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**Taxing Income Across  
International  
Borders**

*A Policy Framework*

30 JULY 1991

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International  
Borders**

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30 July 1991

# PREFACE

Minister of Finance, Hon Ruth Richardson

Minister of Revenue, Hon Wyatt Creech

## TAXING INCOME ACROSS INTERNATIONAL BORDERS

International tax is the most complex area of taxation policy, as it potentially involves the interface between the New Zealand tax system and every other tax system in the world.

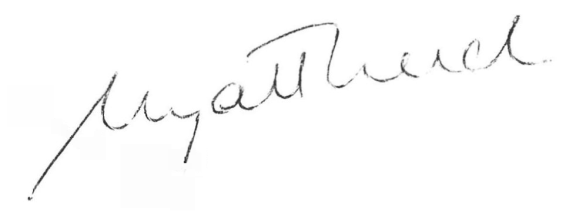
A clear international tax policy will reduce the uncertainty surrounding international taxes and assist taxpayers, professional tax advisers and tax administrators.

The Government has issued this framework paper to raise the issues, and the interrelationships between them, for debate.

The Government welcomes comment on these issues.

The intention is to develop proposals for implementation on the basis of consideration of this framework and submissions received.

The Government’s current intention is to have these policy issues decided in time for implementation by 1 April 1992.

Ruth Richardson Wyatt Creech

Minister of Finance Minister of Revenue

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# Chapter 1 Introduction

This document sets out the Government’s policy framework for international taxation.

New Zealand’s international tax policy must address four basic questions:

* Who is a resident of New Zealand?
* What is New Zealand-source income?
* How should New Zealand residents be taxed on their foreign-source income?
* How should non-residents be taxed on their New Zealand-source income?

The answers to these questions are often inter-related. Answers to one question may alter the answers that can be made to others.

To put these inter-relationships into context, the Government has developed a framework for consideration of international tax principles and objectives. This sets the groundwork for the detailed development of policy proposals.

The first decision based on the framework has been made. This is the change to Non-Resident Withholding Tax (NRWT) on interest announced in this year’s Budget.

Chapter 2 outlines the policy framework which the Government has developed and explains why the particular framework was selected.

Chapter 3 sets out directions for reform of the taxation of non-residents. It first discusses the taxation of debt supplied by non-residents. Detailed decisions on this have been announced in the Budget. The paper then goes on to cover the taxation of non-residents’ equity investments.

The taxation of residents’ foreign-source income is the subject of Chapter 4.

The paper concludes in Chapter 5 with an outline of the Government’s proposals to co-ordinate its international taxation actions with those of other governments.

# CHAPTER 2 Policy framework

## Introduction

The international tax policy outlined in this paper is a key element of the Government’s fiscal and economic plans.

The Government’s objective is to shift the New Zealand economy from a slow-growth to a high-growth track.

To grow, New Zealand needs investment. Much of the funding required to finance that investment will come from overseas.

A credible fiscal plan is one of the necessary conditions for achieving long-term growth. The 1991 Budget sets out a clear plan to bring Government expenditure and revenue into a sustainable fiscal position.

To maintain that fiscal position, the tax system must continue to be able to raise revenue effectively. However, the Government needs to consider more than just the revenue raising potential of various taxes.

Taxes on residents’ offshore incomes should be designed to ensure that capital flows to where it will produce the highest yield for all New Zealanders. If this is done effectively, the taxes should raise revenue directly and inhibit residents from locating their income outside of New Zealand to knowingly or unknowingly take advantage of lower or less effective tax structures elsewhere.

Taxes on non-residents should be designed to raise revenue without raising interest rates or barriers to the foreign funding for investment that New Zealand needs to grow and without risking serious erosion of the New Zealand tax base. New Zealand needs to be an attractive destination for quality investment: investment that will improve the New Zealand skills base, raise productivity and encourage an outward-looking business focus.

## Background

New Zealand’s international tax regime encompasses:

* domestic laws defining New Zealand residence
* domestic laws defining New Zealand-source income
* taxes on the foreign-source income of New Zealand residents
* taxes on the New Zealand-source income of non-residents
* double tax agreements (DTAs) with other countries.

The two key questions discussed in this paper are:

* How should New Zealand tax non-residents who earn income in New Zealand?
* How should New Zealand tax residents who earn foreign-source income?

Of special significance is the taxation of income both resident and non-resident individuals earn through separate legal entities like companies.

### Ways of earning income

Individuals can earn income directly or indirectly through a company or other legal entity.

Direct income includes dividends from companies, interest from bank accounts and wages and salaries.

New Zealand taxes direct foreign-source income of residents in much the same way as such income earned domestically, although New Zealand often gives a credit for any taxes paid to foreign governments.

For example, interest earned from a bank account in a foreign country is taxable in the hands of a New Zealand resident in the same way as interest from local banks is taxed. However, New Zealand would provide a credit for any NRWT paid to the foreign government in question.

Likewise, New Zealand taxes the income that non-residents earn directly in New Zealand.

For example, it applies non-resident withholding tax on interest, royalties and dividends paid to non-residents.

Income earned indirectly through separate legal entities poses special taxation problems. This is because, legally, an individual and a company they own are not the same. Therefore, income earned by a company is not usually regarded as income earned by the individual.

The individual shareholder, however, does expect to ultimately benefit from the income earned by the company. They can receive

this benefit through either the payment of dividends by the company or by selling shares in the company.

Domestically, the company tax is used to ensure that individuals cannot escape tax by earning income through companies.

New Zealand’s imputation credit system allows residents to claim credits for New Zealand company tax against personal income taxes on dividends where that company is a New Zealand-resident company. The combination of company tax, personal income tax, and the imputation system ensures that resident shareholders are taxed on both the retained and distributed income that they earn through resident companies.

New Zealand cannot, however, apply its company tax to income earned through overseas companies or funds owned by its residents. To the extent that it seeks to tax this income, New Zealand must tax individuals themselves on the income they earn through such vehicles.

## Analysis

Developing international tax policy depends on understanding the inter-relationships between international taxation, domestic taxation and the domestic economy.

### Taxes on non-residents

This section presents an analysis of the taxation of non-residents. The examples given are stylised to bring out the key points. Specific directions for change to specific parts of the current taxation regime are discussed in Chapter 3.

The taxes that New Zealand imposes on non-residents earning income in New Zealand can, while raising revenue, increase the cost of capital (including domestic interest rates) to all New Zealand businesses.

This is because New Zealand has an open economy and is largely a price taker in world capital markets.

For example, consider foreigners deciding whether to invest $1,000 in domestic bonds issued by their own country or in New Zealand bonds. If they could earn $100 (i.e. 10%) from the domestic bonds before home taxes, they would, all other things being equal, require the same return after New Zealand taxes before they would buy the New Zealand bonds.

If New Zealand imposes a 15% tax on interest paid to foreigners, then New Zealand issuers of bonds would have to pay $117.65 to the foreigner to induce them to buy New Zealand bonds. That is, the

before-tax interest rate paid to foreigners would be 11.765%, while the rate would be 10% after New Zealand taxes.

In other words, the post-New Zealand tax rate of interest the foreign lenders receive is the same, regardless of the tax New Zealand imposes. The tax is not in fact borne by the foreigner. It is borne entirely by the New Zealand borrower in the form of higher interest rates.

Moreover, because bond markets are open to both local savers and foreigners, the bond issuers would have to offer a return of 11.765% to all purchasers of the bonds. This would have the effect of raising all interest rates in New Zealand.

Accordingly, imposing a tax on foreigners, while raising revenue (in this example $17.65), also imposes an indirect cost on New Zealand residents in the form of higher interest rates, which will tend to lower investment and real wages.

