will be repealed.

Further work will explore the development of a targeted anti-avoidance provision relating to the foreign tax credit rules.

2.13 Some of the base maintenance measures suggested in the discussion document will not be taken up as part of the package. In particular:

- The burden of proof on the Commissioner of Inland Revenue on transfer pricing reassessments will remain with the Commissioner and not be shifted to the taxpayer.
- Base company rules will not apply to the sale of goods by a CFC and associated services performed by that CFC.
- Many of the possible changes to the general interest allocation rules (and therefore those applying to outbound investments) that were raised in the discussion document will not proceed. There will be no changes to:
  - the safe harbour of 75 percent;
  - the 110 percent uplift for the worldwide test;
  - the on-lending rules;
  - the treatment of goodwill and foreign tax credits (meaning that the banking provisions will not be extended to the general interest allocation rules).

3. GETTING ON WITH BUSINESS

Exempting active income

3.1 The cornerstone of the new system is an exemption for active income earned through a CFC. This represents a radical shift from the current paradigm of accrual taxation of offshore income. Consultations have shown strong support for this change, which would bring New Zealand into line with the international tax rules of most other developed countries. This section considers the scope of the exemption – which businesses and what sort of income will be covered.

3.2 Active businesses can also be carried on through branches or non-portfolio FIFs. The discussion document supported the principle that an active income exemption should be extended to such vehicles as well as CFCs. There was considerable support for such an extension in the consultations. Australia currently has an active income exemption for branches and FIFs.[2] The development of detailed rules will form part of the post-Budget technical consultations.

Exempting dividends from CFCs

3.3 As a complement to the active income exemption, dividends repatriated to a New Zealand parent company from CFCs will be exempted. For reasons of simplicity and to minimise compliance costs, this exemption will apply to dividends from CFCs regardless of whether the CFC passes the active business test or whether the dividends are paid out of active or passive income. This simplification is possible on the assumption that any passive income has already been taxed on accrual. Again, there is widespread support for this change.

3.4 The discussion document indicated that exemption was the preferred course of action, provided that other rules were sufficiently robust to ensure the integrity of the system – in particular, that passive income would in fact be taxed on accrual. The government considers that the proposals in the package, particularly the removal of the grey list and the extension of the interest allocation rules, allow the exemption for dividends.

3.5 Dividends that would not qualify for an underlying foreign tax credit under the current rules would not be eligible for the exemption. These dividends are those where:

- the recipient does not have a sufficient interest in the CFC; or
- the share is a fixed rate share; or

[2] The Australian Board of Taxation is currently undertaking a review of all of Australia's anti-tax-deferral rules, including its CFC rules. One objective of the review is to consider whether harmonisation of the current regimes can reduce complexity and compliance costs.

- the CFC is allowed a deduction for the dividend in calculating its liability for tax.

3.6 The repeal of the dividend withholding payment rules is a natural consequence of removing dividends from tax. The removal of the ability to refund a portion of New Zealand tax paid upon ultimate distribution to non-resident shareholders would also follow. This is appropriate as offshore active income is exempt from New Zealand tax. Any income which is taxable is passive income and should be treated as New Zealand income. Accordingly, it should be subject to New Zealand tax at the full company rate of tax and be subject to the general imputation rules.

Types of passive income

3.7 A relatively narrow definition of passive income is proposed. In particular, passive income treatment would generally be reserved to the types of income which are not location-specific and therefore may be assigned to jurisdictions purely for tax purposes, rather than in response to underlying economic drivers, such as costs or markets.

3.8 This narrow definition is influenced by company concerns that a broad definition of passive income would expose them to considerable compliance costs. A broader definition could lead to more companies failing the active business test, thus calculating and paying tax on accrual. That is undesirable.

Interest

3.9 Interest and interest substitutes are generally included as passive income. In particular, interest that arises from investments or as part of the business of lending money would be treated as passive. Thus passive income would include income that is financial in nature such as guarantee fees, interest swap payments and the interest portion of financial lease payments and sale and repurchase agreements.

