New Zealand's International Tax Review: a direction for change

A government discussion document

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FOREWORD

The government is committed to creating an environment that enables New Zealand business to thrive in the global economy. Our tax system plays an important role in fostering a competitive business environment, and is therefore a key focus of the government's Economic Transformation agenda.

New Zealand's International Tax Review is an important step for the government in advancing its economic priorities and the objectives of the Confidence and Supply Agreements with United Future and New Zealand First.

This discussion document complements the range of possible business tax initiatives that are being advanced through the Business Tax Review to help transform the New Zealand economy. It makes a case for a major change in New Zealand's paradigm for taxing offshore income – the introduction of an active-passive distinction. Offshore active income of New Zealand business would no longer be taxed as it is earned, but would be exempt from New Zealand tax.

It also looks at possible changes to New Zealand's tax treaty policy on non-resident withholding tax. These changes would make our rules for taxing offshore income more consistent with those of our major trading and investment partners.

Bringing our international tax rules into line with international norms would reduce barriers faced by New Zealand-based firms under current tax rules to exploiting the benefits of operating internationally. Together these changes would encourage New Zealand-based businesses with international operations to remain, establish and expand.

Many important details of implementation remain open. Consultations with New Zealand business and submissions from interested parties will pay a critical role in determining the final form of the proposals.

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GLOSSARY OF TERMS USED IN THIS DISCUSSION DOCUMENT

Active income. Generally includes income derived from active business, such as manufacturing or industrial activity.

Approved issuer levy (AIL). A mechanism that allows NRWT on interest paid to an unrelated lender to be reduced to nil provided the borrower agrees to pay a 2 percent levy.

Base company income. Defined by rules designed to counter situations where domestic income is shifted offshore to benefit from an active income exemption.

Capital export neutrality. The idea that residents should face the same amount of tax on income from domestic and foreign investments. This promotes efficient capital allocation worldwide and is achieved by taxing residents' foreign income on accrual with a credit for foreign taxes.

Conduit rules. Rules that remove the tax liability of New Zealand companies on foreign income to the extent of their non-resident ownership.

Controlled foreign company (CFC) rules. Rules that apply to the income from direct investment in foreign companies controlled by a small number of resident shareholders.

Deferral-with-credit system. Method of implementing an exemption for offshore active income. The income is exempt from accrual taxation. Taxation is deferred until profits are repatriated, with a credit for foreign taxes paid.

Direct investment. Substantial investment in the shares of a company – typically, an interest of 10 percent or greater.

Dividend withholding payment (DWP). Withholding payment imposed at 33 percent on foreign dividends received by New Zealand companies. Such dividends are exempt from income tax.

Double tax agreement (DTA). A bilateral treaty between countries designed to avoid, or provide relief from, double taxation and to prevent fiscal evasion.

Entity approach. An approach to attributing CFC income to resident shareholders that looks at whether the CFC is active or passive. All income of the company is taxed according to that categorisation.

Exemption system. Method of implementing an exemption for offshore active income. The income is exempt from accrual taxation, with no taxation of subsequent dividends.

Foreign direct investment (FDI). Direct investment from a resident of one country in a company resident in another country.

Foreign investment fund (FIF) rules. Rules that apply to investments in foreign entities not covered by the CFC rules, including portfolio investments in CFCs, direct or portfolio investments in foreign companies not controlled by New Zealand residents, and beneficial interests in a foreign life insurance policy or superannuation scheme.

Foreign investor tax credit (FITC). A mechanism that reduces company tax on profits distributed as dividends to non-residents so that the total New Zealand tax impost (company tax and NRWT) does not exceed the normal company rate.

Foreign tax credit. A method of relieving international double taxation. If income received from abroad is subject to tax in the recipient's country, foreign tax imposed on that income may be credited against the domestic tax on that income.

Grey list. A list of eight countries considered to have tax systems similar to New Zealand. They are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States. Income from grey list companies is exempt from accrual taxation.

Gross domestic product (GDP). The total value of goods and services produced in a year within a country's borders.

IMF. International Monetary Fund.

Non-resident contractors withholding tax (NRCWT). Withholding mechanism for contract payments to non-resident contractors.

Non-resident withholding tax (NRWT). Withholding tax imposed on non-residents receiving dividends, interest and royalties from New Zealand. Rates imposed under domestic law are typically reduced by DTAs.

OECD. Organisation for Economic Co-operation and Development.

Passive income. Investment income that the investor does not actively participate in earning, such as dividends, interest, royalties and rents. It could include income which is passive in form but the derivation of which involves certain activity.

Permanent establishment. A concept used in double tax agreements that refers to an enterprise of one country having a fixed place of business in another country.

Portfolio investment in a company. A holding of shares in a company amounting to a small portion of the total shares of the company – typically, an interest of less than 10 percent.

Residence basis of taxation. Refers to the principle that all persons or entities resident in a country are subject to tax in that country on their world-wide income.

Safe harbour ratio. A term used in relation to the thin capitalisation rules to mean that those rules do not limit interest deductions if the taxpayer's New Zealand debt percentage does not exceed a specified amount, currently 75 percent.

Source basis of taxation. Refers to the principle that all income which originates in a country is subject to tax in that country, whether the person or entity to which the income accrues is resident or non-resident.

Tainted income. Passive income and base company income.

Tax Review 2001. An independent review commissioned to undertake a broad review of the New Zealand tax system and to develop proposals to guide the future direction of New Zealand tax policy.

Thin capitalisation rules. Rules that protect the domestic tax base against excessive interest deductions. The rules are designed to prevent multinational groups allocating a disproportionate share of their global interest costs to New Zealand. They currently limit interest deductions when the taxpayer's New Zealand debt percentage exceeds 75 percent (the safe harbour ratio) and also exceeds 110 percent of the taxpayer's worldwide debt percentage.

Transactional approach. An approach to attributing CFC income to resident shareholders that examines each item of income to determine whether it produces tainted income or non-tainted income. Different income streams attract different treatment according to their categorisation.

Transfer pricing rules. Rules that apply to transactions between related parties and seek to determine the prices that would be charged on an arm's length basis.

Treaty. In this discussion document, refers to a double tax agreement.

UNCTAD. United Nations Conference on Trade and Development.

Underlying foreign tax credit (UFTC). Available to a resident company owning at least a 10 percent interest in a foreign company. It allows the New Zealand company to reduce its liability to DWP by taking into account foreign tax paid by the foreign company on its earnings.

CHAPTER 1

Introduction

1.1 The government is committed to creating an environment that enables New Zealand businesses to thrive in the global economy. The International Tax Review is linked to the government's Business Tax Review, the aim of which is to facilitate economic transformation by improving incentives for productivity gains.

1.2 New Zealand's tax system plays an important role in fostering a competitive business environment. It sits alongside other elements such as infrastructure, skills and education, and research and development that are a key focus of the government within its Economic Transformation agenda.

1.3 It is important that New Zealand's tax system is not out of line with systems in comparable jurisdictions, particularly Australia. Within an increasingly borderless global economy, New Zealand must be able to attract and retain capital, and our businesses must be able to compete effectively in foreign markets.

1.4 New Zealand's rules for taxing offshore investment through controlled foreign companies (CFCs)[1] are more stringent than those of other countries. Since 1988, New Zealand residents have been taxed on all income earned by their CFCs[2] at the time that income is earned (accrual taxation). Other countries limit accrual taxation of offshore income to passive income and certain special categories.[3] Active income is generally exempted or taxation is deferred until the income is returned in the form of dividends.

1.5 Concern has been expressed by the Tax Review 2001[4] and other commentators that the current system could inhibit the internationalisation of New Zealand business.

1.6 This discussion document deals with the taxation of outbound, non-portfolio investment by focusing on:

- relaxation of the current CFC rules by introducing an active/passive distinction – offshore active income would be exempted from accrual taxation, and passive income would continue to be taxed as it accrues;

[1] A controlled foreign company is essentially a company resident in a foreign jurisdiction that is controlled by a small number of New Zealand residents.
[2] The main exception being CFCs resident in eight grey list countries. This exclusion is described further in chapter 2.
[3] Passive income includes investment income such as interest, dividends, royalties and rents. The concept is often extended to other transactions which could erode the domestic tax base, so-called base company income. Together, such income is often referred to as "tainted" income and is subject to accrual taxation.
[4] The independent Tax Review 2001, under the Chairmanship of Robert McLeod, commissioned to undertake a broad review of the tax system and to develop proposals to guide the future direction of New Zealand tax policy. It made its final report to the government in October 2001.

- the implications for other aspects of our international tax rules to protect the New Zealand domestic tax base; and
- possible changes to New Zealand's tax treaty policy on non-resident withholding tax (NRWT) on dividends, interest and royalties.

1.7 An exemption for the active income of CFCs would put New Zealand companies on a more equal footing internationally by removing an additional tax cost not faced by firms based in comparable jurisdictions, such as Australia.

1.8 Lower treaty limits for NRWT would also reduce tax barriers to offshore investment. New Zealanders receiving payments sourced in countries with which New Zealand has a double tax agreement would enjoy lower rates of foreign withholding taxes.

1.9 Bringing our international tax rules into line with international norms would reduce the barriers faced by New Zealand-based firms, under the current tax rules, to exploiting the benefits of operating offshore. These changes would encourage businesses with international operations to remain, establish and expand.

Links with the Tax Review 2001

1.10 The issues canvassed in the discussion document were raised in the Tax Review 2001 and then, more recently, by other commentators such as the New Zealand Institute.

1.11 Indeed, international tax reform has been on the government's agenda since the release of the *Final Report* of the Tax Review in 2001. Many of the recommendations of the Review centred on proposals to reform the taxation of inbound and outbound investment. As a result, the government has considered the following issues:

- ***A major reduction in taxes imposed on inbound foreign direct investment (FDI) to increase levels of FDI in New Zealand.*** As the government announced in September 2003, it had decided not to proceed with this proposal because the expected spill-over benefits would be outweighed by substantial fiscal costs.
- ***A temporary tax exemption on the foreign income of new migrants, to facilitate the migration of skilled labour to New Zealand.*** The government agreed with the Tax Review's recommendation and has since passed legislation implementing a four-year tax exemption on foreign income for both new migrants and returning New Zealanders.

- ***Examination of a risk-free return method (RFRM) for taxing income from offshore portfolio investments.*** The government has proposed new tax rules for offshore portfolio investment that are broadly consistent with this proposal. The measures examined in this discussion document do not affect those proposed rules.

1.12 The other important recommendation of the Tax Review was that the government explore the merits of adopting an active/passive distinction in our CFC rules. The Tax Review expressed the broad concern that our comprehensive taxation of CFC income was out of step with international norms.

1.13 The New Zealand Institute echoes the Tax Review's concerns. In its 2006 discussion paper, *The Flight of the Kiwi*, the Institute argues that the current CFC rules generate "real economic costs in terms of aspirational companies being lost to the New Zealand economy rather than electing to go global from a New Zealand base (or deciding not to venture abroad at all)."

1.14 The government shares these concerns. Providing an exemption for offshore active business is intended to help retain dynamic companies in New Zealand. Otherwise, there can be economic costs from migration of existing businesses or the establishment offshore of potential businesses, or by inhibiting the expansion of existing business into offshore markets.

Key features of the reform

1.15 The central feature of the reform described in the discussion document is to provide an exemption for *offshore active* income. Consequently, new rules will need to ensure the exemption does not extend to passive or domestic income.

1.16 New Zealand can benefit from extensive international experience in distinguishing between active and passive income. Even so, international experience can take us only so far. In the end, New Zealand's international tax rules need to be developed to reflect the realities of our business environment and other features of our tax system.

1.17 A critical issue informing the development of a new system will be the compliance and administrative burden imposed by new rules. While the rules themselves will inevitably be complex, reflecting the complexity of international business arrangements, the government believes that the system described here could be much simpler in actual operation than the current system.

1.18 While the discussion document expresses a clear preference on the direction for change, many important issues of implementation remain open. Final decisions will be made only after consultation with the businesses that will have to apply the new rules. In the process, trade-offs between the scope of the active income exemption and the implementation of the various base maintenance measures will be inevitable. Submissions will be important in evaluating those trade-offs.

SUMMARY OF POSSIBLE CHANGES

A new direction for taxing CFC income

Possible changes

1. Under a new active/passive distinction, offshore active income would be exempted from accrual taxation, and passive income would be taxed as it accrues.

2. Complementary changes to other aspects of our international tax rules, in particular, the thin capitalisation rules, would be needed to protect the New Zealand domestic tax base.

3. New Zealand's tax treaty policy on non-resident withholding tax could also change.

Implementing an active/passive distinction

Possible changes

1. Offshore active income would be exempt.

2. The broad international consensus to define passive income positively would be adopted, leaving active income as the residual undefined concept.

3. Passive income and base company income (collectively called "tainted income") would continue to be taxed on accrual.

4. The main categories of tainted income would include:

    - ***Passive income***: dividends, interest, royalties and rents. It could include income which is passive in form but the derivation of which involves certain activity.
    - ***Base company income***. Base company rules would be designed to counter situations where domestic income is shifted offshore to benefit from the active income exemption.