A similar argument applies, with some qualifications, to the returns to equity capital. That is, applying a tax on dividends paid to non-residents would require New Zealand firms to pay higher dividends to their non-resident shareholders to compensate for the New Zealand tax.

Increasing productive investment is a key part of the Government’s economic strategy. Foreign capital can play a vital role in financing the productive investment that New Zealand needs to grow and prosper.

In general, therefore, New Zealand should reduce the taxes imposed on non-residents. This would benefit borrowers from domestic financial institutions as well as borrowers from overseas.

There is, however, one qualification to this general rule, which concerns the tax treatment non-residents receive from their home governments.

New Zealand’s double taxation treaties are intended to co-ordinate New Zealand’s tax system with those of its treaty partners. They can help to improve the economic impact of those tax systems and reduce tax compliance and administrative costs.

Tax treaties often involve a system of foreign tax credits. That is, in return for both parties agreeing to impose lower rates of NRWT, they agree to give a credit for each other’s NRWT against the taxes they impose on their own residents’ foreign-source income.

Such credits allow New Zealand to raise revenue from NRWT (albeit at a lower rate) without increasing the cost of capital.

This leads to the conclusion that New Zealand might wish to lower some taxes on non-residents, except in the context of bilateral arrangements to tax non-residents with an offsetting credit.

However, before this (or any) final decision can be made on the taxation of non-residents, it is necessary to explore the wider implications of such a decision.

### Taxes on residents

There is a close link between the taxation of non-residents’ New Zealand-source income and the taxation of residents’ foreign-source income. Thus, the question of taxing residents on their foreign-source income needs to be considered in conjunction with the taxation of non-residents and decisions on the two integrated.

Economic costs would result and the domestic tax base would be eroded if residents were able to use the lower taxes levied on foreign investors to reduce their New Zealand tax liability[[1]](#footnote-1).

Consider the example in the previous section of foreigners buying New Zealand bonds. Suppose that New Zealand chooses not to tax non-residents. In that case, a New Zealander could receive 10% before New Zealand tax on New Zealand bonds. After a 33% New Zealand income tax, the rate of return falls to 6.7%. However, there are a number of ways that a New Zealander could receive 10% rather than 6.7%.

First, they could become a ‘tax exile’ by ceasing to be a resident of New Zealand while still having New Zealand-source income. They would receive the same 10% return after New Zealand taxes as foreigners, for the same reasons. This is not a significant policy concern, as the costs of becoming a tax exile usually mean that this is not a viable proposition.

Secondly, they could remain a resident, but interpose a non-resident legal entity like a company or a trust that is not subject to New Zealand tax between themselves and the New Zealand source of their income. (This, in essence, is what ‘Island run-around’ tax avoidance

schemes used to involve.[[2]](#footnote-2)) The company would earn 10%, because it is a non-resident and, therefore, not subject to New Zealand tax. The person could defer paying New Zealand tax by accumulating the interest, tax free, in the company. Alternatively, they could repatriate the income tax-free, for example by way of a tax-exempt capital gain.

Arrangements such as this would have a limited effect on investment or employment in New Zealand. However, as they have in the past, they would lead to substantial erosion of the New Zealand tax base.

Finally, the person could remain a resident, but divest themselves of their New Zealand-based assets in favour of offshore assets which may be less productive from New Zealand’s viewpoint, but which are subject to lower New Zealand taxes. The incentive to do this would arise if the foreign-source income of residents is subject to a lower rate of New Zealand tax than domestic-source income.

Such divestiture of assets is undesirable for a number of reasons.

It results in New Zealanders undertaking investment which yields New Zealand a lower return even though it is more profitable for the individual concerned.

Although the investment that New Zealanders no longer undertake will be partially replaced by foreign investment, it is unlikely to be fully offset. This has an obvious impact on the associated jobs and real wages in New Zealand.

The New Zealand tax base would also shrink. The higher tax rates required to recover this tax base erosion will themselves have an adverse impact on investment and encourage further erosion of the base.

In short, not taxing residents on their offshore income has much the same effect as not taxing a particular sector of the domestic economy. That is, it produces investment decisions that are, either knowingly or unknowingly, made for tax rather than commercial reasons and can directly or indirectly reduce tax collections.

However, if the Government could put in place a robust regime for taxing residents on their foreign-source income, it can have low taxes on non-residents (with the lower interest rates and higher real wages

that implies) without either risking erosion of the tax base by residents or inducing them to invest offshore.

## Taxation of residents in practice

Low taxes on non-residents are important to the Government’s employment and growth objectives. However, pursuing that policy goal while exempting New Zealanders’ foreign-source income would have severe adverse economic and revenue impacts.

This means that foreign-source income should be taxed unless the compliance and administrative costs outweigh the economic and revenue effects of not doing so. At the same time, New Zealand’s experience suggests that taxing all such income is impractical.

In the New Zealand context, the most comprehensive way of taxing all foreign-source income would be to tax residents on all the income they earn directly offshore, to remove the ‘grey list’ and control tests from the CFC regime, and allow residents a deduction for foreign taxes when calculating their CFC income, rather than the current credit.[[3]](#footnote-3)

It should be stressed that the Government is not advocating this extreme position.

Such a regime would be past the point where the benefits of taxation (in terms of revenue and business behaviour) are offset by compliance and administration costs.

The Government will not put in place tax structures where compliance and administration costs are larger than the benefits.

The key question in addressing the taxation of residents’ foreign-source income is the design and scope of the CFC and FIF regimes.

The key policy issues for these regimes are discussed below. Options to change the detailed design of the regimes are presented in Chapter 4.

### The CFC regime

The desirable scope of the CFC regime involves judgements about the trade-off between compliance costs and the consequences of exempting some forms of income from tax.

If some income is exempt from tax, other types of income need to be taxed more heavily. Thus reducing taxes on the people who earn income through CFCs involves a higher tax burden on those who do not.

As discussed above, not taxing some sorts of income while taxing others will encourage people to earn the less heavily taxed income, even if that results in a lower yield to all New Zealanders.

Exempting income also increases the ability of taxpayers to avoid tax more generally by converting their income into the exempt form.

The operation of the ‘grey list’ in the CFC regime means that most offshore income is exempt from New Zealand tax and thus the regime does not impose any compliance costs on that income.[[4]](#footnote-4) However, the CFC regime does prevent the worst forms of abuse. For example, ‘Island run-arounds’ are now very difficult, if not impossible, to implement effectively.

The Government considers that it will be necessary for a robust CFC regime to remain in place. It will consider easier ways of calculating CFC income for those to whom the regime does apply. Options are discussed in Chapter 4 below.

### The FIF regime

A tax regime is required to protect the tax base from New Zealanders diverting their savings to overseas investment vehicles that they do not control. As noted above, this need becomes even greater if the Government has low effective taxes on non-residents.

The FIF regime is intended to serve this purpose.

The difficulty with all FIF-type regimes is the lack of control exercised by investors. This means that the method of calculating tax must not require detailed records of the fund’s underlying activities.

In New Zealand’s case, the method chosen was ‘comparative value’, which includes an element of taxation of accrued but unrealised (and potentially unrealisable) income.

The FIF regime has a greater anti-avoidance focus and hence a narrower target than the CFC regime. The CFC regime applies to all companies outside the ‘grey list’, while the FIF regime is limited to those funds that have the most potential for tax avoidance and deferral.

While the Government considers that the basic form of the FIF regime should stay in place, the regime can and must be improved.

The comparative value method can result in a different tax treatment compared with domestic taxation of similar investments. This is because comparative value is only a proxy for the domestic company tax and personal income tax systems.