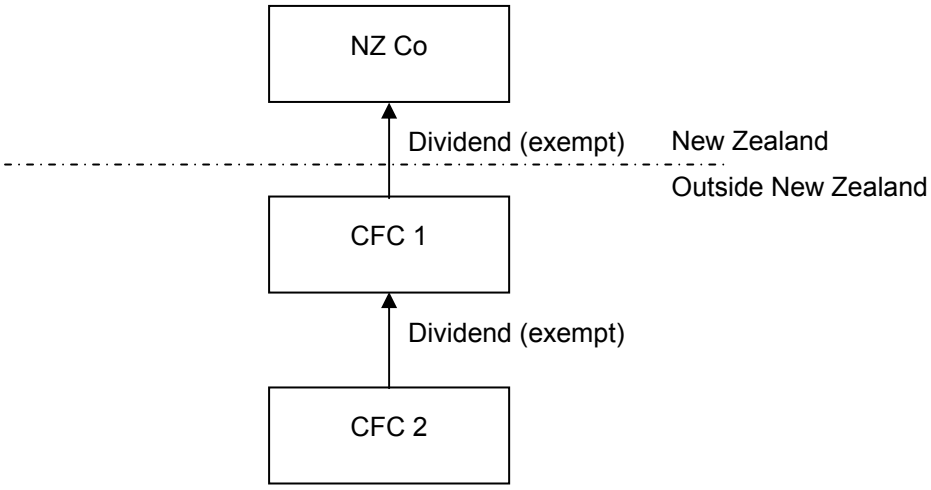
3.10 Even so, interest can also arise as a consequence of active business. Such interest would not be treated as passive income. An example is trade debt. Further consideration in the next round of consultations would need to be given to hire purchase and other vendor financing arrangements.

Dividends

3.11 In general, dividends and FIF income derived by a CFC are passive income.

3.12 As already noted, however, the government proposes to exempt dividends repatriated by a CFC to its New Zealand parent. This means that dividends paid between associated CFCs should also fall outside the definition of passive income. They will be exempt, as shown in figure 2.

FIGURE 2: Exempt dividends



Holding companies and financing subsidiaries

3.13 Groups of CFCs in a jurisdiction are often owned through a holding company. Furthermore, a group of active companies may have one subsidiary which centralises the financing operations for the group. In the absence of relieving provisions, holding and related party financing income earned from other active companies in the group could be treated as passive, which would effectively negate the active income exemption for the group.

3.14 In principle, the government is seeking to address this problem by excluding from the definition of passive income interest and dividends earned by a company from active related companies in the same jurisdiction. A related company would be considered active if it passed the active business test.

3.15 There will be issues for further consideration. For example, if related party interest is considered to be active income, the deduction of interest on money borrowed by the finance company to invest in other group companies should not be used to shelter otherwise taxable passive income.

3.16 Several New Zealand companies have regional holding and financing subsidiaries that receive income from related parties outside of the jurisdiction of the CFC. Under the "same jurisdiction" requirement, the holding/finance company would need to attribute any passive income. However, as previously noted, dividends paid between related CFCs would be exempt. This means that regional holding companies that receive dividends only from related CFCs will have no passive income to attribute, regardless of jurisdiction.

Royalty income

3.17 The taxation of royalty income requires further development.

3.18 As a starting proposition, royalty interests provide a financial return and can be traded like other investments. Accordingly, they would generally be considered to be passive in nature. One question is whether an exception should be made for royalty interests developed as part of an active business. In principle, there is a case to exclude such royalty income from passive income, and some countries do so. Australia, for example, treats as active royalties received from non-associates in the course of carrying on a business provided the property or right for which the royalty is paid originated with the CFC or was substantially improved or developed by the CFC. However, the determination of appropriate borderlines is very difficult. The wider question of the taxation of intellectual property remains controversial internationally.

3.19 A number of factors must be considered in determining whether such an exception for royalties associated with an active business is desirable, including:

- the possibility of the transfer of intellectual property out of New Zealand without incurring a tax liability;
- the general difficulty of separating royalty income from the value of related goods and services; and
- the difficulty in assigning such income to a jurisdiction with certainty.

3.20 As a consequence of these difficulties, further consultation is necessary before the appropriate treatment of royalty income can be determined.

Rental income

3.21 In most jurisdictions, rental income is considered passive in nature. This is also our starting position.

3.22 It might be argued that, in certain circumstances, rental income could be considered to have the character of active income. Specifically:

- when the CFC is actually in the business of renting;
- when the CFC is not in the business of renting, but is an active business earning incidental rental income – for example, by leasing spare capacity; and
- when the CFC holds property used by related CFCs for the purposes of carrying on an active business, receiving rental income from those other CFCs.

3.23 In practice, appropriately distinguishing between active and passive rental income can be difficult and subjective. However, real property, by its nature, is tied to the jurisdiction in which it is situated. While equipment is obviously more mobile, concerns about profit shifting only arise if the CFC is earning rents from outside its jurisdiction. In the interests of keeping the definition of passive income limited, appropriately targeted and as straightforward as possible, it is therefore proposed to treat all rental income as active to the extent that it is derived from the leasing of real property or equipment situated in the same jurisdiction as the CFC. Other rental income will be passive.