The transactional and entity approaches

Possible approaches

The government could adopt one of two approaches to attributing the income of a CFC to its resident shareholders:

- The *transactional approach* examines each item of income derived by a CFC to determine whether it produces tainted income or non-tainted income. Accordingly, different income streams of the CFC attract different treatment depending upon their category; or
- The *entity approach* looks at whether the company is active or passive. Once categorised, then all of the income of the company is taxed in the corresponding manner, regardless of the nature of the income derived.

Interest allocation and transfer pricing rules

Possible changes

1. The current thin capitalisation rules would be:
    - extended to cover all New Zealand entities with outbound investments, taking into account the compliance cost considerations;
    - modified to deal with outbound investments in CFCs; and
    - reviewed to ensure that the safe harbour ratio is appropriate.
2. Technical aspects of the thin capitalisation rules would be reviewed to make them consistent with the minimum capital requirement rules for banks.
3. The transfer pricing rules would be strengthened by shifting the burden of proof on transfer pricing matters from the tax administration to taxpayers.

Implications for the taxation of dividends and other international tax rules

Possible changes

1. A key issue is whether dividends from CFCs should continue to be taxed. The government is more attracted to the exemption method provided such an exemption would not lead to erosion of the New Zealand tax base.
2. Repeal of the grey list exemption and conduit rules would be consistent with an active/passive distinction that focuses on exempting active income rather than whether the income has been comparably taxed in the host country.
3. Consideration should be given to whether the active/passive distinction should apply in respect of foreign branches and non-portfolio interests in foreign investment funds (FIFs).

Non-resident withholding tax

Possible changes

1. NRWT on dividends could be lowered through bilateral treaty negotiations, although the case for this is stronger for non-portfolio dividends. The changes would have implications for the foreign investor tax credit (FITC) rules.

2. Reducing NRWT on either interest or royalties is a possibility but may not be justified.

3. A number of technical changes to the NRWT and approved issuer levy (AIL) rules would rationalise information requirements and withholding arrangements across different payments.

How to make a submission

1.19 The government invites submissions on the issues raised in this discussion document. Submissions should be made by 16 February 2007 and be addressed to:

International Tax Review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Or e-mail policy.webmaster@ird.govt.nz with "International Tax Review" in the subject line.

1.20 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

1.21 Submissions may be the source of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who feel there is any part of it that should properly be withheld under the Act should indicate this clearly.

1.22 In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document, including detailed design issues, with key interested parties.

CHAPTER 2

A new direction for taxing CFC income

Possible changes

1. Under a new active/passive distinction, offshore active income would be exempted from accrual taxation, and passive income would be taxed as it accrues.

2. Complementary changes to other aspects of our international tax rules, in particular, the thin capitalisation rules, would be needed to protect the New Zealand domestic tax base.

3. New Zealand's tax treaty policy on non-resident withholding tax could also change.

Details of how the rules within this general framework might work are the subject of consultations and submissions.

2.1 How best to tax income on outbound direct investment is one of the most vexed tax policy issues.

2.2 New Zealand's current system of international taxation is to tax offshore income as it accrues, with credits given for foreign taxes that have been paid. No other OECD country has adopted this approach. All other OECD countries either defer taxing offshore active income or exempt it altogether. Since New Zealand taxes the income of its CFCs more heavily than other countries, it can be attractive for innovative and dynamic firms to migrate from New Zealand, establish themselves in other countries or simply stay small and local.

2.3 Since New Zealand's rules applying to CFCs were introduced in 1988, other countries, including Australia, have liberalised their tax rules for the active income of their CFCs. Moreover, it has become easier for both firms and workers to shift across international borders.

2.4 For these reasons, the government supports a change to New Zealand's paradigm of comprehensive taxation of CFC income toward providing an exemption for offshore active income. Other measures, to protect the domestic tax base, would form an integral part of the new system.

Current approach to taxing CFC income

2.5 New Zealand generally taxes both active and passive offshore income of its CFCs as it accrues, with a credit for foreign taxes. As a departure from this comprehensive taxation, income from CFCs in eight grey list countries[5] is exempt. The policy motivation for the grey list is to reduce compliance costs. Income earned in a grey list country is considered to be taxed comparably to New Zealand-earned income, so there would be negligible New Zealand tax to pay after allowing foreign tax credits.[6]

2.6 It is sometimes argued that despite New Zealand's tax treatment of the income of its CFCs being relatively stringent by world standards, it is not stringent enough. Standard economic analysis would suggest that there is a case for taxing on a pure residence basis. Under a pure residence basis, foreign taxes would be treated as a cost just like other costs of doing business, and deductions rather than credits would be allowed for foreign taxes. Such a tax system is, under strong assumptions, said to promote national welfare maximisation. It would provide incentives for investing abroad only if the benefits to New Zealand (which are net of any foreign taxes) exceed the benefits from investment in New Zealand.[7]

2.7 Even so, under international tax treaties and in practice, countries of residence relieve double taxation by either providing credits for foreign taxes or exempting foreign-source income.

2.8 A system of comprehensive taxation of CFC income, with credits for foreign taxes paid, is sometimes advocated on the grounds of "capital export neutrality". Other things being equal, it provides incentives for capital to be allocated around in the world in ways which lead to the highest, risk-adjusted, pre-tax returns. This is consistent with promoting the global efficiency of capital allocation.[8] In practice, it makes very little sense for a small, open economy like New Zealand's to "go it alone" in promoting capital export neutrality. New Zealand is much too small to do anything significant to promote global efficiency in the way that worldwide capital is allocated.

[5] "Grey list" countries are those considered to have tax systems similar to that of New Zealand. They are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.

[6] Tax preferences available abroad or asymmetries in tax systems may mean that income sourced from these eight grey list countries need not necessarily be comparably taxed. This is discussed further in chapter 3.

[7] While standard analysis suggests a "first-best" case for full taxation of outbound investment, the see-saw principle suggests that there can be a "second-best" case for a lower tax on outbound investment. If, for some reason, an economy is constrained to levy a higher than optimal rate on inbound investment, there can be a case for a somewhat lower tax rate on outbound investment.

[8] If instead the income of CFCs is exempt or taxed with a credit only when dividends are remitted, this can lead to investment in low-tax jurisdictions being more attractive on an after-tax basis than domestic investments, even when the pre-tax returns are lower than those obtained on domestic investments.

2.9 The main argument in favour of New Zealand's current approach to taxing the income of its CFCs would appear to be that while it falls short of the pure residence base which might be advanced on grounds of national welfare maximisation, it is the nearest internationally acceptable alternative. A secondary attraction of New Zealand's current approach is that it avoids any need to distinguish between active and passive income. Other countries cope with such a distinction, although there are inevitably contentious borderlines.

2.10 The key argument against New Zealand's current approach is the disincentive it provides New Zealand-based companies to internationalise their businesses from a New Zealand base when other countries offer much more lenient rules for CFCs. This will be explored in greater detail in the next section.

2.11 There is a second concern. A foreign tax credit system can provide incentives for domestic firms to channel offshore investment into higher-tax foreign countries in ways which are not in New Zealand's best interest. This is illustrated in Table 2.1. In the example, investment into Country A, a higher-tax country, provides a higher pre-tax return than an investment into Country B, a low-tax jurisdiction. From New Zealand's perspective, it would be better if the investment were channelled into the low-tax country B as there is a higher net return of 990 to New Zealand, split 737 to the investor and 253 to the government. However, under a foreign tax credit system, the investor ends up preferring the investment in Country A on an after-tax basis. Thus investment into higher-tax countries can displace investment into low-tax countries even though New Zealand as a whole would be better off from investment into the low-tax countries.

TABLE 2.1
Investments in high-tax and low-tax countries – an example

	Country A High-tax	**Country B Low-tax**
Gross Return	1200	1100
Host Country Tax	300	110
New Zealand Tax[9]	96	253
Return to Investor	804	737
Return to New Zealand	900	990

[9] New Zealand tax is net of foreign tax credits. In Country A, the potential New Zealand tax of 396 (.33x1200) is reduced by a tax credit for the 300 of foreign tax paid; in Country B, the potential New Zealand tax of 363 (.33x1100) is reduced by a credit of 110.

2.12 Finally, a number of taxpayers have commented that not only are New Zealand's tax rules for CFC income comparatively harsh, the associated compliance costs can also be high, with firms required to restate the accounts of non-grey list CFCs under New Zealand tax rules. This can be very difficult when foreign accounting and tax rules are substantially different from New Zealand's, the degree of control is limited, and the CFC's financial accounts are prepared in a different language. There are also aspects of the CFC rules that are extremely complex and difficult to comply with. As the Tax Review 2001 concluded, it is important to take these into consideration when framing any new rules.

Pressures caused by tax treatment in other countries

2.13 In contrast to New Zealand, other OECD countries either exempt offshore active income or defer taxation of the active income of CFCs until the time that dividends are remitted by the CFCs to their parents. Some non-OECD countries, such as Singapore, have territorial systems which exempt all forms of offshore income from domestic taxation (see Table 2.2). This means that companies with active business subsidiaries in low-tax jurisdictions may pay little or no tax on this income for long periods of time. Even then, tax minimising strategies may reduce the effective tax rate further.

TABLE 2.2
Taxation of outbound investment in other countries

	Accrual taxation of income		Treatment of dividends	
	Active	**Passive**	**Exempt**	**Tax with deferral**
Australia	X	√	√	
United States	X	√		√
United Kingdom	X	√		√
Singapore	X	X	√	
Japan	X	√		√
New Zealand (non-grey list)	√	√	NA[10]	NA

[10] New Zealand taxes dividends under the DWP rules but there is no deferral as offshore income is taxed as it accrues.

2.14 Australia's tax rules are particularly important. The proximity of Australia to New Zealand as a choice for a multinational's regional headquarters, the ease of migration, the integration of imputation systems and the large levels of FDI between the two countries make Australia the most likely destination for migrating firms.[11] Greater alignment of New Zealand's tax rules with those of Australia can only enhance and deepen trans-Tasman integration. Such alignment is consistent with the government's wider set of single economic market initiatives.

2.15 If New Zealand taxes offshore income more heavily than other countries (especially Australia), a company planning to expand into active businesses in third countries has a tax incentive to relocate its headquarters outside of New Zealand. If it retains its headquarters in New Zealand, it is taxed on active income from the third-country CFC as the income accrues. This could lead to a substantial tax impost if the third country has low tax rates on active income. If, however, it relocates its headquarters to a country offering an exemption or deferral of taxation on offshore income, no tax need be paid on the income accruing in the CFC.

2.16 There are many commercial factors that influence where firms choose to locate their operations. Firms may be attracted to deeper capital markets, proximity to global markets, and the access to skilled labour and global stocks of knowledge in other countries. Relocation may be the best way to benefit from having a presence in such markets. Given the strength of these factors, some migration of New Zealand firms is likely to continue regardless of tax changes. Nevertheless, it is unattractive for New Zealand's tax treatment of CFC income to inhibit the retention or establishment of New Zealand-based multinational businesses.

2.17 Migration of even one or two of New Zealand's large dynamic firms could have a substantial negative effect on the economy. Such firms help New Zealand to maintain close connection with new ideas and commercial developments in other countries. They also help maintain a base of intellectual property within New Zealand. Not only would migration lead to jobs within head offices being shifted offshore, so too would be the demand for associated professional services.

2.18 Firm migration also reduces the extent to which New Zealand could benefit from cluster effects. When a number of firms locate near each other, or cluster, they can attract higher levels of skilled labour and customers than a single firm could. Once a critical number of firms locate in an area they can become a cluster, and benefits of economies of scale may be available to them. Within New Zealand, potentially in Auckland, clusters involved in specialised areas of R&D could be envisaged. It is important therefore that policies do not prevent the achievement or the maintenance of clusters.

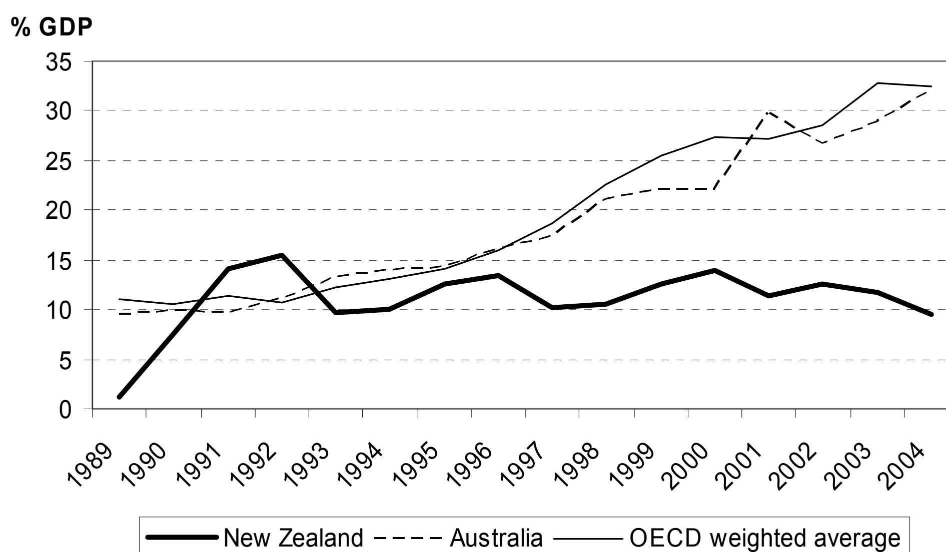
[11] Australia represents New Zealand's most significant source of foreign capital, contributing 46 percent of inward FDI.