It may also tax returns not taxable under domestic rules, for example genuine unrealised capital gains. This could only be justified if no other practical alternative is available.

There are other difficulties with the FIF regime. The boundary of the FIF regime is often difficult to determine and, in some circumstances, the valuations required to calculate tax are almost impossible to obtain.

While some changes will be made to make the FIF regime easier to comply with, there must be in place a regime that adequately protects the New Zealand tax base.

Experience in New Zealand and overseas shows that countries without exchange controls will face accelerating erosion of the tax base if they do not have FIF-type regimes in place.

Details of the reforms of the FIF regime being considered are discussed in Chapter 4 below.

## Directions for reform

The New Zealand Government has decided in principle that it will move to limit the taxes on income from capital it imposes on non-residents, while maintaining a comprehensive system for taxing residents on their world-wide income. In line with its general tax policy, it will seek to minimise the compliance costs of that regime.

Little change is envisaged in relation to the taxation of labour income.

In reaching this view, the Government has balanced the need to raise revenue, its desire to make New Zealand an attractive investment destination, its policy of securing low interest rates and the compliance costs that the various taxation options involve.

A strong revenue base is necessary for a sustainable fiscal position.

New Zealand needs foreign capital to finance the productive investment necessary for economic growth. Taxes on non-residents, while raising revenue, can increase the cost of financing investment by raising interest rates.

Low taxes on non-residents will both attract foreign capital to fund investment and contribute to low domestic interest rates.

# CHAPTER 3 Taxation of non-residents

This chapter explains the implications for the taxation of non-residents flowing from the above decisions.

The two most important sources of income earned by non-residents are debt (money that foreigners lend to New Zealand firms) and equity (direct investment in New Zealand firms).

Taxes on non-residents raise significant amounts of revenue. NRWT on debt and equity brought in about $265 million in the year to 31 March 1991.

Company tax cannot be precisely separated into payments attributable to resident and non-resident shareholders. However, non-residents own, on average, about 40% of all New Zealand companies. This suggests that non-residents pay about $800 million in company tax.

## Taxes on debt supplied by non-residents

New Zealand taxes income earned from debt supplied by foreigners by applying NRWT to interest paid to non-residents.

Most foreign countries provide tax credits for NRWT. However, credits are effectively limited for many financial intermediaries because NRWT is applied to gross interest and credits are restricted to net income. Tax-exempt bodies, like foreign pension funds, also cannot take advantage of credits because they have no domestic tax liability against which to credit NRWT.

Intermediaries and pension funds are very important players in debt markets.

There are a number of well-known techniques for avoiding NRWT. As a result, until recently the practical effect of New Zealand’s NRWT on interest tended to be:

* NRWT was paid by those taxpayers who could receive credits.
* Taxpayers who could not receive credits avoided or evaded NRWT.

This produced a desirable result from New Zealand’s point of view, as the Government raised revenue with a very limited effect on interest rates.

Interest NRWT appears to have increased bond yields by about 2% of the yield during 1990. This was equivalent to about 30 basis points (0.3 of a percentage point) on average during 1990. This implies that additional interest paid to foreigners on overseas debt because of interest NRWT was about $100 million.

In contrast, NRWT on interest raised approximately $180 million in the year to 31 March 1991. This suggests that a large proportion of NRWT was borne by foreigners.

Thus New Zealand already has low effective taxes on interest paid to non-residents. However, this is achieved by wide-scale avoidance and evasion - practices this Government cannot and will not condone.

### Reforms

As a first step to implementing its policy of maintaining low taxes on interest paid to non-residents, the Government has decided that resident borrowers will be able to apply for ‘Approved Issuer’ status under the Income Tax Act. Approved Issuers will be able to pay NRWT-free interest to the non-residents from whom they borrow.

Approved Issuers will be required to pay a levy for the right to pay NRWT-exempt interest. The amount of the levy will be equivalent to 2% of the exempt interest paid.

Full details of this scheme are contained in the Budget supplement on taxation measures.

The practical effect is that residents who have been avoiding or evading their obligations to deduct NRWT will be able to become Approved Issuers and so pay interest that is exempt from NRWT.

## Taxation of equity supplied by non-residents

New Zealand applies the company tax to the earnings of companies owned in whole or in part by non-residents and NRWT to dividends paid to non-resident shareholders out of those earnings.

New Zealand’s imputation credit system allows residents to claim credits for New Zealand company tax paid by New Zealand resident companies against personal income taxes on dividends. The combination of company tax, personal income tax, and the imputation system ensures that resident shareholders are taxed on both the retained and distributed income that they earn through New Zealand resident companies.

New Zealand’s imputation credit system does not extend to non-residents and New Zealand charges NRWT on dividends. As a result, non-residents earning income in New Zealand are taxed twice by New Zealand on that income: once as the income is earned and again when dividends are paid.

At first sight, it appears that this system for taxing foreign equity will raise the cost of capital in New Zealand and also encourage debt financing.

The true situation, however, is less clear-cut. The Government has commissioned further work on this issue.

First, it may be that there is a bias towards debt financing inherent in world capital markets caused by other countries’ tax systems. If this is the case, then it would not be practical nor desirable for New Zealand to attempt to correct that bias through its tax system.

The tax system should allow taxpayers to finance their operation in the least costly manner before New Zealand taxes, given the costs of various types of capital New Zealanders face in world markets.

Second, foreign credits for the tax New Zealand imposes on equity may reduce or eliminate the effect of New Zealand taxes on the return to equity.

An important reason why this is so for the taxation of equity and not the taxation of debt is that financial intermediaries are less active in the equity market. Because NRWT is levied on gross income flows but home taxes are levied on net income, NRWT can exceed intermediaries’ net profits. However, if intermediaries are not large players in the equity market, this is not such a problem.

On the other hand, tax-exempt investors, like foreign pension funds, are often active in both the debt and equity markets. Foreign tax credits are not available to such investors. In this case, it is likely that the imposition of New Zealand taxes would tend to increase the cost of capital in New Zealand.

In many cases, New Zealand taxes on income from foreign-source equity may only alter which country gets the revenue from taxation rather than reduce taxation itself.

This would be the case, for example, for a small non-resident individual investor who pays dividend NRWT to New Zealand and pays income tax with a credit for dividend NRWT to his or her residence country. Any reduction in New Zealand NRWT would be matched by an increase in home country taxes. The rate of return earned by the investor after all taxes would not have changed. The foreign government would, however, have collected more revenue at New Zealand’s expense.

In order to actually lower the effective rate of taxation, reduction in taxes by either the source or the residence country and recognition of those reductions by the other country without counteracting adjustments is necessary.

This suggests that bilateral or multilateral action is an important part of any move to effectively reduce the taxes New Zealand imposes on equity supplied by non-residents.

One option is bilateral recognition of imputation credits.

Australia and the United Kingdom are the two countries with imputation systems that provide the bulk of investment into New Zealand at present. Australia is by far the major destination for New Zealand outward investment and is one of the chief sources of investment into New Zealand.

New Zealand will be exploring the possibility of mutual recognition of imputation credits in forthcoming bilateral discussions.

# CHAPTER 4 Taxation of residents’ foreign-source income

This chapter reviews the practical implications of taxing residents’ foreign-source income. The particular emphasis is on the taxation of income earned through separate legal entities.

The total foreign-source income of residents, earned both directly and through companies, is about $1 billion. It appears that only a small percentage of this amount is paid in New Zealand tax[[5]](#footnote-5).