3.24 Finance leases will be treated as loans giving rise to passive income irrespective of whether the source of the payments is within the same jurisdiction as the CFC.

Foreign exchange gains and losses

3.25 Foreign exchange gains are brought to tax as interest under the rules for financial arrangements. When foreign exchange gains arise from trading foreign exchange instruments or when such instruments are part of an arrangement that yields a return that has the same nature as a return on a passive investment, they should be taken into account for the purposes of attribution and the active business test.

3.26 On the other hand, when the gains arise as part of hedging strategies for an active business, conceptually they should be considered to be part of that active business. Moreover, in a pure hedge no net gain or loss is made by the business.

3.27 This separate treatment requires foreign exchange transactions to be classified as active or passive. Further work is needed to explore whether this distinction can be based around categories used under IFRS accounting standards.

Other income

3.28 Some types of income are incidental to the conduct of a business, with amounts involved typically being small: bank interest on the CFC's account would be one example. Rather than attempting to make a specific definition of "incidental to the business", such income would be covered by the five percent threshold of the active business test.

Financial institutions

3.29 The discussion document raised the issue of whether the offshore interest and other income of financial institutions should be considered to be active or passive. The document recognised that such income, while passive in form, could be derived from an active business. Nevertheless, the document stated that, in the absence of substantial offshore activity for such industries, there was a preference to treat it as passive; that is, to continue to subject it to accrual taxation in New Zealand.

3.30 The government's view continues to be that income earned by financial institutions should be treated as passive.

3.31 Consultations have demonstrated, however, that there are a number of insurance companies with offshore insurance CFCs. This raises the question of whether there should be a specific exception from the general rule for insurance companies. Whether to extend the active income exemption to such companies would depend upon the resolution of a number of difficult areas:

- Defining the borderline between active and passive: investments within a CFC could be passive in nature even if the business of the New Zealand parent company were active.
- Allocating expenses and income between New Zealand and the CFC. This is particularly difficult for any financial institution owing to the fungibility of money and its simple relocation.
- Interest allocation rules: these would need to be developed and extended (for example, to deal with the role of reserves of insurance companies).
- Managing the risk to the New Zealand tax base associated with vehicles such as captive insurance companies.

Base company income

3.32 A number of countries, including the United States and Australia, have broad base company rules. Base company rules treat certain nominally active income of a CFC as passive in cases where there is a risk that either the income relates to activities conducted in the home jurisdiction or that the CFC has been created to relocate profits into a low-tax jurisdiction.

3.33 In our consultations, many companies expressed the view that, in the New Zealand context, broad base company rules would interfere with normal commercial business arrangements. The government acknowledges this concern. Indeed, it is very difficult to design any base company rules that do not catch some legitimate business in their net. Given this reality, the government proposes that base company rules should apply only where there appears to be a significant risk of tax base erosion and where transfer pricing rules are not applicable or would be especially difficult to apply.

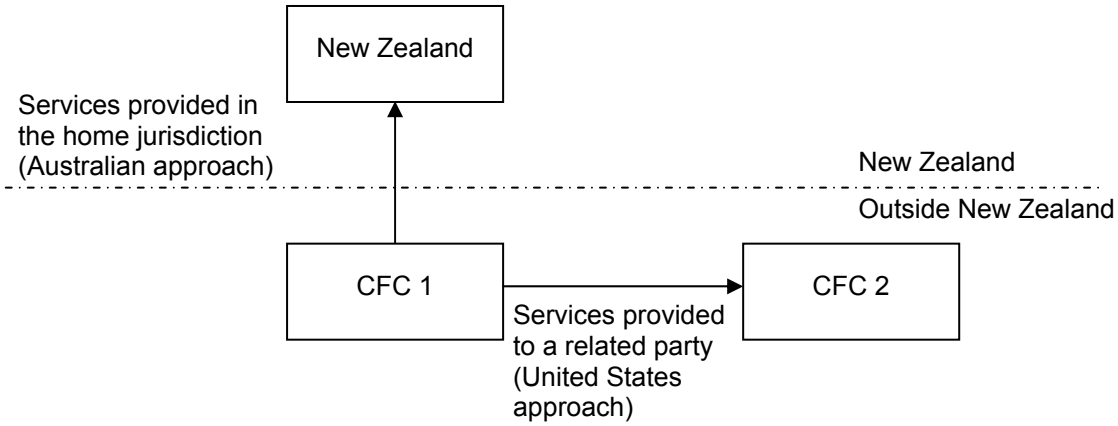
3.34 For the sale of goods, transfer pricing rules are well developed, so base company rules should not apply. This logic extends to the supply of services by the CFC that are related to that sale of goods. Overall, the absence of base company rules for goods means that firms engaged in export and distribution activities will not be subject to such rules.