2.19 Finally, higher taxes on offshore income may also make it difficult for New Zealand-based firms to expand out of local markets; so, if they stay in New Zealand, they may stay small. For example, a New Zealand-based company which seeks to exploit lower cost production in a non-grey list country might be disadvantaged relative to other companies operating in that jurisdiction.

New Zealand's outbound FDI performance

2.20 It is of interest to examine how New Zealand's level of outbound FDI has compared with that of other countries in recent times. The stock of outbound direct investment from New Zealand has remained relatively constant as a share of GDP, fluctuating between around 10 to 15 percent of GDP over the period since the early 1990s. In contrast, the stock of outbound direct investment in OECD countries increased steadily from around 10 percent of GDP in 1990 to around 30 percent of GDP in 2002 (see figure 1).

FIGURE 1
Outbound FDI stock[12]

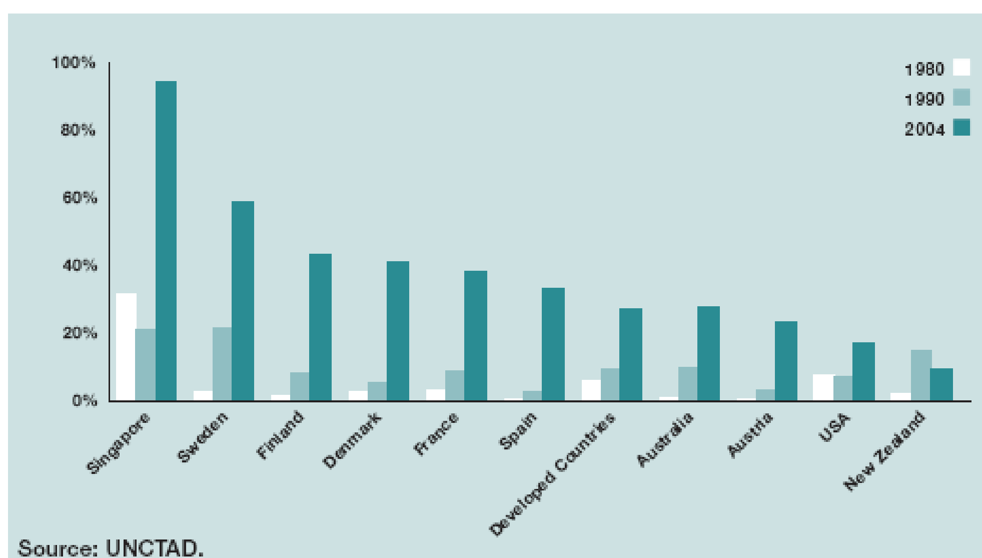


Source: IMF, UNCTAD

2.21 The relative change between 1990 and 2004 in outbound investment as a percentage of GDP is shown for selected OECD countries in figure 2. The data, reported by the New Zealand Institute, show that New Zealand is the only country that has experienced a drop in the intensity of outbound FDI.

[12] Figure 1 illustrates total outbound direct investment, which includes both debt and equity. Ideally, the comparison would focus on outbound direct equity investment only. However, the outbound direct equity investment series for New Zealand is affected by a large structural break in 2001 which makes comparisons difficult.

FIGURE 2
Level of outward FDI as a % of GDP



2.22 There are many factors which may be affecting the evolution of outbound FDI in different countries. Commercial factors such as closeness to markets may be more important influences than taxation.[13] However, over the time that New Zealand's comprehensive international tax rules have been in place, New Zealand has been exceptional in not having the same strong growth in FDI that has been evident in other OECD countries. New Zealand's tax rules may have been a contributing factor on the margin.

Implications for GDP growth and labour productivity

2.23 Any relaxation of New Zealand's CFC rules could increase outflows of FDI from New Zealand. At first sight, this would appear likely to reduce New Zealand's capital stock, thereby reducing labour productivity and GDP growth.

[13] These figures should be interpreted cautiously for a number of reasons:

- Investment that is taxed under New Zealand's CFC rules is not the same as direct investment as measured by statistical agencies.
- The data are not always comparable – both across time (for example, a methodological change affects the New Zealand data from 2001 onwards), and across countries (for example, countries may use different methodology in compiling the data).
- Tapping into offshore markets and access to offshore distribution channels may be more or less important for firms in different industries. For example, in some industries it may be more important to access offshore distribution channels. Different levels of outbound direct investment across countries may, in part, be explained by differences in industry structure across countries.
- Different levels of outbound direct investment across countries could, in part, be explained by distance from other countries, as this could make it more difficult to invest offshore.

2.24 There are a number of important offsetting factors which can work in the opposite direction. First, New Zealand is a net capital importer. To the extent that some firms invest capital abroad that would otherwise have been located in New Zealand, this provides scope for other firms to profitably increase their investment in New Zealand. Moreover, investment abroad and domestic activity in New Zealand are not necessarily substitutes. Investment abroad can be complementary with the demand for products from New Zealand. Moreover, there can a upgrading of the types of jobs being undertaken, with lower value-added tasks being moved offshore while R&D and higher value-added tasks increase in New Zealand.

2.25 For these reasons, the government believes that there is no strong reason to expect that measures to liberalise the tax treatment of outbound CFC income would reduce capital and productivity in New Zealand. Indeed, to the extent that they provide incentives for firms to locate or stay in New Zealand and to expand to exploit opportunities offshore, they are likely to have the opposite effect.

2.26 Even if New Zealand wanted to prevent outflows of capital from New Zealand, it is unclear that an internationally stringent tax treatment of outbound CFC income is in its best interests, given the real world flexibility for companies and workers to migrate to other countries. Put bluntly, firms can always choose to escape New Zealand tax by moving overseas (or perhaps never coming).

A new paradigm for New Zealand

2.27 In the almost twenty years since New Zealand's rules for taxing CFCs were developed, the world of international finance, investment and production has evolved considerably. FDI and exports of most OECD countries have increased significantly as a percentage of GDP, but New Zealand has not kept pace. There are many reasons for this situation. However, New Zealand stands out as the only country to tax offshore active income on accrual.

2.28 As noted by the Tax Review 2001, while the current system is conceptually attractive, its lack of conformity with international taxing norms puts pressure on the New Zealand tax system. There is a concern that it inhibits the internationalisation of New Zealand business. The current system risks inducing New Zealand businesses with significant international operations to migrate, and it could inhibit the development of multinational enterprises based in New Zealand.

2.29 On balance, the government believes that the current tax rules applying to CFCs are no longer well adapted to the world of international business. Accordingly, the government supports the introduction of an exemption for the offshore active income of CFCs.

2.30 There are two ways of implementing the exemption:

- by deferring taxation of active income earned offshore until the profits are repatriated, with a credit for foreign taxes paid; or
- by allowing a permanent exemption for offshore active income, with no taxation of subsequent dividends.

2.31 The Tax Review recommended a deferral, with credits for investments made outside of the grey list. However, there is considerable debate as to the effectiveness of the deferral-with-credit approach relative to the exemption method. Taxes that are imposed only when the dividend is repatriated may not be particularly effective because imposition is at the discretion of the company distributing the dividend. Attempts by countries to shore up their dividend taxation rules have been sources of tax system complexity and have been of limited effectiveness.

2.32 An exemption system would be simpler. It would go further in improving incentives for New Zealand-based firms to take advantage of international opportunities while remaining in New Zealand, and, it would go further in ensuring that such firms are able to compete and succeed on the world stage.

2.33 There is greater attraction to a permanent exemption for active income earned offshore. Adoption of this approach would require adequate confidence that it would not endanger the taxation of domestic-source income. Otherwise the taxation of dividends with credit might need to be examined further.

2.34 The Tax Review noted that an active income exemption should be enacted in a manner that does not jeopardise New Zealand's domestic tax base. The government agrees.

2.35 A number of measures which are intended to ensure that the active income exemption did not result in an inappropriate reduction of New Zealand's domestic tax base would form an integral part of any package introducing it.

2.36 The Tax Review referred specifically to an enhancement of the thin capitalisation rules as an area for development, and the discussion document examines some significant changes in this area. Consistent with the practice of many other OECD countries, offshore passive income would continue to be taxed on accrual, and its taxation could be extended with the elimination of the grey list exemption for such income.

CHAPTER 3

Implications for the international tax system of an active income exemption

3.1 A move to an exemption for active income earned offshore would represent a major shift in New Zealand's international taxation paradigm. This chapter provides an overview of the implementation issues of such a shift.

3.2 The fundamental implementation concern is to ensure that the exemption is targeted to offshore active income in a manner which does not impose an undue compliance burden on New Zealand businesses. Rules to measure such income properly would form an integral part of providing the exemption. For example, rules would be required to distinguish active income from passive income and the thin capitalisation rules would have to be extended and amended.

3.3 A change in the paradigm would have significant implications for other features of the rules for taxing offshore income. Affected areas would include the taxation of dividends, the grey list, the conduit rules, the treatment of foreign branches and non-portfolio FIFs and the calculation of foreign tax credits.

3.4 Choices among alternative implementation options would involve trade-offs, as the various features are inter-related.

Current approach to taxing offshore income

3.5 New Zealand's current international taxation paradigm is based on comprehensive accrual taxation of offshore income. In principle, to the extent all income is considered to be taxable, all costs are deductible.[14]

3.6 In practice, there are exceptions, and not all income is subject to full New Zealand taxation:

- The grey list effectively exempts income earned in grey list countries from New Zealand taxation.
- Application of foreign tax credits has the effect of removing some foreign income from taxation in New Zealand.
- The conduit and DWP rules effectively lower the rate of tax applied to the offshore income of foreign-owned companies.

[14] For example, in the thin capitalisation rules, which seek to protect the New Zealand base from excessive leveraging by foreign controlled companies, no adjustment is made to New Zealand equity for offshore investments by the New Zealand subsidiary.

3.7 As a consequence, limitations on the deduction of interest expenses are provided for in certain situations:

- A limitation is imposed on foreign tax credit claims to ensure credits do not shelter domestic income from tax. In principle, the limitation is intended to restrict the claiming of interest deductions or foreign tax credits when money is borrowed to fund offshore investment giving rise to foreign tax credits.
- Special thin capitalisation rules, which are intended to ensure that a disproportionate share of the interest costs are not applied against New Zealand-sourced income, apply to conduit and DWP companies. Thus interest costs are restricted when tax-reduced offshore investments are made.

3.8 In practice, however, these limitations to interest deductions are not particularly effective, given the safe-harbours and technical deficiencies in the rules.

3.9 On the other hand, no restriction on interest deductions applies with respect to dividends benefiting from the grey list underlying foreign tax credit (UFTC) rules.

3.10 Furthermore, it is a reality of international taxation that there are, inevitably, asymmetries between the tax systems of different countries. These provide opportunities for deducting offshore financing costs from New Zealand income, while the foreign income is not subject to effective New Zealand taxation. For example, asymmetries can arise when countries have different definitions of "debt" and "equity". Dividends arising from preferred shares may be treated as dividends receiving conduit relief in New Zealand, while being treated as interest and deductible in another country. The current system is vulnerable to such exploitation.

3.11 Therefore, while the current system has in place rules that are designed to attribute interest costs to foreign income when it faces lowered levels of New Zealand tax, they are not comprehensive and not particularly effective in practice.

Considerations in designing an active income exemption

3.12 The change to an exemption for active income earned offshore would mean that borders would need to be defined between active and passive income, and between domestic and offshore income. Such distinctions inevitably involve a degree of complexity. In developing the rules, it would be necessary to make trade-offs between those protecting the tax base and maintaining a reasonable compliance burden for firms. The government's ability to achieve the policy goal of exempting active business income from taxation would depend upon attaining an assurance that there were robust rules to prevent the erosion of the domestic tax base.

3.13 The different aspects of the tax system are linked and must be conceptually consistent for it to function properly. Decisions to relax the rules in one area implies that other features would need to be correspondingly tighter.

3.14 The crucial implementation trade-off would seem to be the precision with which the rules attempt to target the exemption to offshore active income versus the complexity of the rules. A more precise system would require more detailed and potentially more complex rules. A looser system, say, one using higher thresholds, might impose a lower compliance burden, but would be less cost-effective in delivering the intended policy as more room would be available for passive or domestic income to receive the benefit of the exemption intended for active offshore income.

Lessons from international experience

3.15 There is considerable international experience in designing and implementing tax rules that distinguish between active and passive income. New Zealand can learn from that experience.

3.16 All OECD countries, except New Zealand, provide some form of tax relief for active business income that is earned abroad. In most cases, this treatment is not extended to passive income, and considerable efforts are made to ensure comprehensive domestic taxation of such income as it accrues.

3.17 The detailed features of the CFC rules of different countries vary considerably, as can be seen in the Appendix.[15] They have been developed over time and reflect trade-offs that responded to pressures and concerns which existed at that time and place. No single approach is clearly superior on all counts.