Taxing foreign-source income also helps preserve the domestic tax base (the New Zealand-source income earned by New Zealand residents), as discussed above. That is, while taxes on foreign-source income might not raise much revenue, they help ensure that individuals pay other taxes by removing an incentive to earn foreign-source income.

## Taxing income earned through foreign companies

There are two important aspects to the taxation of foreign companies owned by residents.

First, taxing domestic and foreign income on the same basis encourages New Zealanders to invest in a manner that produces the greatest benefit for New Zealand as a whole.

Similarly, taxing New Zealanders on income earned on their behalf through companies on the same basis as income they earn themselves directly encourages them to select whichever direct or indirect investment yields the highest return to New Zealand as a whole.

If New Zealanders were not subject to New Zealand tax on income earned on their behalf by non-resident companies, but were subject to company tax on income earned by resident companies, they would be encouraged to invest offshore, even when investment in New Zealand would have a higher yield. In effect, the tax system would be

subsidising the export of productive investment and associated employment.

That is, the tax system should, wherever possible, ensure that New Zealanders invest how and where they can earn the highest return, rather than how or where they can pay the lowest tax.

Secondly, New Zealand residents can use companies in low-tax countries (‘tax havens’) or in concessionally taxed investment in otherwise high-tax countries, as a way of escaping tax on their New Zealand-source income. For example, a New Zealander could own a company in a tax haven that owns a factory in New Zealand. In the absence of the CFC regime, there are a number of ways this structure could then be used to avoid New Zealand tax.

Such practices would have little effect on investment and employment in New Zealand, but could seriously erode the tax base.

Taxing foreign-source income of New Zealand residents, including that earned through separate entities, will therefore both encourage investment with a sound economic base and protect the tax base from avoidance.

## Taxation of foreign-source income

The Government considers that it should continue to tax New Zealanders on the foreign-source income they earn both directly and through separate legal entities.

This section focuses on the three regimes New Zealand has for taxing income earned through such entities:

* the Controlled Foreign Company (CFC) regime
* the Foreign Investment Fund (FIF) regime
* the Foreign Dividend Withholding Payment (FDWP) regime.

In considering these regimes, the Government must find the best possible compromise between three competing policy objectives:

* effective taxation of residents’ foreign-source income
* removing barriers to investment
* low compliance and administration costs.

## Controlled Foreign Company (CFC) regime

### Purpose and description

The CFC regime is necessary to ensure that foreign-source income is taxed effectively. Before the CFC regime was introduced, New Zealand residents could and did avoid tax by accumulating income in companies resident offshore, but effectively controlled from New Zealand.

The CFC regime attributes the current income of an offshore company back to the New Zealand owners if:

* A group of five or fewer New Zealand residents control 50% or more of an offshore company.
* The offshore company is resident outside a ‘grey list’ of seven designated countries - Australia, Canada, France, Germany, Japan, the United Kingdom and the United States.

CFC earnings are subject to New Zealand tax with a credit for foreign income taxes paid. In effect, CFCs are taxed in the same way that the foreign branches of New Zealand companies have been taxed for many years. For this reason, the CFC regime is referred to as a ‘branch-equivalent’ tax.

The seven grey-list countries were selected according to two criteria:

* tax rules (including standards of administration) that produce effective company tax rates similar to those in New Zealand
* comprehensive international tax rules that reduce international tax planning opportunities and support the New Zealand CFC regime.

The grey list is an example of the compromise between the competing objectives of:

* effective taxation of residents’ foreign-source income
* minimising compliance and administration costs.

Each of these countries have tax rates similar to New Zealand’s and the decision was made to allow New Zealand residents a credit for foreign taxes paid by the company. Therefore, applying New Zealand’s CFC regime to companies in these countries was judged to produce insufficient gain in investment allocation or revenue to justify the costs. New Zealand residents’ interests in foreign companies located in grey-list countries were exempted from the CFC regime.

Implicitly, the regime makes the judgement that where avoidance through the use of interposed entities is not a significant problem, and where revenue gains would be small or nil, the compliance cost savings from not requiring the calculation of income are greater than the disadvantages of encouraging investment and associated employment to move offshore and of higher tax rates on other New Zealanders.

It thus means that the bulk of foreign-source income earned on behalf of New Zealanders through CFCs is exempt from tax on an accruals basis. Over the most recent four years for which statistics are available, 80% of New Zealand Direct Investment Overseas was in the seven grey-list countries.

However, in the jurisdictions where it does apply, the regime does tax foreign-source income of all kinds earned by controlled foreign companies.

In short, the operation of the ‘grey list’ means that most offshore income earned by controlled foreign companies is exempt from the CFC regime.

The CFC regime will continue to tax foreign-source income except where the compliance and administrative costs of doing so outweigh the revenue gain and where there is no significant risk of tax avoidance.

### Some options for change

The Government is investigating ways of modifying the current CFC rules to improve the balance between:

* encouraging New Zealanders to invest where the returns to all New Zealanders are highest
* raising revenue and protecting the tax base
* compliance and administrative costs.

In considering options for change, the Government will have regard to:

* the compliance costs of the current regime, and any changed regime, for different classes of taxpayers
* the revenue effects of any changes, including any tax avoidance possibilities such changes might create
* the effect of any change on the location and quality of New Zealanders’ investment
* the Government’s view that foreign-source income as a general rule should be taxed.

The Government will look to the experiences of other countries when considering the available options.

#### Calculation of CFC income

A principal source of CFC compliance costs is the need to convert CFC income, calculated in accordance with the tax laws of the country in which the CFC is resident, to the income definitions in force in New Zealand.

More flexible methods of calculating CFC income are being considered.

The Consultative Committee on Tax Simplification suggested that CFC calculations could be simplified by providing the Commissioner of Inland Revenue with the authority to accept some countries’ tax treatment of some assets and transactions. The Government is considering this approach.

One option is for a list of the countries and/or acceptable tax provisions to be published. Under this approach, there would be three classes of CFC income:

* exempt income, which is earned in a company resident in a ‘grey list’ country
* income earned in ‘second list’ countries, with simplified calculation provisions
* income earned outside either list, where the current ‘branch-equivalent’ regime would apply.

Another approach would recognise that smaller taxpayers tend to have the most compliance problems by targeting the regime more towards large companies.

#### A black list

In its election manifesto, the Government said that it would consider applying the international tax regime to a restricted list of countries.

During a transitional period from 1 April 1988 to 31 March 1991, in broad terms the CFC regime applied only to companies resident in a ‘black list’ of some 61 countries with very low effective tax rates and to specified corporate entities granted tax preferences in 10 other countries.

The current regime exempts virtually all income earned by CFCs resident in seven listed countries, but applies to companies resident in all other countries.

The Government will be considering whether the current ‘grey list’ should be modified. In particular, it will be considering whether the ‘grey list’ should be replaced with a ‘black list’ of low tax countries, with all income earned by companies resident outside listed countries being exempt from the CFC regime.

#### Passive income

The Government’s election manifesto also said that the Government would consider only applying the CFC regime to passive income.

Australia, Canada and the United States restrict their CFC regimes to ‘passive’ or ‘tainted’ investment income and exempt earnings of ‘active’ business operations.

‘Passive’ income is often regarded as income that is most likely to involve tax avoidance. That is, it is income that is either:

* really New Zealand-source income that has been disguised as foreign-source income by interposing a foreign entity between its true New Zealand source and its ultimate New Zealand owner
* a close substitute for New Zealand-source income, which may be chosen because of tax advantages rather than any innate superiority.

‘Active’ income is foreign-source income that is earned by a business largely for commercial reasons, rather than being tax driven.