3.35 Developing the final policy and methods of implementation of base company rules for services requires further consultation.

3.36 Internationally, base company rules for services are focused on a number of situations. As shown in figure 3, factors that are relevant in the tests include:

- (in Australia) whether the services are provided in the home jurisdiction; or
- (in the United States) whether the services are provided to a related party and performed outside the jurisdiction of the CFC.

FIGURE 3: Overseas approaches to base company services income



3.37 It is not yet clear how these rules would affect New Zealand businesses. Consider the first test, in which the services are provided to the home jurisdiction. There could be a concern if a CFC provided services back to New Zealand, giving rise to a deduction against the New Zealand income of a New Zealand resident. On the other hand, as with all base company rules, there is a risk that such a rule would catch income relating to a service provided back to New Zealand for legitimate commercial reasons. Overall, the risks in this area seem more pronounced when the New Zealand resident is a related party of the CFC providing the service.

3.38 The second test focuses on whether the service is provided to related parties, although in the US there is no base company income, even for services to related parties, when the service is performed in the jurisdiction of the CFC. Accordingly, another possible rule would be to apply base company rules if the services were performed outside the jurisdiction of the CFC. An example of the latter situation would be the services provided by a communication satellite. The related service, being the transmission of the information, is not performed in any particular location and so the service income related to the satellite could be allocated to New Zealand.

3.39 There could, however, be concerns with this test. For services, the determination of the place that the service is performed may not be concrete, certain, or necessarily confined to a single place. And, again, there is the prospect of catching legitimate commercial arrangements.

3.40 This is an area where further discussion with business is necessary to establish an appropriate approach for base company rules on services.

Personal service income

3.41 The discussion to date has focussed on larger, multi-national businesses, although the rules could also be employed by individual taxpayers. In some cases the new rules could undermine the residence taxation of personal income. For example, an individual could use a personal service contract through a CFC to avoid personal tax in New Zealand on income arising from personal effort. This issue will be considered as part of the second stage of consultations.

4. MINIMISING COMPLIANCE COSTS

4.1 The discussion document outlined two principal ways that other countries use to implement an active-passive system. The first is the so-called entity approach, which categorises a CFC as active or passive depending upon the characteristics of the company. Once categorised as active, all the CFC's income is exempt; if it is considered to be passive, all its income is subject to attribution.

4.2 The second approach discussed is the transactional method. This method looks at the transactions of the CFC and determines if they are active or passive; exempting the income associated with the former and taxing the income arising from the latter.

4.3 Most submissions on this issue expressed a preference for an entity approach. They expressed concern that the transactional approach would be very compliance-intensive and would force companies to make complex allocations and calculations to tax small amounts of incidental passive income. Also, there was concern that a transactional approach might involve more compliance costs than the current rules.

4.4 The government shares the private sector's concerns about a pure transactional method. However, it does not support a pure entity approach either. The entity approaches used in European countries generally have a high tolerance (up to 50 percent) for passive income, which could lead to considerable amounts of passive income escaping New Zealand tax. Moreover, the large amount of passive income that would be allowed could leave room for considerable avoidance activity.

4.5 On the other hand, if the threshold for passive income were reduced from 50 percent to, say, 10 percent, companies that are predominantly active could be taxed as passive, contrary to the policy intent. In addition, much of the apparent simplicity of the entity system may be illusory once it must be applied in complex situations with many CFCs.

A simple active business test for passive income

4.6 Instead, the government proposes a hybrid method, which arguably has the advantages of the pure methods, while avoiding or minimising their disadvantages. Under this approach, which would be similar in concept to the Australian method, CFCs would be allowed to earn up to five percent of their gross income from passive sources without triggering the attribution rules.

4.7 A five percent threshold may sound low, but in practice is anticipated to be relatively generous. First, using gross, rather than net, income when applying the active business test will make it easier for businesses to pass the test. This is because gross returns on active assets (such as manufacturing plants or distribution/sales facilities) are typically higher than those on passive assets (such as investments in securities) providing comparable net returns. This is as a result of the higher costs associated with generating returns from active assets. So firms that have a mixture of active and passive income would have to hold a significant proportion of passive assets to breach the five percent threshold.