3.18 Therefore, while international experience and norms can greatly inform the New Zealand exercise, there is no consensus on the details of taxation of offshore income. New Zealand's system will need to be developed to reflect the realities of its business environment and other features of its tax system. Decisions will be a pragmatic compromise between the policy goals of the new approach, protecting the New Zealand revenue base and keeping the administrative and compliance burden to a minimum. Moreover, as New Zealand's economy and business activity evolves, any rules will need to be monitored to ensure that they remain appropriate for the changing environment in which New Zealand business operates.

[15] The Appendix outlines the systems of a number of New Zealand's major trading and investment partners. They demonstrate the variety of ways that different countries have chosen to deal with the implementation of an active income exemption. Reference to other countries' rules throughout the discussion document have been chosen on the basis of interesting features of their taxation of offshore income. The description of CFC rules in different countries is based on a mixture of publicly available information (such as the websites of revenue agencies in Australia and the United Kingdom); *OECD Studies in Taxation of Foreign Source Income – Controlled Foreign Company Legislation*, OECD (1996); and *Studies on International Fiscal Law*, International Fiscal Association (2001).

Compliance concerns

3.19 Rules to tax and/or exempt offshore income are irreducibly complex, given the variety and complexity of international business arrangements. The rules must be written so that they can be applied to the myriad of transactions and business forms that firms adopt in relation to particular business situations. Therefore a new paradigm, with borders between active and passive income, together with other rules needed to target the exemption appropriately, would be unlikely to result in legislative simplification, indeed, it might result in the reverse.

3.20 In actual application, however, an active/passive distinction could be much simpler for the types of firms and activities which it seeks to benefit. A firm with genuinely active operations abroad would no longer need to face the calculation burden that exists under the current branch-equivalent rules. If dividends could be exempted, the firm would not need to comply with the DWP rules. The one area of extra complexity could be the extension of the thin capitalisation rules, although these rules would rely on domestically available information, and are reasonably straightforward.

3.21 Under the transactional method described in chapter 5, considerably more complexity would be faced by firms with a mix of active and passive income in a single subsidiary. Even so, they would have the opportunity to reduce this potential complexity by arranging their affairs accordingly – for example, by placing passive investments in separate, special purpose vehicles. In this way, the more complex aspects of the rules would provide a precautionary function, rather than being an integral part of most firms' tax compliance.

Major implementation concerns

3.22 The fundamental implementation concern is to ensure that the exemption is appropriately targeted to offshore active income and does not allow tax on domestic New Zealand income to be reduced. As noted earlier, the New Zealand tax system already faces challenges in fully taxing New Zealand-source income. Nevertheless, a general active income exemption would make resolving this problem more critical. Accordingly, the major design challenges (refer to figure 3, at the end of this chapter) are distinguishing active and passive income and ensuring the appropriate allocation of income and expenses between the domestic tax base and offshore.

Distinguishing active and passive income

3.23 Most countries distinguish between the active and passive income of their CFCs. To protect the domestic taxation of investment income, passive income is commonly taxed as it accrues, with a credit for foreign taxes. The rationale is that offshore passive income is easily substituted for domestic investment income, with no fundamental change in the economic characteristics of the investment. Accrual taxation of passive income would be an essential part of protecting the New Zealand tax base.

3.24 Different approaches can be taken to distinguishing active from passive income. One approach, in principle, would be to define "active income" conceptually, based on criteria relating to the nature of the activities performed within the business. International experience suggests that this is a difficult border to police, creating uncertainty for businesses and exposing the tax system to significant erosion, as a small amount of activity can be attributed to what is, in fact, a passive investment.

3.25 New Zealand would adopt the international norm of defining passive income directly, by listing investments which are passive in nature. Other types of income could also be taxed on accrual – for example, some "active" income – so-called base company income – which could otherwise erode New Zealand's tax base.

3.26 A critical question is whether passive income would be taxed on a transaction-by-transaction basis or by the characteristics of the entity (such as having a level of passive income above a prescribed amount). The former method is more consistent with the policy of restricting any exemption to active income. On the other hand, the entity approach appears, at first sight, to be simpler; particularly when it allows generous thresholds for passive income in "active" entities. However, a level of threshold under an entity approach which is too high could expose the New Zealand tax base to erosion.

3.27 These issues are discussed in chapters 4 and 5.

Allocation of expenses

3.28 The appropriate measurement of offshore active income requires that costs which are associated with that income should be deducted against it and should not reduce income that is subject to tax in New Zealand.

3.29 The most significant example of this in the New Zealand tax system is the allocation of interest expense between taxable and tax-exempt activities. The rules applied to tax-reduced conduit income and the new minimum capital rules applied to foreign-owned banks provide a framework for how rules of more general application could be designed. With the provision of an active income exemption to all businesses, it would be appropriate to extend similar rules to all businesses making offshore investments. What level of safe-harbouring to provide would involve a trade-off between the proper measurement of New Zealand and offshore income and minimizing compliance burdens of businesses.

3.30 These issues are discussed in chapter 6.

Other implications of the new approach

Taxation of dividends

3.31 The government favours an active income exemption without taxes being levied on subsequent dividends. However, it would proceed in this direction only if confident that the non-taxation of dividends would not lead to an erosion of tax on New Zealand-sourced income. If this confidence cannot be achieved, it would be necessary to determine whether taxation of repatriated dividends would continue to be required.

Grey list

3.32 The repeal of the grey list exemption would be more consistent with active/passive CFC rules that focused on exempting active income rather than whether the income has been comparably taxed in the host country. On the other hand, a number of countries, including Australia, provide some form of grey list exemption for passive income.

Conduit rules

3.33 The conduit rules were introduced in 1998 to remove the income tax liability of New Zealand companies on foreign income to the extent of their non-resident ownership. These rules were introduced as a result of the comprehensive nature of our CFC rules.

3.34 If foreign active income is no longer subject to accrual taxation, there will be no need for the conduit mechanism in relation to such income. At the same time, there is a strong case for removing the conduit mechanism in relation to foreign passive income, while subjecting it to accrual taxation.

Taxation of foreign branches

3.35 A move to an active/passive distinction to the CFC rules may have implications on the way foreign branches should be taxed. A key consideration is trying to ensure that New Zealand-resident investors are not influenced by tax considerations in deciding whether to operate in a foreign jurisdiction through a subsidiary or a branch.

Treatment of non-portfolio FIFs

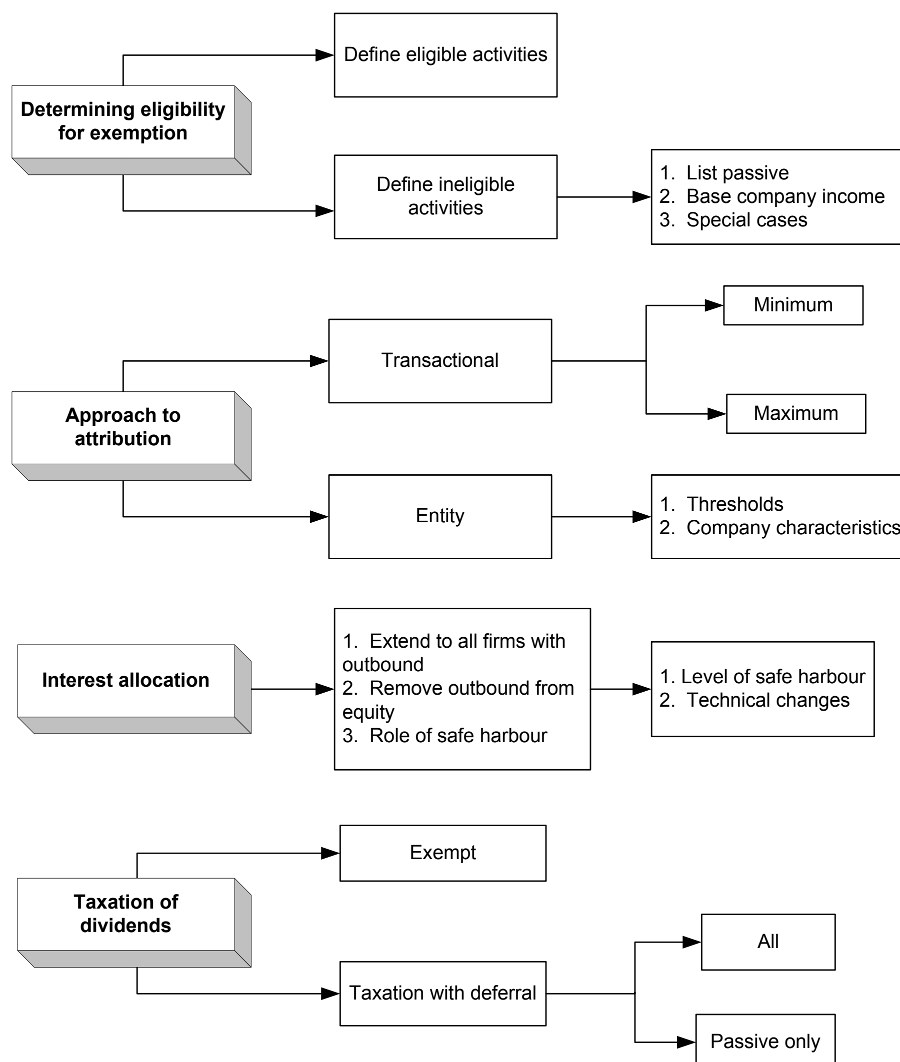
3.36 Changes to our CFC rules are likely to have implications for the tax treatment of New Zealand residents who hold non-portfolio interests in FIFs. Ideally, non-portfolio investors in either CFCs or FIFs would all be subject to the same accrual rules. However, international practice is to distinguish between FIF and CFC interests in terms of implementing an active/passive distinction.

3.37 The tax treatment of offshore portfolio investments (with investor interests of less than 10 percent) is currently being reviewed. The possible changes described in this discussion document would not affect reforms that are already under way.

Calculation of foreign tax credits

3.38 While active business income earned in CFCs would be exempt, some categories of income, such as passive income and income of foreign assets not held through an offshore branch, would continue to be taxed domestically. In that case, foreign tax credits would be provided. An important area for examination would be the allocation of costs to the foreign income for purposes of the limitation rules on foreign tax credits, to ensure that the credits did not effectively offset tax on domestic income.

FIGURE 3
Implementing an active income exemption: major design considerations



CHAPTER 4

Implementing an active/passive distinction

Possible changes

1. Offshore active income would be exempt.

2. The broad international consensus to define passive income positively would be adopted, leaving active income as the residual undefined concept.

3. Passive income and base company income (collectively called "tainted income") would continue to be taxed on accrual.

4. The main categories of tainted income would include:

    - ***Passive income***: Dividends, interest, royalties and rents. It could include income which is passive in form but the derivation of which involves certain activity.
    - ***Base company income***: Base company rules would be designed to counter situations where domestic income is shifted offshore to benefit from the active income exemption.

Details of how the rules within this general framework might work are the subject of consultations and submissions.

Distinguishing between active and passive income

4.1 Passive income generally comprises investment income which the investor does not actively participate in earning.

Approach to defining the active/passive boundary

4.2 There is a question as to how the boundary should be defined. The general approach of many countries is to define passive income positively, with active income defined by default as any income falling outside the passive income definition.

4.3 The challenge of using a positive definition of passive income is that any item which is inherently passive but is omitted from the list will not be passive income for the purposes of the CFC rules, and will therefore be exempt from attribution. There may be drafting techniques, such as the use of an inclusive definition augmented by examples, which would minimise this risk.

4.4 The alternative, a positive definition of active income, may provide legislators with less control and certainty over the scope of the active income exemption than would occur under a positive definition of passive income. That is because even a small amount of "activity" associated with an inherently passive transaction would bring the transaction within the active income net.

4.5 On balance, the government considers it preferable to define passive income positively.

Types of passive income

4.6 The following income types are generally considered to comprise passive income and would generally form part of any definition introduced in New Zealand. Potential exceptions to this approach are discussed later.

Interest

4.7 Interest is generally considered to be part of passive income.

4.8 As a general proposition, a wide definition of "interest" would be required in this context – including income derived from a finance lease or other financial arrangements.

Rents and royalties

4.9 Rent and royalties are generally considered to be passive income.

Dividends

4.10 Dividends received by a CFC are generally considered to be passive income.

4.11 Australia excludes non-portfolio dividends paid to a CFC by a non-Australian resident company. It considers this exclusion to be a natural consequence of the general exemption for participation dividends.[16] If New Zealand exempted dividends (see chapter 7) it would be necessary to consider whether we should also follow the Australian approach to non-portfolio dividends earned by a CFC.

[16] A participation dividend is a dividend paid by a foreign company to an Australian-resident company that has a 10 percent or greater interest in the voting power of that company.

Other passive income

4.12 In addition to the preceding categories of income, the following categories of income could be treated as passive:

- ***Gains from commodities transactions***.[17] The United States includes gains from commodities transactions unless they are part of hedging transactions connected to the CFC's business. Australia also includes such gains, but there is an exception for CFCs that produce or process the commodity, or use the commodity as a raw material (and other conditions are satisfied).
- ***Foreign currency gains***. Australia, however, treats such gains as active in certain limited circumstances – for example, if the CFC was carrying on the business of currency trading and no other party to the transaction was an associate or Australian resident.
- Income from annuities and insurance products.