## Foreign Investment Fund (FIF) regime

### Purpose and description

As outlined in Chapter 2, New Zealand’s domestic income tax system ensures that residents cannot defer tax by investing through separate entities.

Company tax and the taxation of trusts (including superannuation and life insurance funds) ensure that New Zealand-source income earned on behalf of residents is taxed as it is earned.

By reducing tax deferral opportunities and incorporating more income into the tax base, New Zealand has been able to reduce marginal tax rates.

The measures that eliminate tax deferral on domestic-source income would be undermined if New Zealand residents could avoid or defer tax by accumulating income in offshore funds in which they do not have a controlling interest. In the absence of a FIF regime, New Zealanders would have an incentive to shift their investments offshore to get around the accruals regime for financial arrangements and the taxation of superannuation and life insurance funds.

The objective of the FIF regime, where it applies, is to levy the same tax on the income earned by the FIF on behalf of the resident as would be levied if the fund were a New Zealand company. Because the FIF is resident offshore with no effective connection with New Zealand, the only way of levying the tax is on the New Zealand holder.

Furthermore, because FIF investors do not exercise control over the fund, they do not normally have access to the detailed records of underlying activities needed for the branch-equivalent calculation of CFC income. Therefore, a proxy for this calculation is required.

Annual FIF income is currently calculated according to the comparative-value method, which measures the change in the market value of a FIF interest during the taxation year plus any cash distributions.

The comparative-value method seeks to tax foreign-source income that would be taxable if it were domestic-source income on the same basis that that domestic-source income is taxed. However, because details of the actual income earned by the FIF are often not available, the comparative-value method must approximate domestic taxation.

The Government will consider alternative methods of calculating FIF income. The final choice of method will, however, depend on the method’s ability to meet the goal of effectively measuring the income earned by the taxpayer through a FIF.

The FIF regime also complements the CFC regime. If the FIF regime did not exist, the CFC provisions might be avoided by structuring offshore investments to fall below the ownership levels that define a CFC interest (five or fewer New Zealand residents own 50% or more of a foreign company outside the seven grey-list countries). Even if not deliberately structured to avoid the CFC regime, FIF investments could also be easily substituted for domestic investments.

The FIF regime or an equivalent regime will remain in place to support the CFC regime and protect the tax base.

However, the Government recognises that the current FIF regime does pose compliance problems, sometimes insurmountable

problems, for taxpayers. Modifications to reduce compliance costs are being reviewed.

As in other areas of international tax, the Government has to weigh the need to minimise compliance costs against the objectives of taxing income that should be taxed, removing barriers to productive investment and protecting the tax base.

In practice, the FIF regime should be targeted on the areas which pose the greatest risk to the New Zealand tax base.

The current FIF regime covers investments that provide the greatest scope for diverting New Zealand-source income or which are regarded by investors as being close substitutes for alternative New Zealand investments.

The definition of a FIF is based on criteria that assess whether the offshore entity is structured to defer tax. An offshore entity is not a FIF if it meets one of these tests:

* It is resident in one of the seven ‘grey-list’ countries.
* It distributes at least 60% of its aggregate annual income, profits and capital gains.
* No more than 40% of its total assets consist of listed assets that could be broadly described as ‘portfolio investments’.
* It pays total (foreign plus New Zealand) tax at an effective rate of at least 20%.

However, investors often cannot obtain the information needed to determine whether an entity is or is not a FIF.

### FIF regimes in other countries

The Government has reviewed FIF-type regimes in other countries to see whether another country has found a simpler and less costly way to prevent tax avoidance and deferral in offshore investment funds.

Canada, the United Kingdom and the United States have provisions similar to the FIF regime.[[6]](#footnote-6)

The review showed that, in all these countries, provisions to tax FIF income are both more complicated and more severe on the taxpayer owning the interest than equivalent provisions to tax domestic-source income. Complexity and severe treatment appear to be necessary

costs of protecting the tax base from offshore funds that provide tax avoidance or deferral benefits.

#### Canada

Canadian residents with interests in Offshore Investment Fund Property are subject to an annual imputation of income. Canada avoids any difficulties in obtaining information on the annual return of the fund by deeming the investment to earn a prescribed rate of return equal to the interest rate levied on unpaid taxes.

Offshore investment funds are subject to this treatment if tax deferral is a primary motivation for holding the interest. Canada decides to accord this special tax treatment by looking at such factors as the foreign tax paid by the fund and the extent of fund distributions.

The calculation of income from Offshore Investment Fund Property for Canadian residents is simpler than the FIF calculation for New Zealand residents. However, under the Canadian approach, taxpayers are levied on the basis of an assumed return, which may bear no relation to actual earnings.

#### United Kingdom

The United Kingdom does not tax income from non-qualifying offshore funds (non-resident companies, unit trusts or similar entities that distribute less than 85% of income) until distribution or realisation.

British investors must report net gains from sales of non-qualifying offshore funds as ordinary income, rather than capital gains. Thus, investors in offshore funds cannot take advantage of the annual capital gains exemption and indexation allowance for capital gains. Investors cannot offset any losses on offshore funds against other income.

By delaying tax until realisation, the British approach can induce a ‘lock in’ effect, discouraging the sale of offshore investments. Realisation taxes also require records of the purchase price of assets to be kept until disposal. Special ordering rules are also required to deal with disposal of part of a holding.

#### United States

American shareholders of Passive Foreign Investment Companies (PFICs) are not taxed until they receive distributions or sell their shares. A PFIC is any foreign corporation or fund that earns 75% or more of gross income from ‘passive investments’ or holds 50% or more of total assets in the form of ‘passive investments’.

Unlike tax on other income, the tax calculation for PFICs includes an interest charge to offset the benefits of tax deferral. The calculation

of this interest charge can be very complicated and can require extensive record keeping.

### Problems with the current FIF regime

The definition of what constitutes a FIF is based on a set of qualifying tests of whether the offshore entity is structured to avoid or defer tax. However, individual investors often cannot obtain the information needed to determine whether an entity is or is not a FIF.

Taxpayers have been dependent on determinations by the Commissioner of Inland Revenue on whether particular entities are FIFs. The determination process has itself been lengthy because of the difficulty of obtaining information on foreign entities.

Whether there are any significant compliance problems apart from the determination that the entity is a FIF depends on the nature of the entity.

If the market value of the interest is readily available, for example traded shares, then compliance with the current FIF regime is reasonably easy. The calculation of taxable income is very simple.

For some offshore funds, however, the market value required for the annual calculation of FIF income cannot be easily established because the funds are not traded. For example, in most cases, New Zealand residents with interests in foreign superannuation and life insurance funds will not be able to obtain a current market value of their interests.

### Some options for change

The Government believes that New Zealand’s FIF regime can and must be improved to ease taxpayer compliance. The Government is particularly concerned about the compliance problems facing small investors with minimal FIF interests.

In considering changes to the FIF regime, the Government will have regard to:

* compliance costs
* the role of the FIF regime in backing up any modified CFC regime
* the revenue effects of any changes, including tax avoidance possibilities created by any changed regime
* the interaction of the FIF regime with other parts of the tax system, especially the taxation of domestic superannuation and life insurance
* the desirability of taxing foreign-source income.

#### Definition of a FIF

As noted above, the greatest difficulty in the FIF regime is determining what is a FIF. Taxpayers and administrators often do not have and cannot easily obtain the necessary information to determine whether an entity meets the tests listed above.

The Government will consider whether the definition of what constitutes a FIF can be changed to make the regime easier to comply with.

One option is to class as FIFs all entities that are resident outside an expanded list of countries and are not CFCs.

This would reduce the costs of determining whether an entity is a FIF, but would expand the scope of the regime.