4.8 Second, the Australian experience suggests that limiting the components of passive income is much more important than increasing the threshold in achieving compliance savings. The limited definition of passive income, particularly the absence of base company rules on goods, would simplify the test for most companies.

4.9 Consultation with New Zealand business to date has indicated that the proposed definition of passive income, outlined earlier, should exempt most major New Zealand companies with CFCs from the need to attribute offshore passive income, while also protecting the tax base from substantial erosion from tax minimising strategies using passive income. An advantage of a hybrid approach is that were a predominantly active business to cross the threshold, only its passive income would be taxed as it accrues. The active income would remain exempt from New Zealand tax, consistent with the underlying policy objectives of an active income exemption.

Basing the test on the CFC's books

4.10 Under the active business test none of the income of a CFC will be attributed if the passive income of the CFC is less than five percent. It is expected that very few genuinely active businesses will breach the five percent threshold. However, if they do, it will be necessary for passive income to be calculated under New Zealand tax rules.

4.11 It is proposed to base the active business test on amounts as calculated in the CFC's books (using IFRS accounting principles). Taking the CFC's financial statements as the basis for the active business test should minimise compliance costs for businesses determining whether they qualify for the full exemption.

4.12 Australia already adopts a similar approach. Indeed, implementation of the test in New Zealand should be comparatively more straightforward because of the more limited definition of passive income – in particular, the absence of base company rules on goods.

4.13 Two general questions might arise in using accounting standards for purposes of the test.

- Can the categories of passive income be adequately identified from the accounts?
- Are the amounts of income that are measured appropriate given differences in rules – for example, around timing?

4.14 Using financial statements might give rise to some odd results in particular cases. For instance, discrepancies between accounting principles and tax rules may result in CFCs failing the active business test but then having less than five percent passive income to attribute when the tax rules are applied. The opposite result could also happen. This is an inevitable consequence of using the financial statements as a proxy for the purposes of the threshold rule.

4.15 Further work will be undertaken to resolve any issues or difficulties associated with relying on accounting rather than tax principles. Managing the trade-offs between the clear advantages of using financial statements and consistency with the measure of passive income for the purposes of attribution (where applicable) will be the subject of further consultation. Keeping compliance costs to a minimum will be a key objective.

4.16 Another important issue for further exploration and consultation is the possibility of allowing businesses to use a single set of consolidated accounts for CFCs in a given jurisdiction when applying the test. This would allow the test to be applied once in each country, rather than separately for every CFC. This is consistent with the regulatory requirements in some jurisdictions, under which only one set of financial statements, covering a number of companies, is prepared. The Australian Securities and Investment Commission, for example, allows some groups of companies to file consolidated financial statements or provides relief from filing requirements under a financial reporting class order.

Dealing with foreign exchange gains and losses for the purposes of the test

4.17 During the consultation process, it was pointed out that unanticipated foreign exchange gains and losses could produce considerable uncertainty in the operation of the active business test. To a certain extent, any active business with foreign currency debt transactions may experience gains or losses from year to year as a result of currency fluctuations. As noted earlier, to the extent that any gains are passive in character, it is appropriate to take them into account as passive income for the purposes of attribution.

4.18 However, the requirement to calculate any foreign exchange gain/loss by reference to fluctuations against the New Zealand dollar (NZD) may affect whether a company passes the active business test in any given year. It may fail the test one year and pass it the next because of fluctuations in the NZD exchange rate, even though the activities of the company and the nature and size of its revenue streams remain constant.

4.19 One way of preventing fluctuations in the NZD exchange rate affecting the active business test would be to allow the CFC to calculate foreign exchange gains and losses by reference to its functional currency, rather than the NZD, for the purposes of that test. This result would naturally occur if the test could be based on the books of the CFC, as discussed earlier.

4.20 Calculating foreign exchange gains and losses for the purposes of the active business test by reference to a currency other than the NZD does raise some base maintenance concerns because of the risk that choice of functional currency will be manipulated. This is the reason the rules currently stipulate that NZD must be used as the reference point. It will be necessary to explore how far this risk can be managed through appropriate anti-avoidance rules. The appropriate treatment of foreign exchange gains and losses for the purposes of the active business test will be a subject of further consultation.