Base company income − active in form but subject to accrual taxation

4.13 CFCs engaged in nominally active business could be used to divert income that should properly be taxable as domestic income. The response of many countries (for example, Australia, the United States and the United Kingdom in the context of their active business exemption) has been to carve out "base company income" from their active exemption.

4.14 Generally speaking, "base company income" refers to income derived by a CFC from selling property or providing services on behalf of the group of companies in a manner intended to avoid or defer domestic tax. An example would be a CFC of a New Zealand company that simply processed the paperwork for a sale from New Zealand to some third market, but captured a "marketing" margin which consisted of the bulk of the profits from the sale. The concern would be that the CFC had been established to avoid New Zealand tax. With a base company rule, the margin captured in the CFC would be "base company income" and would be attributable to the controlling New Zealand shareholders on accrual.

4.15 In principle, base company income rules should not apply to commercially driven transactions between New Zealand companies and their CFCs. It would be difficult to draw an appropriate boundary between legitimate commercial transactions and those that should be included within base company income.

[17] Commodities transactions and foreign currency transactions fall within our financial arrangements rules. As such, any gain derived would be "interest", and thus passive income, even in the absence of a specific rule related to these transactions.

4.16 Following international best practice, it would appear to be preferable for New Zealand to have base company income rules as part of a system having an active/passive distinction. There is, however, considerable variation in the design and implementation of base company rules internationally.

4.17 Generally, two major factors are relevant to the determination of base company income: the first is the geographical location of the transaction, and the second is the relationship of the parties to the transaction.

Transactions with the domestic jurisdiction

4.18 Transactions by a CFC with the domestic jurisdiction of its controlling shareholder can clearly reduce the domestic tax base. For example, when a CFC provides services or sells property in the country in which its controlling shareholder is resident, the arrangement could result in an artificial reduction of domestic tax. The income derived by the CFC, unless the CFC has a permanent establishment in the domestic jurisdiction, will not be subject to any domestic tax. The concern is that the sale or services are, in reality, made or provided by the controlling shareholder, or other domestic subsidiary, and income which would be taxable in the domestic jurisdiction has been inappropriately converted to exempt foreign income.

4.19 The United Kingdom's rules focus on transactions in the domestic jurisdiction. Under the United Kingdom's rules, the active business exemption is denied if the CFC performs services in the United Kingdom. Furthermore, a CFC whose main business consists of dealing in goods for delivery to or from the United Kingdom, unless the goods are physically delivered into the CFC's country of residence, is excluded from the United Kingdom's active business exemption.

4.20 Australia's base company income definition is also focused on transactions in the domestic jurisdiction. These rules require income from the supply of services by a CFC to an Australian resident, or Australian permanent establishment of a non-resident, to fall *prima facie* within the definition of base company income. This is true whether the supply is to related or unrelated parties. In addition, in relation to sales transactions, Australia includes income derived when a related Australian resident or an Australian permanent establishment of a related non-resident either purchases the goods from the CFC or supplies goods to the CFC as *prima facie* base company income.

Related party transactions

4.21 Some countries use their base company income concept to supplement their transfer pricing rules. When that happens, the focus is on transactions between related parties.

4.22 Countries vary, however, over whether income derived from related party transactions in a CFC's local market should be outside the concept of base company income. Some countries consider that income from transactions in a CFC's local market should be exempt because current domestic taxation on such income would adversely affect the ability of the CFC to compete there. However, when a CFC derives income outside its local market, current domestic taxation would not affect its ability to compete in its local market.

4.23 Under the United States' rules, if a CFC purchases goods from a related party and sells the goods to any person, or purchases goods from any person and sells to a related party, the sales income will be *prima facie* base company income. However, the income derived will be excluded from base company income if the property purchased was manufactured, used or consumed in the CFC's local jurisdiction.

4.24 Australia's rules similarly provide an exemption for related party sales income. As already noted, income from the sales of goods is included within base company income when a related party resident in Australia or an Australian permanent establishment of a related non-resident is involved. However, the income derived will not be base company income if the CFC substantially alters, manufactures or produces the goods sold.

4.25 The United Kingdom takes a different approach. Under its rules, whether a transaction takes place in the CFC's local market is irrelevant. If a CFC is primarily engaged in a wholesale, distributive, financial or service business, income from related parties could cause the CFC to be ineligible for the active business exemption, whether or not the transactions take place in the CFC's local market.

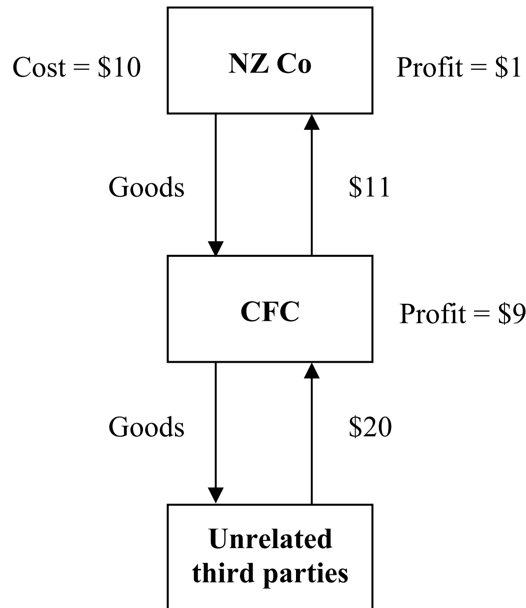
4.26 It is reasonable that income derived by a CFC from related party transactions should be exempt if that income is a reflection of genuine business activity in the CFC's local market. Even so, care must be taken in designing a test which cannot be easily manipulated.

Interaction with transfer pricing rules

4.27 A key issue is how the base company income concept interacts with a country's transfer pricing rules. Transfer pricing applies to transactions between related parties and seeks to determine correct prices with precision on a transaction by transaction basis. The base company rules apply to a wider set of circumstances, to groups of transactions, and have an anti-avoidance purpose. Base company income rules are generally viewed as a necessary reinforcement of the transfer pricing rules.

4.28 Take the example of NZ Co, a New Zealand-resident company which manufactures goods costing $10 (see figure 4). NZ Co sells the goods to its CFC, resident in a low-tax jurisdiction, for $11. The CFC then sells the goods to unrelated third parties for $20.

FIGURE 4
Example of base company income



4.29 One dollar of the profit from the sale is sourced in NZ Co, and $9 in the CFC. However, assume very little activity took place in the CFC to justify the profit sourced there. Say, for example, the arm's length consideration for the supply by NZ Co to its CFC is determined to be $17. The result of the application of the transfer pricing rules, then, is that $7 of the profit will be taxable in NZ Co (and $3 in the CFC). Under the CFC rules, however, all the income derived by the CFC ($9) would be base company income and taxable on attribution to NZ Co in New Zealand.

4.30 The appropriate interaction between the base company income concept and New Zealand's transfer pricing rules will have to be determined.

Special cases − passive in form but with activity

4.31 The approach that New Zealand takes to various boundary issues should have regard for the New Zealand business environment. There may be times when it is appropriate for the new rules to depart from international norms. On the one hand, this may give rise to concerns that an over-cautious approach could inhibit the establishment of some new offshore activity that might otherwise develop. There are risks, however, associated with instituting an exemption that tries to anticipate changes to the current business environment. This section explores the question of when it might be appropriate to limit the active income exemption, recognising, however, that the active/passive boundary will need to evolve over time as New Zealand business conditions change.

4.32 One issue on which New Zealand might depart from international norms is whether a CFC that is actively engaged in the business of earning a category of income that is typically passive (the classic example being interest earned by banks) should qualify for the active exemption. This issue is particularly problematic and is dealt with by countries in different ways for different types of passive income.

4.33 This section examines areas where businesses which arguably are active earn income which is passive in form. The question is whether the active income exemption should be extended to them.

Banks and financial institutions

4.34 In the case of banks and other financial institutions, interest often would constitute active business income and should therefore be excluded from the definition of passive income. The problem is that interest earned by a CFC of a bank might be passive in nature. Therefore treating all interest of a bank as active income creates potential for an erosion of tax revenues because banks can be established in low-tax jurisdictions with minimum capital or presence in that jurisdiction.

4.35 For example, a bank could put a portfolio of its loans to non-residents into a CFC, effectively moving such loans out of the domestic tax base. Identifying such arrangements can be difficult, particularly if the CFC carries on some legitimate active banking business of its own.

4.36 A few countries attribute income derived by banks and other financial institutions. For instance, in Denmark, the CFC rules are targeted at income from financial activity (including insurance). An entity will be a CFC if its financial income is in excess of 33 $^{1}/_{3}$ percent of its gross income or its financial assets are in excess of 33 $^{1}/_{3}$ percent of its total assets.

4.37 Other countries provide exemptions for interest earned by banks. Australia exempts interest derived by financial institutions in principle, although such interest might still be attributable if it falls into the definition of base company income. Similarly, the United Kingdom exempts CFCs dealing in banking, deposit-taking, money-lending or similar activities in principle, but requires them to satisfy a complex capital structure test (as well as satisfying minimum presence and effective management requirements) in order to be eligible for the active business exemption.

4.38 If New Zealand had a local retail banking industry that operated offshore through CFCs there could be merit in extending the exemption to interest earned by these CFCs. However, it is difficult to design an appropriate exemption in anticipation of such an industry development. Moreover, there is a fiscal risk that such an exemption would be used to exempt interest not intended to be covered by the exemption. It is possible that the problems associated with attempting to design and institute a suitable exemption in a vacuum outweigh any potential benefits from providing such an exemption.

Inter-affiliate financing

4.39 Multinational groups will often be organised in such a way that one subsidiary operates as an intra-group financial centre, with loans from third parties channelled through the subsidiary to other group members. Those subsidiaries can be used to consolidate financial expertise in one specialist centre and manage intra-group financing transactions. In such situations, they might receive interest payments from other members of the group which are then consolidated and used to pay interest on the loans from third parties.

4.40 Without an exception to the general rule, those subsidiaries would be considered to be earning passive income and potentially taxed in New Zealand.

4.41 To relieve this taxation, it is sometimes suggested that the treatment of income received by a CFC from a related party borrower should be dependent on the origin of that income. Under this principle, interest that is received by a CFC from a loan to a related party borrower and deducted against active income of the borrower should be treated as active income of the recipient CFC.

4.42 The United States has an exclusion from passive income for inter-affiliate financing if certain "same country" (and other) conditions are met. Other countries (including Australia) always treat interest on loans to related parties as passive income. Implementing an inter-affiliate financing exception would necessarily be complex, given the fungibility of money and the complexity of intra-group financial arrangements. As such, the government does not favour exempting interest derived from inter-affiliate financing from accrual taxation.

Income from insurance

4.43 Many countries consider the insurance industry to be another special case. As with banks and other financial institutions, countries vary in the way they treat the business of insurance.

4.44 The United Kingdom's rules, in broad terms, provide that a CFC whose main business is insurance cannot be eligible for exemption unless less than 50 percent of its business is derived from the risks of related parties. Japan's rules also require a CFC whose main business is insurance to conduct more than 50 percent of such business with unrelated parties for the CFC to be eligible for exemption. In Canada, income from insurance is *prima facie* attributable, but will qualify for exemption, if not related to the insurance of Canadian risks, if the CFC's business is conducted principally with arm's-length persons and more than five individual employees are employed full-time in the active conduct of the business. Australia has special rules for calculating the passive income of life assurance and general insurance CFCs. The effect of these rules, in broad terms, is to require attribution for income from assets held to meet liabilities on policies held by associates or Australian residents or that are in excess of the assets required to meet the liabilities referable to policies. Income from insurance can also fall within the definition of base company income in certain circumstances.

4.45 Concerns particularly arise when companies use offshore captive insurance companies to provide “insurance” for their operations. As the premiums for such insurance are deductible against domestic income, such companies can be used to shift income out of the domestic tax base.

Management of real and other property

4.46 There is an argument that rent derived by a company actively engaged in owning and managing commercial property should be excluded from attribution. Similarly, royalties derived by a company engaged in owning and managing intellectual property could be said to constitute active business income and, arguably, should be excluded from attribution.

4.47 Countries vary in the way they treat rents and royalties derived from active management in their CFC rules.

4.48 The United Kingdom takes a strict approach and treats rent and royalties as always passive: a CFC whose main business is holding intellectual property or leasing any property or rights will not qualify for exemption.

4.49 The United States treats rents and royalties as active if they are:

- derived by a CFC in the active conduct of a business, if derived from unrelated parties; or
- for the use of property within the CFC’s jurisdiction, if derived from related parties.

4.50 Australia provides an exemption for property in the same jurisdiction as the CFC. However, to be exempt, a substantial part of the rental income must be attributable to the provision of labour-intensive property management services in connection with the land by the CFC. Australia also provides an exemption for royalties received from unrelated parties if derived in the course of carrying on a business and either the property or right in respect of which the royalty is consideration originated with the CFC, or the CFC substantially develops, alters, or improves the property or right for which the royalty is paid.