The Government has not made any decision on whether it will pursue this option.

#### Small FIF holdings

The Government is exploring the possibility of providing a simpler method of taxation for taxpayers with FIF investments below a minimum threshold.

One option is an outright exemption if a taxpayer’s total FIF interests or FIF income were below a specified threshold. However, as the Consultative Committee on Tax Simplification pointed out, such an exemption would lead to a variety of problems.

In particular, an outright exemption based on the level of FIF income earned will still require taxpayers to determine whether they earned FIF income and how much. Thus taxpayers would still incur significant compliance costs, but would pay no tax.

An outright exemption would also undermine the objective of protecting the tax base. All taxpayers would have an incentive to avoid or defer tax by investing in FIFs up to the minimum threshold. This means that the threshold would have to be so small as to be of little practical value if significant fiscal costs and flight of funds for investment offshore were to be avoided.

#### Choice of taxation methods for small FIF investors

A further option is to offer those with total FIF interests below a specified threshold a choice between:

* the current system of calculating and taxing FIF income annually; or
* taxation on distribution or realisation of FIF returns.

To offset the benefits of deferring tax, a higher rate might be applied for small FIF investors opting for the realisation basis.

Alternatively, a deemed earnings rate, along the lines of the Canadian approach, might apply during the time the individual holds an interest in a FIF.

#### Foreign superannuation and life insurance funds

Foreign superannuation and life insurance funds pose a particular problem.

Earnings of offshore funds cannot be taxed directly on the same current basis as domestic superannuation and life insurance funds. However, if offshore funds were not subject to similar tax treatment as domestic funds, New Zealand superannuation funds and life offices would face a severe competitive disadvantage.

Foreign superannuation and life insurance funds are included in the FIF regime to place the tax treatment of foreign and domestic funds on a comparable basis. However, it is often very difficult to obtain an annual market valuation of an investor’s interest in a foreign superannuation or life insurance fund.

One possible solution to this problem would be to develop a separate tax treatment for investments in foreign superannuation and life insurance funds.

One option might be to require New Zealand residents to pay a withholding tax of 33% of gross contributions. This would effectively act as a withholding of tax on future fund earnings. At the end of the term of the investment, contributors could have the option of reconciling on a Yield to Maturity basis or of paying tax on the withdrawals.

## Foreign Dividend Withholding Payment (FDWP) regime

FDWP is a withholding payment on income earned offshore on behalf of shareholders of New Zealand companies.

### Operation of the regime

FDWP applies when offshore income is repatriated to New Zealand in the form of dividends. Companies receiving such dividends are required to withhold 33% of the dividend against the future taxation liability of their shareholders.

When a New Zealand company which has paid FDWP distributes dividends to its shareholders, it attaches a FDWP credit which the shareholders can apply against their own tax liability. FDWP credits in excess of any tax liability are refunded in cash. However, to the extent the New Zealand company receiving the foreign-source dividend (and therefore paying FDWP) does not distribute its profits to its shareholders, FDWP constitutes a final tax.

FDWP applies to dividends received by a company from foreign companies in all countries.

For reasons outlined in Chapter 2, it is generally desirable that offshore income earned on behalf of New Zealand residents should be subject to tax.

FDWP acts as a complement to the CFC and FIF regimes by ensuring that income earned on behalf of New Zealand residents in foreign entities is taxed when it is received by a New Zealand entity.

The FDWP regime has been criticised for discouraging repatriation of dividends to New Zealand. This would occur when the New Zealand parent was not immediately passing all FDWP credits on to individual shareholders.

In contrast, the CFC and FIF regimes, by taxing on an accruals basis, avoid this ‘lock-in’ effect, but do so at the expense of higher compliance costs.

In reviewing the place of the FDWP within the tax system, the Government will have regard to:

* the effect FDWP has on companies’ decisions to repatriate profits to New Zealand
* the role FDWP has in supporting the CFC and FIF regimes
* the compliance costs of the FDWP regime
* the general desire to tax foreign-source income
* the role of the FDWP regime in the context of the repeal of the inter-corporate dividend exemption.[[7]](#footnote-7)

# CHAPTER 5 Bilateral Action

There is a limit to the international taxation objectives New Zealand can achieve alone.

While domestic law will always be the primary source of any country’s international tax rules, there are instances where a country has to work with another country to achieve a desired taxation result. In principle, two countries working in concert can obtain better investment patterns than each can obtain working in isolation.

This chapter discusses bilateral tax agreements and the bilateral actions New Zealand plans to take in the near future.

## The role of bilateral tax agreements

### Defining the international tax base

A country’s domestic laws form the basis of its international tax system. As there are no international laws allocating taxing rights, countries can claim the right to tax any income earned anywhere.

New Zealand’s rules for imposing tax on international income flows, like those of all countries, are found in domestic law.

The inevitable result of having any international taxing rules is that New Zealand and other countries will in some cases assert taxing rights over the same persons and transactions. Thus, a secondary issue is whether it is in New Zealand’s interest as a whole to relieve instances of double taxation.

Double taxation should be relieved where it is distorting business decision making away from New Zealand’s overall interests. But the extent of the relief should be limited to that necessary to remove the distortion. In some circumstances, this will require some double taxation to remain.

In seeking to reduce the adverse effects of double taxation, New Zealand needs to remember that taxes paid to foreign governments are of no benefit to New Zealand or its residents. Taxes paid to foreign governments are no different from any other cost of doing business in a foreign country (see footnote 3).

In contrast, taxes paid to New Zealand, by either residents or non-residents, are of benefit to New Zealand as a whole.

### Reducing undesirable double taxation

Co-ordinated action by two countries to impose similar tax burdens on investment funds flowing between them to the tax burdens applying to purely domestic investment can, however, yield benefits to both.

In particular, it can lead to a pattern of investment which yields higher pre-tax returns to aggregate investment within the two countries, notwithstanding that higher taxes will be required elsewhere to make up the revenue foregone by reducing international double taxation.

Once any undesirable double taxation has been identified, the best way to reduce that double taxation must be found.

The only way that double taxation can be relieved is by governments giving up the right to tax certain types of income or agreeing to limit the taxes they impose on other types.

As part of being co-operative members of the community of nations, many countries including New Zealand reduce double taxation unilaterally in domestic law. This usually takes the form of a foreign tax credit or an exemption for foreign-source income. In New Zealand’s case, it is a credit system.

Section 293 of the New Zealand Income Tax Act provides a New Zealand tax credit for foreign taxes paid by the taxpayer up to the New Zealand rate of tax applicable on that income. This is a unilateral provision applying to all foreign income taxes.

Bilateral measures can also be used to reduce undesirable double taxation. The most common form of bilateral action is a double tax agreement or DTA.

DTAs involve a government agreeing to give up or limit its taxing rights, in exchange for reciprocal action by the other government. DTAs can also aid tax administration; for example, by allowing for the exchange of information between tax administrations and by containing dispute resolution procedures.

Where states have taken unilateral measures to alleviate undesirable double taxation, DTAs by and large refine and adapt these general domestic rules in the context of two particular tax systems.

DTAs allow countries to divide the cost of reducing undesirable double taxation in a manner that may make both countries better off.

DTA provisions which limit taxing powers prevail if there is any conflict between the DTA provisions and domestic rules imposing taxes. However, DTAs do not impose taxes.

As DTAs involve bilateral negotiation, they tend to be more difficult to amend than domestic law and give investors a greater degree of certainty than if the rules merely appeared in legislation.

### Dealing with international tax problems

With modem developments such as the globalisation of the world economy and the removal of exchange and other government controls, countries are finding it increasingly difficult to protect their income tax bases. The problem is particularly acute in relation to the multinational corporate groups that are responsible for much international investment and trade.