Attribution under a hybrid approach

4.21 For a CFC that fails the active business test, all its passive income will be taxable as it accrues (that is, not just that passive income that exceeds the five percent allowed under the active business test). Compliance costs can arise in calculating the passive income of the CFC and allocating foreign tax paid and costs to that income. While the later calculation is potentially complex, it is not expected that many firms would have mixed active and passive entities. The detail of the calculation methodology will, in any case, be the subject of further consultation.

5. KEY BASE MAINTENANCE ISSUES

Replacement of the grey list

5.1 At present, all income earned by CFCs is subject to tax on accrual, except for income earned in eight grey list countries, which is exempt from tax. This exemption applies to both active and passive income because, in contrast to the proposed system, there is no such distinction in the current New Zealand system.

5.2 The grey list exemption is designed to reduce compliance costs. It assumes that the eight grey list countries have comparable tax systems to that of New Zealand. On the assumption of comparable taxation, applying New Zealand taxation would simply impose high compliance costs, with no net New Zealand tax being paid after the granting of foreign tax credits on the income. Should specific provisions lead to a less than comparable level of tax, there is provision for the current grey list exemption not to apply and the income to be taxed.

5.3 With the introduction of an active-passive distinction, the policy considerations "for and against" a grey list change substantially. Under the current system, the exemption depends upon the assumption of comparable taxation, regardless of the nature of the income. Under the proposed active income exemption, the exemption depends upon the nature of the income, regardless of the level of taxation.

5.4 The proposed system involves no taxation of the dividend and allows considerable margin in the application of the interest allocation rules (owing to the 75 percent safe harbour). Accordingly, taxation of passive income, no matter where it occurs, forms a cornerstone in protecting the domestic tax base from tax-eroding strategies.

5.5 Thus, in principle, passive income should be taxed, even if it is earned in a grey list country.

5.6 Submissions gave strong support in favour of retaining the grey list. For taxpayers, it is seen as the simplest way to avoid the compliance burden of proving that a CFC is active. The arguments advanced were essentially those for the current grey list exemption. It was argued that any passive income would be comparably taxed, except perhaps for certain specific provisions in the country. Submissions argued that such provisions could be easily monitored and specific exceptions from the exemption provided.

5.7 For active income there is considerable merit in these arguments. However, for passive income, such arguments are much less compelling. It is not easy to monitor changes in other jurisdictions, where non-taxation of passive income may occur, not just from explicit incentives, but from the architecture of the other country's tax system.

5.8 For instance, the tax systems of different countries have technical differences that can be exploited with arbitrage schemes. Differences in tax treatment of preference shares between New Zealand and countries such as Australia and the US provide examples. Differences may also occur in the classification of entities, such as the treatment of limited partnerships in New Zealand and Australia and the check-the-box rules in the US.

5.9 The concern over compliance costs, however, is a valid one. In response to those concerns, a simplified active business test will be developed to limit the number of CFCs that are required to attribute passive income under New Zealand tax laws. Given that the new rules would apply to CFCs in all countries, they should result in a significant reduction in compliance burden for companies with CFCs in non-grey list jurisdictions. In the future the government expects there to be considerable growth in the number of CFCs in such jurisdictions.

5.10 Other methods of determining when passive income would be taxed have been considered. A number of countries apply tests based upon the nature of the CFC, such as whether it has paid a comparable level of tax or pays out most of its income as dividends. Such tests do not have an explicit grey list. As compared to the proposal, they would generally be more compliance intensive and would be less effective in targeting the exemption to situations where it is appropriate from a policy perspective.

5.11 In any event, it is not simply a question of whether or not to retain the grey list. Any future grey list would need to be supported by specific anti-avoidance rules to deal with existing and future tax minimising strategies. These rules would be complex and at risk of being circumvented by the development of future strategies that avoid their application.

Extending interest allocation rules to outbound investment

5.12 The policy case for interest allocation rules is clear. If an exemption is to be given for offshore active income it is necessary to measure it properly. Among other things, this requires a reasonable allocation of interest costs throughout the group to match those costs to the income being earned. Otherwise a disproportionate share of the global interest costs could be allocated against the New Zealand tax base.

5.13 To protect the New Zealand tax base, the government proposes to extend the existing interest allocation rules to companies with CFCs and to remove investments in the CFCs from their New Zealand assets for purposes of calculating their New Zealand debt-to-assets ratio.

5.14 Australia has comprehensive interest allocation rules, and Canada has just announced that it will be denying interest deductions for loans incurred to fund outbound investments earning exempt income. The US has a form of interest allocation rule as part of its foreign tax credit system. Other countries, such as the UK, Denmark and Germany, are currently re-examining their treatment of interest.