4.51 While there is a conceptual argument to exempt rents and royalties that are actively managed, it would be extremely difficult to administer a boundary that has the more general “active business” exemptions used in the United States and Australia. (There is already concern that intellectual property is being moved offshore to reduce New Zealand taxation.) It would appear preferable to follow the United Kingdom’s approach and treat all rent and royalties as passive.

Submission points

Submissions are sought on the following matters, in particular:

- whether positively defining passive income, with active income defined by default as the remainder, is appropriate;

- the appropriate scope of the definition of "tainted income":
  - the list of passive income to be included (interest, dividends, royalties and rent);
  - treatment of a CFC which is actively engaged in the business of earning a category of income that is typically passive; and
  - extent of base company rules.

CHAPTER 5

The transactional and entity approaches

Possible approaches

The government could adopt one of two approaches to attributing the income of a CFC to its resident shareholders:

- The *transactional approach* examines each item of income derived by a CFC to determine whether it produces tainted income or non-tainted income. Accordingly, different income streams of the CFC attract different treatment depending upon their category; or

- The *entity approach* looks at whether the company is active or passive. Once categorised, then all of the income of the company is taxed in the corresponding manner, regardless of the nature of the income derived.

Details on how the rules within this general framework might work are the subject of consultations and submissions.

Attribution of profits using the transactional approach

5.1 Australia and the United States apply a transactional approach to income of CFCs. Under this approach, the shareholder in the CFC is attributed certain "tainted" income of the CFC as it is earned by the CFC. Income is designated as tainted income if it is passive investment income or base company income.

5.2 The transactional approach has the attraction of being the most precise approach to achieve the policy goal of exempting active business income. This is because the obligation to attribute income arises only in relation to those sources of income that are viewed as passive or base company, and so susceptible to manipulation.

5.3 The main disadvantage that the Tax Review 2001 saw with the transactional approach was that it would seem to impose some significant compliance and administrative costs – relative to the entity approach. As will be explored in more detail later, this conclusion must be qualified by comparing the intended precision of the implementation.

5.4 Complexity arises in part because each transaction of a CFC must be considered to determine on which side of the tainted/non-tainted boundary it falls.

5.5 Complexity is also associated with attribution of income to shareholders under the transaction approach when the CFC derives a mix of tainted and non-tainted income. This complexity stems from the requirement to allocate expenses and foreign tax credits to that tainted income.

5.6 For instance, to calculate the amount of income that should be attributed to the shareholder, it would be necessary to calculate the expenses of the CFC that are deductible in earning that income. This might require some apportionment when expenditure is incurred by the CFC for the purposes of earning both tainted and non-tainted income.

5.7 Similarly, if the CFC has paid tax in the foreign jurisdiction in respect of all its income, those foreign taxes would need to be allocated between the tainted and non-tainted income. That would be necessary to determine the amount of the underlying foreign tax credit available to the New Zealand shareholder for the tainted income.

5.8 Considerable complexity arises in the systems of other countries when an attempt is made to tax the income as it is distributed to the shareholder (with a credit for tax previously paid as the income accrued). If a system of taxing the tainted income once, as it accrues, were implemented, this area of complexity would be avoided.

5.9 Finally, if the CFC has passive losses, those losses would need to be separately calculated and ring-fenced to be set off against future passive income of the CFC, consistent with current law. These losses would not be deductible against the domestic income of the New Zealand-resident controlling shareholders. Active losses would similarly need to be ring-fenced from passive and domestic income.

Hybrid transactional approaches

5.10 Australia introduces an element of an entity approach in conjunction with its transactional approach when the proportion of tainted income is very low (a minimum threshold rule). The United States has both a minimum threshold and a maximum threshold rule.

5.11 The concept of a minimum threshold is that a taxpayer should be able to avoid the compliance features of a transactional approach when the proportionate amount of tainted income is small. Australia has an active income exemption if (among other things[18]) less than 5 percent of a CFC's gross turnover is tainted income. In that case, none of its income is attributed.

5.12 In principle, this minimum threshold seems to be a sensible simplification measure. Active businesses may legitimately derive small amounts of tainted income, such as interest on bank deposits, and should not be required to incur the compliance costs of attribution in relation to that small amount.

[18] There are additional requirements that the CFC has a permanent establishment, has kept accounts in accordance with generally accepted accounting principles (which are satisfied if it complies with the accounting standards applicable in the CFC's country of residence), and it has complied with certain substantiation requirements.

5.13 The main downside of a minimum threshold exemption is that it still has the potential to facilitate the erosion of the domestic tax base, using a CFC earning mostly active income, up to the minimum threshold. Also, if the threshold is set as a proportionate amount, the size of the exemption could, arguably, be too generous, depending on the size of the CFC. These concerns may be dealt with by limiting the exemption to tainted income sourced outside New Zealand from unrelated parties.

5.14 The United States uses a maximum threshold approach in relation to foreign base company income. If foreign base company income exceeds 70 per cent of the total income of the CFC, all of the income of the CFC is subject to attribution. This type of rule also has merit – particularly if used in tandem with a minimum threshold rule.

Attribution of profits using the entity approach

5.15 Many European countries, including the United Kingdom, implement their CFC rules using an "entity approach", best described as an "all or nothing" approach. In other words, if the CFC satisfies an active business test, none of the income earned by the entity is attributed to the shareholder of the CFC on an accrual basis.

5.16 Countries which use the entity approach exempt CFCs primarily engaged in active business. Eligibility is often determined by focusing on whether:

- The CFC has a substantial presence in the jurisdiction.
- The income derived by the CFC is from activities in its country of residence.
- The business of the CFC is mainly "active".
- The CFC deals with unrelated parties.

As such, eligibility requirements for exemption under an entity approach incorporate features that are analogous to the definition of base company income under a transactional approach.

Substantial presence

5.17 Many countries (including the United Kingdom) require a CFC to have a substantial presence in its local jurisdiction for the CFC to qualify for their active business exemption. This is designed to prevent "letter-box" CFCs from being eligible for exemption. The test focuses on whether the CFC has permanent business premises in its jurisdiction of residence for use in carrying on its business. This may depend on whether the CFC has sufficient employees in that jurisdiction to conduct its business. It may also depend on whether the CFC has effective management and control of its own business.

Income derived from country of residence

5.18 Some countries also require the CFC to earn its income (or a certain percentage of its income) in the country of residence. The idea behind this requirement is that a CFC which primarily derives its income in its jurisdiction of residence is likely to have legitimate reasons for its presence in that jurisdiction.

Active business criteria

5.19 The requirement that the business of the CFC be active has two key elements under the entity approach. The first element is the identification of the types of activity that will qualify as active. The second element is the requirement that the qualifying activity be the primary or main business of the CFC.

5.20 Identifying the types of qualifying activity is sometimes implemented by positively defining active businesses (such as manufacturing or agriculture). For example, the French exemption is limited to CFCs principally engaged in manufacturing or production, services or the purchase of goods for sale or lease. Finland limits its exemption to CFCs whose income is principally derived from industrial or any other comparable production activities or shipping activities, or sales and marketing related to those activities.

5.21 Alternatively, countries can positively define passive activities (such as investing or leasing). For instance, the United Kingdom's exemption is not available to CFCs whose main business is investment. This includes the holding of securities or intellectual property, dealing in securities other than as a broker, leasing, or "money box" functions. Similarly, Japan excludes from exemption a CFC whose main business is investment – holding stocks, bonds or debentures, providing patents, other rights regarding intellectual property, and leasing ships or aircraft.

5.22 Countries have different approaches to determining whether the qualifying/disqualifying activity is the principal activity of the CFC. In the United Kingdom, the "main business" of the CFC must not be an "investment business". The term "main business" is not defined. Comparative turnover, profitability and capital investment in different activities are taken into account in applying this test. Japan also refers to the "main business" being other than the non-qualifying activities – without specifically defining the term "main business". Portugal requires 75 percent of income to be from the permissible activity.

5.23 A related issue is whether the threshold for tainted income should be set as a proportionate amount – as is the case in Portugal and France. That would mean that the quantum of tainted income that escapes attribution would depend on the size of the CFC. Arguably, this raises equity concerns because large operations will be able to shelter much more passive income than smaller operations.

5.24 Finally, there would need to be rules for dealing with CFCs that moved above or below the threshold, and therefore in and out of the exemption, across income years.

Transactions with unrelated parties

5.25 Countries usually require that the income, or a sufficient proportion of income, derived by a CFC should be derived from transactions with unrelated parties. If a CFC deals primarily with related parties the CFC is considered to be more likely to be a tax-avoidance vehicle used to divert income which should be properly taxable in the country where the controlling shareholders are resident. For example, the United Kingdom's rules exempt CFCs whose main business is "wholesale, distributive, financial or services business" but only where 50 percent or more of the CFC's gross trading receipts from that business are derived from unrelated parties (and certain specified unconnected United Kingdom companies and individuals).

Level of threshold

5.26 Countries typically provide that an entity is "active" if it is primarily (50 percent or more) engaged in earning active income. Such a test could in principle be applied using ratios of gross or net income, or assets. Consideration also could be given to using a lower threshold, say 25 percent, for passive income in categorising the entity. In that case a CFC would be taxed on accrual if its percentage of passive income or assets exceeded 25 percent of the total.

Evaluating the transactional and entity approaches

5.27 On the surface, the entity approach is considered to be simpler than the transactional method. However, much of this apparent simplicity arises because passive income thresholds used to determine what qualifies as a passive entity are typically much higher (around 50 percent) than the minimum thresholds under which the transactional method does not apply. If approaches with a similar level of precision are compared, then, the apparent differences in complexity between them cease to be significant.

5.28 The entity approach appears technically simpler because, within the firm, there are none of the apportionment or allocation issues in relation to expenditure or foreign tax credits. Arguably, an entity system which sought to segregate active and passive income with the same precision as is theoretically possible with a transactional approach would involve a similar level of technical complexity.

5.29 Most of the complexity concerns associated with a transactional approach have direct analogues in an entity system.

5.30 For example, under an entity approach applied to a group with a mix of active and passive subsidiaries, the same allocation concerns arise if costs, such as interest, are disproportionately allocated to the passive subsidiary.

5.31 If dividends from passive income were to be taxed when the income was repatriated, the character of the underlying income and taxes paid with respect to different streams of income would need to be tracked through chains of subsidiaries.

5.32 From a taxpayer perspective, the disadvantage of an entity approach that has a low tolerance of passive income is that if the entity fails the active entity test, all of its non-tainted income is attributable to the shareholder. On the other hand, from the point of view of the government, a problem with a fairly generous threshold of passive income would arise if the entity passed the active entity test and none of its tainted income was attributed to the shareholder.

5.33 The critical question is how much tainted income should be allowed to accumulate in the active CFC under the entity approach. As discussed in chapter 3, a key issue in the design of CFC rules is prevention of the erosion of the New Zealand tax base by accrual of untaxed tainted income in CFCs. If tolerance of tainted income is too high, achieving that objective is seriously compromised.

Submission points

Submissions are sought on problems that might arise if:

- a *transaction approach* is adopted to determine the income of a CFC that must be attributed to resident shareholders as it accrues in the CFC; or

- an *entity approach* is adopted to determine the income of a CFC that must be attributed to resident shareholders as it accrues in the CFC.

CHAPTER 6

Interest allocation and transfer pricing rules

Possible changes

1. The current thin capitalisation rules would be:
    - extended to cover all New Zealand entities with outbound investments, taking into account the compliance cost considerations;
    - modified to deal with outbound investments in CFCs; and
    - reviewed to ensure that the safe harbour ratio is appropriate.
2. Technical aspects of the thin capitalisation rules would be reviewed to make them consistent with the minimum capital requirement rules for banks.
3. The transfer pricing rules would be strengthened by shifting the burden of proof on transfer pricing matters from the tax administration to taxpayers.

Details of how the rules within this general framework might work are the subject of consultations and submissions.

Interest allocation in multinational companies and taxation of New Zealand income

6.1 A number of interest allocation rules have already been introduced into the tax legislation in an attempt to address the interest allocation problem presented by multinational companies. These rules, which include the general thin capitalisation rules for foreign controlled entities, conduit company interest allocation rules and the minimum capital requirement rules for New Zealand banking groups, are intended to limit the interest costs that multinational companies can claim against their New Zealand-sourced income.

Current general thin capitalisation rules

6.2 The overall objective of the general thin capitalisation rules is to protect the New Zealand tax base against excessive interest deductions. This is achieved by requiring certain multinational groups to allocate their global interest costs in accordance with their worldwide gearing ratio. Thus, the rules are intended to ensure that New Zealand does not bear a disproportionate share of the global interest costs of multinational groups.

6.3 The general thin capitalisation rules apply to foreign controlled entities: non-residents operating in New Zealand through a fixed establishment, New Zealand companies controlled by a single non-resident, and certain forms of trust. That is because such entities, being controlled by a single non-resident, could thinly capitalise their New Zealand operations to reduce their New Zealand tax without any effective commercial constraint.