As a result, a country with an open economy like New Zealand needs to consider what, if any, its response should be to issues such as:

* the setting of artificial prices between related parties as means of shifting profits to low-tax countries - ‘transfer pricing’
* the practice of non-residents over-funding resident companies with debt in order to reduce company taxes -‘thin capitalisation’
* the structuring of transnational financial leases in order to take advantage of the tax bases of several countries to lower the cost of capital.

Should New Zealand decide that it needs to act against thin capitalisation, transnational financial leases or any other international tax problems in the future, it will need to do so by enacting more domestic rules.

Bilateral action, however, may be needed to help harmonise the unilateral provisions of two countries and make them more effective.

Where a DTA is contributing to a problem in New Zealand’s tax system it will be necessary to seek amendments to the DTA.

## Implications for policy making and treaty negotiation

In relieving undesirable double taxation and dealing with current international tax problems, domestic tax rules have a primary role and DTAs play a secondary but important role.

This has implications for prioritising work on international tax and developing DTA negotiating objectives and strategies.

The first task is to identify New Zealand’s international tax goals. These goals have been set out in broad terms in the preceding parts of this paper.

The second is to determine how to implement those goals. In most cases that will be in domestic law, taking into account any impediments that might exist in DTAs.

Where New Zealand is unable to persuade another country to accept a New Zealand policy goal in the DTA, we should at least make sure that the DTA does not prevent us acting unilaterally to safeguard our essential interests through our domestic law.

## Effect of DTAs

DTAs are fiscal documents. In addition to their role in removing double taxation, effective DTAs can assist investment and trade. However, particularly where New Zealand is a net capital importer from the proposed DTA partner, concluding a DTA can reduce the amount of revenue available to the Government.[[8]](#footnote-8) The Government needs to consider, therefore, whether the gains from a DTA in terms of increased investment and trade outweigh the fiscal cost.

The interaction of the unilateral provisions of the two countries’ tax systems often means that the total tax burden of a taxpayer does not change as a result of a DTA being concluded. In practice, all that changes because of a DTA is the government to which those taxes are paid. This is illustrated in the Annex.

New Zealand grants a unilateral foreign tax credit for income taxes paid by New Zealand residents to foreign governments. This applies regardless of whether there is a DTA or not. In this context, the use of the term ‘double tax agreements’ is a misnomer. New Zealand’s unilateral action is the primary means of relieving double taxation. The DTA refines the relief granted. DTAs mainly distribute the cost of relieving double taxation between Governments.

While DTAs concern all types of income (including investment, trade and personal services income), their major impact is in respect of investment income. One reason is the magnitude of international capital flows. For example, annual international capital flows are now around 40 times higher than the value of international trade flows. In addition, DTAs can have a clear impact on the overall taxation on investment income. For example, DTAs often lower rates of NRWT on gross interest payments. This can ensure that a financial intermediary’s net profit on a transaction is not entirely

taxed away in the source country (see Chapter 3). The impact of DTAs on the overall taxation of trade income, however, is often limited. (See the Annex .)

## DTA policy

### Review of existing DTAs

The Government is considering instigating an ongoing review of each of New Zealand’s 24 existing DTAs to ensure that they are in line with current taxation and economic policy and are contributing to New Zealand’s economic growth.

Highest priority will be given to the DTAs with New Zealand’s major trading and investment partners.

The taxation aspects of the the 1992 Review of the Closer Economic Relations Agreement with Australia are discussed in greater detail below.

New Zealand will seek to re-negotiate DTAs that have fallen out of line with current policy.

### Criteria for assessing DTAs

In addressing international tax matters, the Government will first identify any taxation problems before going on to identify the possible solutions and, importantly, their cost.

If New Zealand is considering a new DTA or is re-negotiating an existing DTA, it should ask:

* What are the tax problems that the DTA will overcome?
* How will a DTA correct these problems?
* What will be the fiscal cost of the DTA?
* What are the risks to the New Zealand tax base of the DTA?
* What will be the benefits to New Zealand as a whole from the DTA?
* What alternative solutions exist to solve the tax problems the DTA will correct, and what are the costs and benefits of those alternatives?

Once it has answered these questions, the final decision will be based on an assessment of the relative costs and benefits of the available options.

### International relations considerations

DTAs can be valuable demonstrations of the good relations between nations.

New Zealand will continue to seek to strengthen its ties with other nations through DTAs.

However, DTAs concluded largely for foreign policy reasons should include provisions for termination in the event that changing circumstances (for instance, changes in the tax system of the DTA partner) result in the DTA causing an unacceptable fiscal cost.

### Conclusion

The same criteria that are used to assess proposed changes to domestic tax laws will be used to assess proposed DTAs.

Within these constraints, New Zealand will continue to use DTAs where they can provide a positive effect on investment and trade.

## Australia

New Zealand’s most important bilateral economic relationship is with Australia.

With the achievement of free trade in goods and near free trade in services under the Australia-New Zealand Closer Economic Relations Trade Agreement (CER), the remaining major area of unfinished business under CER is investment. Beyond both governments agreeing to consult on specific issues as they arise, investment has effectively remained outside the CER agenda to date.

An efficient trans-Tasman investment regime is important to achieving and realising the full benefits of an integrated Australia-New Zealand market.

The tax regime has been identified in both countries as a critical impediment to rational investment and efficient trans-Tasman equity/debt markets. The current rules and high compliance costs are seen as particularly detrimental.

The New Zealand Government is committed to reforms of the trans-Tasman tax system.

The New Zealand Minister for Trade Negotiations has agreed with his Australian counterpart that tax should be high on the agenda of the 1992 Review of CER.

New Zealand officials have been instructed to pursue trans-Tasman tax reform as a priority issue. Face to face discussions with Australia will begin soon.

### Mechanisms for reform

Many trans-Tasman tax issues arise from the CER free-trade zone and, therefore, are outside the scope of a traditional double taxation agreement.

The New Zealand Government is committed to finding the best solution to trans-Tasman tax problems.

Reforming trans-Tasman tax brings new challenges to the way taxation policy is developed.

The New Zealand Government has no preconceived ideas about whether an expanded DTA, a separate tax treaty under the CER umbrella or reciprocal legislation presents the best solution.

New Zealand’s approach is to start with the problems, look for possible solutions and think about possible mechanisms last (e.g. a new double tax agreement, reciprocal legislation, administrative action or unilateral legislation).

In thinking about solutions, New Zealand will keep in mind its tax design criteria of efficiency, fairness and simplicity. The fiscal cost and likely benefits of each option will also be important factors.

# ANNEX The practical effect of DTAs on tax paid by New Zealand exporters

## Introduction

This annex illustrates two points:

* The effect of DTAs on the overall tax paid by New Zealand exporters on their business profits is often limited.
* DTAs may have important effects on the respective tax takes of New Zealand and the other country involved.

The examples are highly generalised to draw out what often happens in practice.

It is not possible in a short Annex to deal with all possible impacts of DTAs on New Zealand’s exports. The focus of this Annex is on what generally happens. Exceptions have been ignored, particularly where they involve technical rules.

## Cases compared

The Annex compares in broad terms the typical tax consequences for the business profits of a New Zealander trading:

* with a country with which we have a DTA that follows the OECD Model
* with a country with which we do not have a DTA.

The examples follow a New Zealand exporter penetrating an export market step by step. They outline the likely tax consequences as the exporter takes each step further into the market. The revenue implications for both countries at each stage are noted at the end of each section.