5.15 It is recognised that, at times, loading debt into New Zealand is likely to be attractive. On the other hand, firms will not always prefer to borrow and take interest deductions in New Zealand rather than offshore. If, for example, income is taxed at a higher rate in the offshore CFC than in New Zealand, it would normally be preferable to borrow and take interest deductions offshore. Even where the tax rate in the offshore CFC is lower than in New Zealand, New Zealand's full imputation system may provide incentives for New Zealand-owned firms to avoid stacking excessive debt into New Zealand.

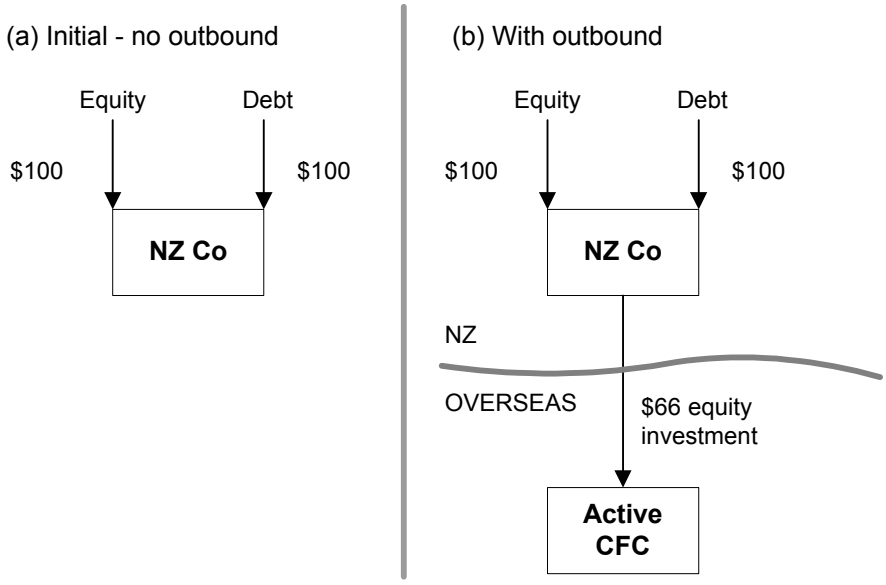
5.16 Furthermore, the government recognises that the interest allocation rules will apply to a range of different businesses and industry sectors. Appropriate levels of debt will vary across those sectors. It will therefore be necessary to keep the interest allocation rules relatively loose. Tighter rules, which may be appropriate in some circumstances, would risk unfairly denying interest in others. This is in contrast to the banking sector, where capital is a main input in the structure of a bank and the focus of its regulatory and accounting rules. In that case, it was possible to develop thin capitalisation rules that are closely correlated with the income earning capacity of the bank.

5.17 The discussion document raised the possibility of lowering the 75 percent safe harbour.[3] However, as already noted, a tighter system risks denying interest that should be deductible. Moreover, Australia has a safe harbour of 75 percent. The government therefore proposes to maintain the safe harbour at its current percentage.

5.18 With a 75 percent threshold, a significant percentage of the New Zealand income of a company with either an offshore parent or CFCs is open to be sheltered by interest expenses relating to offshore activity. Figure 4 shows the impact of the 75 percent safe harbour for a company, NZ Co, which has a worldwide debt to assets ratio of 50 percent initially. In this example, NZ Co could move about one-third of its assets offshore to generate exempt income and still not breach the 75 percent safe harbour. As such, a portion of its New Zealand income could be sheltered by interest expenses relating to the offshore investments.

[3] Under the current rules, interest deductions for an entire New Zealand group are not challenged if the group debt percentage does not exceed 75 percent (a debt-to-asset ratio of 3:1 for the entire New Zealand group). If this safe harbour is exceeded, interest deductions for the group will be limited to the higher of a debt level consistent with the 75 percent New Zealand group debt percentage or 110 percent of the worldwide group debt percentage.

FIGURE 4: Impact of 75% safe harbour ratio



5.19 Nevertheless, for companies with active businesses offshore, even a relatively generous threshold of 75 percent would offer protection against aggressive tax planning when coupled with the taxation of passive income.

5.20 Therefore interest allocation rules with a 75 percent safe harbour can be seen as providing a basic protection for source taxation, and to buttress rules related to the definition of passive income. The rules would allow some allocation of interest costs from debt related to offshore investments to be deducted against New Zealand-sourced income. This could be of particular benefit to firms newly entering offshore activities if a threshold were part of the package.