6.4 Under the current rules, interest deductions for an entire New Zealand group are examined, but are not challenged if its group debt percentage does not exceed 75 percent (a debt to equity ratio of 3:1 for the entire New Zealand group). If the group's total debt-to-asset percentage exceeds the safe harbour ratio, allowable interest deductions for the group will be limited to the higher of a level consistent with 75 percent group debt percentage or 110 percent of its worldwide group debt percentage.

The interest allocation problem under active income exemption

6.5 Exempting foreign active income would exacerbate the interest allocation problem that the current thin capitalisation rules aim to resolve. Under the proposed active/passive rules, the active income of CFCs would no longer be taxable in New Zealand. To the extent that New Zealand has a higher tax rate than the jurisdiction in which the CFC is located, the revised rules would also create an incentive for firms to allocate their interest costs against New Zealand income as opposed to the tax-exempt foreign income. This can be done by the parent company financing investments in active CFCs in the form of equity, as opposed to debt.

6.6 In the example in figure 5, a New Zealand entity, NZ Co, has $2,000 capital, made up of $1,000 equity and $1,000 loan (with 10 percent interest). NZ Co made a domestic profit of $100 and a $1,000 outbound investment in a CFC which generates a profit of $100, and is funded purely by way of equity. Table 6.1 shows that if the income of the CFC is not taxable in New Zealand, NZ Co could allocate its entire financing costs against its New Zealand domestic income, even though half of its income is exempt active income of a CFC. In this case, the exemption of foreign income could lead to an erosion of the New Zealand-sourced income as the overall profits of NZ Co are reduced to zero by the over-allocation of its global interest costs.

FIGURE 5
Interest allocation problem under active income exemption

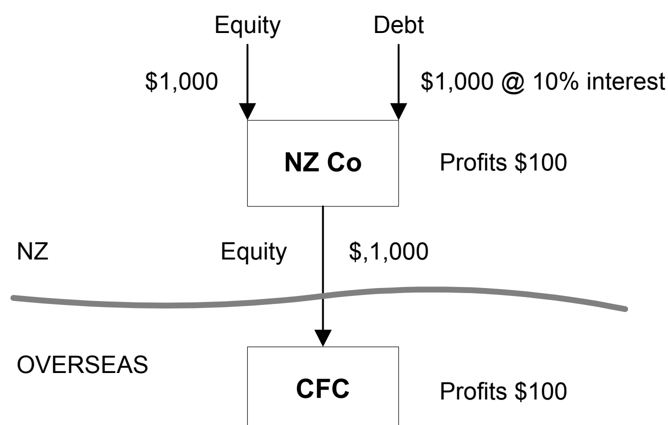


TABLE 6.1
Existing thin capitalisaiton rules: New Zealand tax calculation

Domestic income	100.00
CFC income – exempt	-
	100.00
Interest cost	(100.00)
Net income	-
New Zealand tax	Nil
New Zealand income is entirely sheltered	

6.7 Current thin capitalisation rules would not deal with this concern, for three reasons. First, the general thin capitalisation rules apply only to foreign controlled entities. The scope is too narrow as it does not apply to all entities with investments in CFCs that would have access to the active income exemption.

6.8 Second, these rules limit total debt of the New Zealand group as a fraction of total assets, whether the assets are employed domestically or overseas. This means that the New Zealand group effectively takes on the debt funding costs of the assets employed to generate foreign income. This would create a mismatch between deducting the interest costs and exempting the associated income. By contrast, the thin capitalisation rules for banks and conduit companies, in effect, limit the level of debt and interest deductions on the basis of assets employed to generate taxable income in New Zealand.

6.9 Third, the general thin capitalisation rules contain a 75 percent debt-to-asset safe harbour ratio. This ratio is used as a compliance cost reduction mechanism for foreign controlled entities under the current rules. However, if the ratio is applied to entities with outbound investments, it would allow these entities to claim full interest deductions in New Zealand up to the 75 percent debt-to-asset ratio while earning a significant amount of tax-exempt income offshore. In this sense, the safe harbour ratio would operate more as a concession than a compliance cost reduction mechanism if applied to entities with outbound investments.

Policy considerations in the development of general thin capitalisation rules

6.10 To provide greater protection for the domestic tax base, it would be necessary to extend and strengthen the general thin capitalisation rules. The following sections set out the main policy concerns that would have to be resolved if the general thin capitalisation rules were to provide the necessary safeguards to New Zealand's tax base under an active income exemption.

Extending the thin capitalisation rules to entities with outbound investments

6.11 There is a case for applying the general thin capitalisation rules to non-foreign controlled entities with outbound investments. These rules would protect New Zealand's tax base by ensuring that the global interest costs of companies with outbound investments were allocated in proportion to their worldwide debt ratio. However, companies with no outbound investments would not be subjected to these rules. Australia has a comprehensive set of interest allocation rules for entities with outbound investments based on the worldwide debt ratio.[19]

6.12 The rules would not be unduly restrictive on the financing methods that entities use for their outbound investments because interest costs would be allocated by reference to their worldwide debt ratio.

Compliance cost considerations

6.13 The compliance costs that could be imposed by the thin capitalisation rules are an important consideration.

6.14 The current thin capitalisation rules apply to foreign controlled entities and are designed to deal with these entities specifically. Extending the thin capitalisation rules to domestic entities with outbound investments would require a careful consideration of the differences between these entities.

[19] The interest allocation rules used in Australia limit the allowable debt (and interest) of outward investing entities (an Australian entity that has a permanent establishment overseas or a 10 percent or more controlling interest in an Australian controlled foreign entity) and their associates to the maximum of the safe harbour ratio, the arm's length amount and the worldwide gearing debt amount.

6.15 For foreign controlled entities, relying solely on the worldwide debt ratio as a benchmark for interest allocation could be problematic as the balance sheet information required is not located within New Zealand. On the other hand, domestic entities in New Zealand would not face similar obstacles in accessing the balance sheet information needed to apply the worldwide debt ratio.

6.16 Compliance cost-reduction measures would be investigated to ensure that entities that already use a funding structure that is consistent with the worldwide gearing ratio would not be required to apply the thin capitalisation rules. In addition, other thresholds could be developed to ensure that domestic companies with a small amount of outbound investments would not be required to apply the thin capitalisation rules.

Entities with outbound investments in passive CFCs

6.17 The interest allocation problem for non-foreign controlled entities is most evident when the outbound investments are in tax-exempt CFCs, as illustrated in the example in figure 5. The treatment of passive investments under the extended thin capitalisation rules would have to be considered carefully. On the one hand, passive investments would be taxable in New Zealand, and interest incurred on behalf of these investments should be deductible in New Zealand. On the other hand, foreign tax credits would be provided to offset the New Zealand tax liabilities on passive income, and the calculation of these foreign tax credits should, in theory, take into account an appropriate share of the interest costs so that New Zealand does not bear both the interest costs as well as the foreign tax credits associated with passive investments.

6.18 Australia does not provide special rules for entities with outbound passive investments. Interest costs incurred by Australian entities with respect to CFCs with passive investments are subject to the thin capitalisation rules, while the passive income is also taxed on accrual.

Adjustment for equity investments in CFCs

6.19 The general thin capitalisation rules limit total debt of New Zealand companies as a fraction of total assets. Assets for the purpose of these rules are measured on the basis of generally accepted accounting practice. Debts are defined as all financial arrangements that provide funds to the taxpayer and give rise to an allowable deduction.

6.20 In effect, the restriction imposed by the current thin capitalisation rules is determined by reference to a ratio and can be summarised as follows:

TD / TA

where TD is total debts
TA is total assets

This formula does not distinguish between assets that have been used domestically or overseas.[20] New Zealand firms would be allowed to have more debts against their New Zealand income for every dollar of assets invested.

6.21 Under the current thin capitalisation rules, if foreign active income were exempt, firms could effectively deduct interest costs attributable to their overseas CFCs against New Zealand income. To prevent this, an adjustment would be needed to the thin capitalisation rules for the equity invested in an offshore CFC. Similar adjustments are also made in the interest allocation rules for conduit companies and the minimum capital requirement rules that apply to New Zealand banking groups.

6.22 In principle, the restriction imposed by the revised thin capitalisation rules would be determined by reference to:

TD / (TA-CFC)

where TD is total debts
TA is total assets
CFC is the equity investment in CFCs

6.23 The revised thin capitalisation rules would make specific adjustments to account for equity investments in the CFCs. Table 6.2 summarises the impact of the specific adjustments for NZ Co in the example in figure 5. With this adjustment its total asset base would be reduced from $2,000 to $1,000. Ignoring the safe harbour ratio for this example, a worldwide ratio of 50 percent would apply. NZ Co would be allowed to have an interest deduction of $50, instead of the full $100.

TABLE 6.2
Revised thin capitalisation rules: New Zealand tax calculation

Domestic income	100.00
CFC income – exempt	-
	100.00
Deductible interest[1]	(50.00)
Net income	50.00
New Zealand tax at 33%	16.50

[1] New Zealand group debt percentage: TD/(TA–CFC) = $1,000/($2,000–$1,000) = 100%, using the 50% worldwide debt percentage, 50% of interest costs would be deductible.

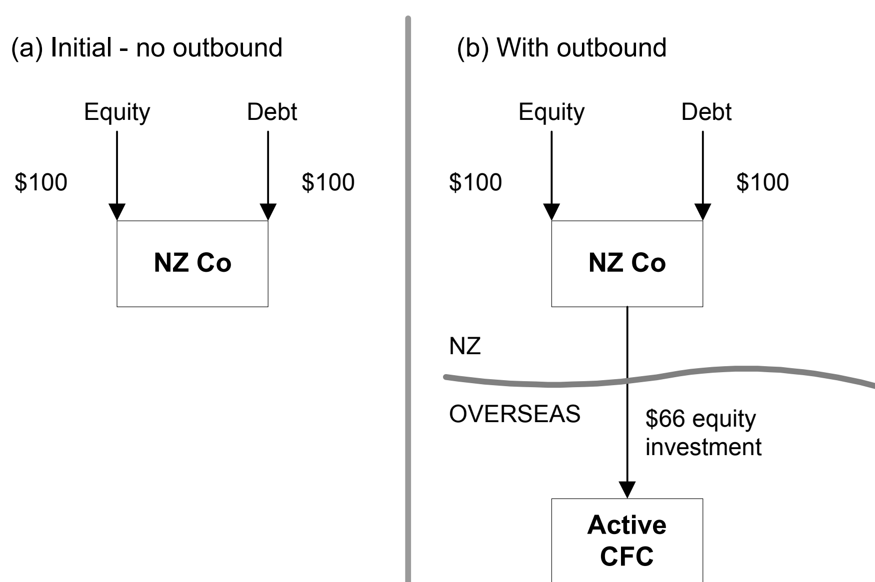
[20] This formula is a highly simplified example and does not take into account other adjustments such as the on-lending concession.

Safe harbour ratio

6.24 The effects of the safe harbour ratio in the current thin capitalisation rules would have to be considered if these rules were to apply to New Zealand entities with outbound investments. With the safe harbour ratio, the interest deductions of New Zealand entities would not be restricted if their total debt-to-asset percentage does not exceed 75 percent. This is considered a compliance cost reduction measure under the current rules but it would have more significant effects when applied to entities with outbound investments.

6.25 The example in figure 6 illustrates the operation of the safe harbour ratio in the case of a New Zealand company with a debt-to-asset ratio of 50 percent initially when it is purely a domestic company. If the company is undertaking outbound investment, it could make equity investments in active CFCs of up to $66 without triggering the thin capitalisation rules because of the 75 percent safe harbour ratio, even after the adjustment for outbound investments discussed in the previous section.

FIGURE 6
Impact of safe harbour ratio



6.26 The example in figure 6 shows that a New Zealand company (assuming that it has a 50 percent debt-to-asset ratio currently) could move 33 percent of its total assets (or $66 in the example) offshore to an active CFC and still stay within the 75 percent safe harbour ratio. This means that the income from those investments would not be taxed in New Zealand, while the interest costs associated with the investments would be deductible against New Zealand income.

6.27 In effect, when the thin capitalisation rules are applied to entities with outbound investments, the safe harbour operates as a concession for these entities. The benefits would vary depending on the existing debt-to-asset ratio of the New Zealand firms – the safe harbour benefits New Zealand firms that have low debt-to-asset ratios more than those firms that are already highly geared.

Is the 75 percent safe harbour ratio appropriate?

6.28 A safe harbour ratio that is too high would allow New Zealand entities to restructure their affairs to achieve a tax advantage and result in under-taxation of these entities. Conversely, a safe harbour ratio that is too restrictive might impose unnecessary compliance and administrative costs.

6.29 Although it is common practice to have a safe harbour, the level of the safe harbour ratio is set differently in different countries. The United States adopts a 60 percent debt-to-asset safe harbour ratio under its earnings stripping rules. Germany lowered its safe harbour debt-to-asset ratio for thin capitalisation rules from 75 percent to 60 percent in 2001, although it has kept the 75 percent ratio for holding companies. Australia uses a 75 percent safe harbour ratio.