## Exporting goods to a foreign firm in Country X

Much international trade would be covered under this heading. In practice, a typical DTA will not alter the basic domestic tax treatment in both countries of the business profits arising from this transaction.

Country X is unlikely to tax the profits on this transaction. The exporter will be fully taxable on its net sales income in New Zealand.

The DTA business profits article is unlikely to alter the revenue collected by either country on this transaction.

## Setting up a storage warehouse in Country X

A typical DTA is likely to result in the same level of taxation as applies when there is no DTA. However, different amounts of tax will be paid to different governments.

A typical DTA would provide that an exporter setting up a storage warehouse does not have sufficient connection with Country X to be taxable there on the business profits attributable to the warehouse. (In technical terms, this warehouse is not a ‘permanent establishment’ of the New Zealand exporter in Country X.) Those profits would be taxable only in New Zealand.

Without a DTA, the business profits of the warehouse are likely to be taxable in both Country X and New Zealand. New Zealand’s tax law, however, permits an offsetting of the tax paid on foreign-source income against the tax due domestically up to the New Zealand tax due on that income. Thus, whether there is a DTA or not, the tax result is likely to be the same unless Country X charges more tax on that income than New Zealand would. In this case, the exporter must pay the excess tax without credit.

In this case, the business profits and permanent establishment rules in the DTA have increased New Zealand’s tax revenue at the expense of Country X’s tax take. The DTA overrode Country X’s source rules that required relatively little presence or activity in that country before the New Zealand exporter was taxed there. In effect, New Zealand can tax those profits and there is no Country X tax for which New Zealand must give credit.

Where New Zealand exports more capital to Country X than vice versa, it is in New Zealand’s interest to negotiate definitions that require relatively more presence or activity before a permanent establishment is said to exist. Where New Zealand is a net capital-importer, it is in New Zealand’s interest to negotiate definitions that require relatively little presence or activity before a permanent establishment is said to exist.

## Setting up retail shop in Country X

A typical DTA is unlikely to produce a different tax treatment or result than the two sets of domestic rules would on their own.

A typical DTA would provide that an exporter setting up a retail shop in Country X does have sufficient connection with that country to be taxable there on the business profits attributable to the shop. (In technical terms, this shop is a ‘permanent establishment’ of the New Zealand exporter in Country X.) The shop’s business profits would also be taxable in New Zealand with a credit for Country X’s tax.

Without a DTA, the business profits of the shop would be taxable in both Country X and New Zealand. New Zealand’s tax law, however, permits an offsetting of the tax paid on foreign-source income against the tax due domestically. Thus, whether there is a DTA or not, the tax result is likely to be the same.

In this case, the business profits and permanent establishment rules in the DTA are unlikely to alter the tax takes of Country X or New Zealand, as defined in their respective domestic law.

## Incorporating the shops trading in Country X

This is the most common way that businesses, other than financial institutions, operate in other countries. An incorporated business managed and trading in Country X is likely to be taxable on its business profits in Country X alone, whether there is a DTA or not. A DTA, however, is likely to lower the rates of non-resident withholding tax (NRWT) that Country X can levy on profits being repatriated to New Zealand.

However, as New Zealand grants a credit for NRWT, the effect of lower rates of NRWT in most cases is not to reduce the total burden of tax payable but to change the distribution of taxes paid to Country X and New Zealand.

Where New Zealand is the net capital-exporter of the two countries, the general effect of a DTA lowering NRWT rates is to increase New Zealand’s tax take. There will be less foreign tax to credit and, accordingly, more scope for New Zealand taxation. The opposite is true where New Zealand is the net capital-importer of the two countries.

## Implications for policy making and treaty negotiation

To sum up, the unilateral foreign tax credit in our domestic tax law often means that DTAs have limited effect on the overall tax paid by New Zealand exporters on their business profits. DTAs, however, may have important effects on the respective sizes of the tax takes of New Zealand and the other country. In order to determine the likely

magnitude of those effects, it would be necessary to take into account more factors than has been possible in this short Annex.

The examples also demonstrate how the interplay between the domestic tax system of New Zealand and another country can often achieve a similar result to that achieved by a DTA.

One of the main exceptions is illustrated by the storage warehouse example above. In that example, the DTA was more generous to the New Zealand investor than the foreign domestic-source rules were in determining when the foreign country could tax the profits of the New Zealand enterprise in that country. This may have little net effect for the New Zealand exporter in that where foreign taxes are paid they will generally be creditable in New Zealand. However, for the period that the exporter is deemed not to have a permanent establishment in that country, the exporter is freed from filing a return in the foreign country and paying foreign taxes that would generally be creditable.

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1. The motive for behaviour that results in escaping New Zealand tax will normally be to achieve the best business deal. Because, other elements being equal, a reduction in taxation increases the return achieved, the investment with the lowest rate of tax will tend to be preferred. The individual may be entirely unaware of the tax implications. This is especially so with small savers. In this case, the relationship between the taxpayer’s motive and a reduced tax burden is indirect. In other cases, the taxpayer’s objective may be quite explicitly tax minimisation and the underlying investment may be largely unaffected, i.e. the taxpayer is motivated for some reason to invest in a project, and will do so in a way that reduces the level of tax incurred. [↑](#footnote-ref-1)
2. ‘Island run-arounds’ were tax avoidance schemes that developed in New Zealand in the period between the removal of exchange controls and the enactment of the Controlled Foreign Company (CFC) regime. Under a run-around, a New Zealand controlled company resident in a third country (often a Pacific island nation, hence the name) was interposed between a New Zealand resident and their New Zealand-source income. Because New Zealand did not tax the income that residents earned through non-resident companies, this allowed New Zealand residents to greatly reduce their lax liabilities. This experience was by no means unique to New Zealand. Similar schemes developed in other countries that removed exchange controls. [↑](#footnote-ref-2)
3. Allowing a deduction for foreign taxes treats such taxes like any other cost of business. Granting a credit implies that New Zealand should compensate taxpayers for foreign taxes paid. The deduction approach may be more appropriate from New Zealand’s point of view, since foreign taxes are a cost to the New Zealand economy as much as to the taxpayer - New Zealand does not benefit from the payment of foreign taxes. A credit provides no incentive for residents to reduce the level of foreign taxes, while a deduction does. If a deduction is allowed, reducing foreign taxes will increase returns to the investor after New Zealand taxes. If, however, a credit is allowed, reducing creditable taxes only results in an offsetting increase in New Zealand taxes. There is no increase in post-New Zealand tax returns to the investor. However, under its Double Taxation Agreements, New Zealand is obliged to grant a credit for certain foreign taxes. [↑](#footnote-ref-3)
4. The CFC regime does not apply to companies resident in Australia, the United Kingdom, the United States, France, Germany, Canada and Japan. The income New Zealanders earn through companies resident in these countries is only taxed by New Zealand when it is actually returned to New Zealand. [↑](#footnote-ref-4)
5. The low rate of taxation on foreign-source income is mainly due to the fact that the vast bulk of this income is earned in companies that are located in the seven ‘grey list’ countries that are excluded from New Zealand’s CFC regime. [↑](#footnote-ref-5)
6. In addition, these and many other countries tax other offshore income earned on behalf of individuals through provisions of their domestic law, like their capital gains taxes. [↑](#footnote-ref-6)
7. The Government has announced that in future resident companies will be taxed on the dividends they receive from other resident companies. Previously, such dividends were exempt from tax [↑](#footnote-ref-7)
8. New Zealand is an overall net capital importer, although it is a net capital exporter to a small number of individual countries. Therefore, the overall fiscal effect of New Zealand’s DTA network is negative - New Zealand has given up more revenue than it has gained. [↑](#footnote-ref-8)