5.21 The details of the interest allocation rules will be a subject of further consultation.

Other interest allocation design issues

5.22 The discussion document raised a number of concerns relating to the design of the interest allocation rules. Following submissions on these issues, the government has decided not to proceed with a number of the options raised.

Worldwide comparison

5.23 The discussion document raised the question of whether it is appropriate to maintain the current ten percent uplift for purposes of the worldwide comparison test for companies that exceed the safe harbour. Following consultations, the government proposes to maintain the worldwide comparison test with the ten percent uplift.

On-lending concession

5.24 The government also proposes to maintain the on-lending concession. This concession facilitates a New Zealand company's movement of debt deductions to the CFC's jurisdiction, in order to avoid interest denial in New Zealand.

5.25 The on-lending concession allows funds that are lent to CFCs to be removed from the liabilities and assets of the New Zealand company for purposes of the interest allocation rules. This would place the New Zealand company in the same position as if the funds had been borrowed directly by the CFC.

5.26 When financing the establishment or purchase of a CFC, a New Zealand parent has the choice of advancing the funds in the form of equity or debt to the CFC, or often, through a holding company in the jurisdiction of the CFC. The on-lending concession would allow the parent to advance the funds in the form of debt and so reduce the net debt recognised in New Zealand for purposes of the interest allocation rules.

5.27 While the interest payments to the parent would attract withholding tax, it would be normal that there were sufficient margin over the average cost of funds of the parent to absorb the foreign tax credit.

Goodwill and the relationship to banking minimum equity rules

5.28 Another technical question raised in the discussion document was to what extent the minimum equity rules for banks should be extended to the non-banking sector. A number of these issues were of particular concern to firms.

5.29 In particular, the possibility that goodwill could be removed from assets for the calculation generated considerable negative comment. Discussions have underlined that the issues for the general business environment are different from those for banks, and that a simple transfer of provisions from the bank rules to the general rules would not make sense. It is recommended not to make an adjustment with respect to goodwill.

5.30 The discussion document also raised the question of whether the foreign tax credit adjustment under the banking interest allocation rules should be extended to the general interest allocation rules. Under the banking rules, a notional amount of foreign assets underlying a foreign tax credit claimed is deducted from New Zealand equity in determining whether there should be a denial of interest. It is not proposed that this adjustment be extended outside the context of the banking rules as it would effectively deny foreign tax credits in situations where this would be inappropriate.

5.31 Nevertheless, it may be appropriate to make some adjustments to the general rules based on the banking rules. Two specific adjustments will be developed for consideration in the second round of consultation:

- The first adjustment would be to include preference shares issued to New Zealand residents as liabilities for purposes of the interest allocation calculations. Removal of preference shares issued to New Zealand taxpayers follows from the interaction of the imputation system and the interest allocation rules. A company at its interest allocation limit, which wishes to issue debt, the interest on which would be denied, can avoid the denial by issuing a debt-substitute preference share.
- The second would be to bring the concept of liabilities used to calculate the worldwide ratio in line with the concept of liabilities used in calculating the debt to assets ratio of the New Zealand entity. Currently, the worldwide ratio includes a variety of non-interest bearing liabilities that, arguably, inflate the worldwide ratio relative to the New Zealand ratio. This disparity can be material for taxpayers who breached the 75 percent safe harbour threshold.

Foreign tax credit rules

5.32 The discussion document also raised the issue of whether more extensive changes in the foreign tax credit rules were warranted. The government does not propose to make changes to the foreign tax credit rules. Rather, in our view, the extension of the interest allocation rules to all outbound investments provides general protection against excessive leverage.

5.33 Nevertheless, the issue of whether sufficient costs have been allocated to foreign income in calculating the allowable amount of foreign tax credits does arise in a specific avoidance context. It is possible to make arrangements that give rise to foreign tax credits and interest deductions against the New Zealand tax base when the tax being paid in the foreign jurisdiction does not impose an economic burden on the transaction. This is because the tax is effectively offset against other income of counterparties of the transaction. To counter this possibility, it is proposed to introduce a targeted anti-avoidance rule. The development of this anti-avoidance rule would be a subject of further consultations, but this rule should not affect active businesses.

The conduit rules

5.34 The current conduit rules remove the income tax liability of New Zealand companies on foreign income to the extent that the company is owned by non-residents. It is proposed that the conduit rules be repealed. They will become unnecessary in relation to active income once the active income of CFCs becomes generally exempt. The rationale for continuing to provide conduit relief in relation to passive income only is much weaker. To do so would involve material, on-going risk to the tax base.