6.30 The safe harbour ratio of 75 percent under the current interest allocation rules is relatively high compared with debt limitations that are commonly found in commercial debt contracts. Empirical evidence from commercial public debt contracts, such as debentures, tends to require New Zealand borrowers to maintain a maximum 60 percent debt-to-tangible-asset ratio.[21]

6.31 Furthermore, as New Zealand has a high level of foreign direct investment from Australia, a lower safe harbour ratio could be justified. Australian controllers of New Zealand entities would prefer to pay tax in Australia to maximise the franking credits that they can attach to dividends to Australia shareholders.

6.32 Practical, anecdotal experience in the administration of the current safe harbour ratio suggests that some overseas controlled New Zealand entities have been taking advantage of it by gearing their New Zealand operations up to the allowable debt limit, thereby reducing the tax they pay in New Zealand.

6.33 On balance, it would appear appropriate to lower the existing safe harbour ratio. Businesses operating in an environment requiring higher leverage could continue to operate at a level consistent with their worldwide group debt percentage.

[21] Law, S., *The choice of fixed accounting ratios as safe harbours in thin capitalisation rules – some guidance from commercial debt contracts*, Australian Tax Forum 21 (2006), pp 363-386.

Design issues

6.34 A number of other design issues are being considered in the development of the general thin capitalisation rules that would apply to foreign controlled entities, as well as to non-foreign controlled entities with outbound investments.

110 percent loading on worldwide group debt ratio

6.35 Under the current thin capitalisation rules, if an entity has breached the safe harbour ratio, it is further protected by the 110 percent loading on the worldwide group debt percentage. The example in figure 7 illustrates the operation of the 110 percent loading for a company with outbound investments in an active CFC, assuming that there is a safe harbour of 75 percent and adjustments are made for outbound investments, as discussed earlier.

6.36 In this example, the company's group debt-to-asset ratio exceeds the 75 percent safe harbour. As its worldwide group debt percentage is 80 percent, the 110 percent loading will allow the company to take 88 percent of its global interest costs ($352 of a total of $400) as deductible, while only 80 percent of its income ($400 over a total of $500) would be taxable in New Zealand (see Table 6.3).

FIGURE 7
Impact of 110 percent loading in worldwide debt ratio

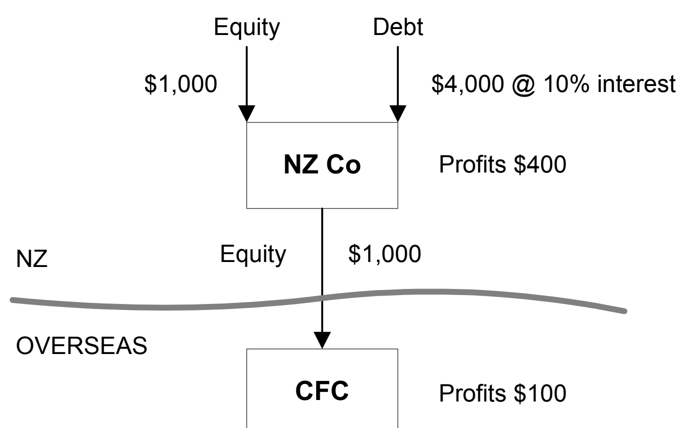


TABLE 6.3
Impact of 110 percent loading on worldwide debt ratio

Domestic income	400.00
CFC income – exempt	-
	400.00
Deductible interest	(352.00)
Net income	48.00
New Zealand tax at 33%	15.84

6.37 In principle, the worldwide gearing amount should be the appropriate benchmark for allocation of global interest costs. When the worldwide gearing ratio represents the average gearing over a range of industries and the New Zealand business is substantially different from the worldwide group, the worldwide gearing ratio may not be entirely appropriate. This could result in either an over-allocation or an under-allocation and does not really justify the use of the 110 percent loading. Australia is the only other country that uses the worldwide group debt ratio as a benchmark in its interest allocation rules for outbound entities. It does not use the 110 percent loading.

Consistency with the minimum capital requirement rules for banks

6.38 For the purpose of the current thin capitalisation rules, assets are measured on the basis of generally accepted accounting practice. In addition, worldwide group debt percentage ratios are calculated on a consolidated basis, taking into account generally accepted accounting practice and the financial reporting standards of the country which are applied in the preparation of a group's consolidated financial accounts. Debts are defined as all financial arrangements that provide funds to the taxpayer and give rise to an allowable deduction. This mixture of concepts can lead to a mismeasurement of the true debt-to-assets ratio of the company.

6.39 To ensure consistent comparisons, the government made specific adjustments to these concepts of assets and equity/debt when the minimum capital requirement rules were developed for banks, in legislation that was enacted last year. It would be appropriate to align these aspects of the current thin capitalisation rules with similar concepts adopted under the minimum capital requirement rules for banks. This would also take into account the impact of international financial reporting standards – for example, in the way goodwill is treated under generally accepted accounting practice.

6.40 The adjustments that would be considered for the purpose of the general thin capitalisation rules include:

- ***Definition of liabilities*** – the scope of the definition of liabilities could be examined to ensure that all 'debts' are included for the purpose of the thin capitalisation rules.
- ***Goodwill*** – goodwill could be excluded from the asset base for the purpose of the thin capitalisation rules.
- ***Foreign tax credits*** – foreign investments that generate foreign tax credits could be excluded from the New Zealand asset base for the purpose of the thin capitalisation rules.
- ***Preference shares*** – instruments such as preference shares that are equity in legal form but are debt in economic substance could be treated as debt for the purpose of the thin capitalisation rules.

Other miscellaneous issues

6.41 Non-residents with investments in New Zealand generating New Zealand-sourced income without using a fixed establishment are subject to New Zealand tax. For example, non-residents who own land in New Zealand earning rental income are taxable on their New Zealand-sourced rental income. Interest costs incurred by these non-residents are deductible against the rental income. The current thin capitalisation rules do not work properly for investments by non-residents when there is no fixed establishment in New Zealand. This aspect of the existing rules should be examined.

6.42 The amount of debt that New Zealand groups are allowed to have under the existing thin capitalisation rules is increased by the amounts that have been on-lent. This on-lending concession applies to funding provided by the New Zealand groups to non-residents, third party borrowers or certain related party borrowers. The application of these on-lending concessions would be reviewed to ensure that they are appropriate under the revised thin capitalisation rules.

6.43 Conduit companies are provided with a tax relief for foreign income earned on behalf of their non-resident shareholders. Such companies are subjected to interest allocation rules. If the conduit rules are repealed, as discussed in chapter 7, it would not be necessary to retain the interest allocation rules for conduit companies. If the conduit rules are retained in whatever form, the interest allocation rules for conduit companies will have to be modified accordingly.

Transfer pricing issues

6.44 The existing transfer pricing rules provide another, and a more general, method for dealing with inappropriate erosion of the domestic tax base that could arise from an active income exemption. These transfer pricing rules require all transactions between New Zealand businesses and their foreign affiliates to be carried out under arm's length conditions. The arm's length standard provides a necessary safeguard against erosion of the New Zealand tax base by ensuring that foreign affiliates' profits are commensurate with their assets, functions and risks.

6.45 The active income exemption would increase the incentives for New Zealand businesses to shift profits offshore (either by moving global expenses to New Zealand or moving income offshore). That would probably put more pressures on the current transfer pricing rules and transfer pricing audit resources. An amendment to shift the burden of proof on transfer pricing matters to taxpayers would be necessary to strengthen the protection that the rules could provide.

Burden of proof

6.46 Taxpayers have an obligation to determine the appropriate arm's length transfer prices. To challenge the transfer prices adopted by taxpayers the tax administration has to demonstrate that better transfer prices exist (unless the taxpayers do not co-operate with the Commissioner's administration of the transfer pricing rules). The "burden of proof" lies with the Commissioner of Inland Revenue.

6.47 The existing burden of proof requirement is workable at present because the comprehensive CFC rules provide the first line of defence against inappropriate transfer pricing behaviour. The transfer pricing rules would be under more pressure if the active income exemption were to be introduced. As such, the requirement for the tax administration to discharge the burden of proof might become impractical in this new environment.

6.48 The requirement for the taxpayer to discharge the burden of proof is not uncommon internationally. Countries such as the United Kingdom and Australia place the initial burden of proof on taxpayers when dealing with transfer pricing matters. Taxpayers in these countries are required to make transfer pricing adjustments, taking into account the arm's length principle, under a self-assessment system.

6.49 It would therefore be appropriate to shift the burden of proof from the tax administration to the taxpayers. This would be more consistent with the placement of the burden of proof on tax matters generally.

6.50 At the same time, it would be necessary to take special care and to use restraint in relying on the burden of proof in the course of the examination of a transfer pricing case because of the difficulties with transfer pricing analyses. The tax administration should be prepared to justify its choice of transfer price in accordance with internationally accepted methodologies, even if the burden of proof is on the taxpayer.

Submission points

Submissions are invited on the following issues:

- What business and compliance cost concerns would arise if the general thin capitalisation rules were extended to all New Zealand entities with outbound investments?
- Should any distinction between foreign-controlled and domestic entities be taken into account in the thin capitalisation rules?
- What business and compliance cost concerns would arise if the safe harbour ratio in the thin capitalisation rules were lowered?
- What are the concerns if the burden of proof on transfer pricing matters were shifted to the taxpayers?

CHAPTER 7

Implications for the taxation of dividends and other international tax rules

Possible changes

1. A key issue is whether dividends from CFCs should continue to be taxed. The government is more attracted to the exemption method provided such an exemption would not lead to erosion of the New Zealand tax base.

2. Repeal of the grey list exemption and conduit rules would be consistent with an active/passive distinction that focuses on exempting active income rather than whether the income has been comparably taxed in the host country.

3. Consideration should be given to whether the active/passive distinction should apply in respect of foreign branches and non-portfolio interests in foreign investment funds (FIFs).

Details of how the rules within this general framework might work are the subject of consultations and submissions.

Taxation of dividends from CFCs

7.1 Approaches to the taxation of dividends from CFCs vary among countries, regardless of whether they use the transactional or entity approaches to attribution. As mentioned in chapter 2, in the case of active income, they adopt one of the two basic approaches:

- deferral of taxation of active income earned offshore until the profits are repatriated, with a credit for foreign taxes paid (referred to as "the deferral with a credit" method); or
- a complete exemption for offshore active income with no taxation of subsequent dividends (referred to as the "exemption" method).

7.2 The United States uses the transactional approach and taxes all dividends from the CFC to the extent tax has not been paid on the underlying profits. The result is that tainted income is taxed to United States shareholders on accrual and then on distribution – to the extent tax was not imposed on accrual. By contrast, tax on active income is deferred until the profits are repatriated by way of a dividend with a credit for foreign taxes.

7.3 The United Kingdom uses the entity approach and, like the United States, the United Kingdom has adopted the "deferral with a credit" method. Accordingly, shareholders in active CFCs are taxed only when the income is distributed with a credit for foreign taxes. Shareholders in passive CFCs are taxed on accrual and then again when the profits are distributed, with credit for taxes paid on accrual.

7.4 Australia uses the transactional approach but exempts *all* dividends from the CFC. This means that Australian tax is levied on the tainted income of a CFC on accrual. Active income is subject to a permanent exemption from Australian taxation.

7.5 The government is more attracted to the exemption method adopted by Australia. Exempting all dividend flows would be simpler than taxing them on deferral. In the case of active income, it recognises the limitations of the integrity of credit with deferral approach highlighted in chapter 2. In the case of passive and base company income, it assumes that income has been taxed on accrual.

7.6 That said, there are legitimate reasons why countries have not taken that step. First, there may be a concern that rules for taxing passive income on accrual are not sufficiently robust to exempt the dividend with confidence. Second, exempting any cash flow presents opportunities for tax arbitrage and avoidance – regardless of whether the transaction takes place domestically or in a cross-border context. For instance, it could be possible to circumvent loss grouping/ring fencing rules by swapping a deductible stream of income from a profitable New Zealand company for an exempt dividend stream from the CFC.

7.7 As mentioned in chapter 2, the government would proceed in this direction only if it is confident that the exemption would not lead to an erosion of tax on New Zealand-sourced income. If this confidence cannot be achieved, it would need to examine whether some form of taxation of repatriated dividends would be required.

Dividend withholding payment rules

7.8 All foreign dividends received by New Zealand companies are exempt from income tax. However, New Zealand companies are required to make dividend withholding payment (DWP) deductions on behalf of their shareholders.

7.9 If it were decided to exempt dividends from CFCs, it follows that DWP on CFC distributions should be removed. If some or all dividends from CFCs were to be taxed on repatriation, the DWP rules could be retained for that purpose. (Some modifications would probably be required to make DWP compatible with new CFC rules.)

7.10 Refundability of DWP credits is also an issue. Under the DWP rules, the payment of DWP gives rise to DWP credits that can be attached to dividends paid to shareholders. These DWP credits are refundable to the shareholders to ensure that the total tax liabilities of these shareholders do not exceed their marginal personal income tax rate. In particular, this ensures DWP credits are refundable to non-resident shareholders when conduit relief on the DWP liability has not been claimed.

7.11 The move to an active/passive distinction and the consequential repeal of the conduit rules (see below) would make it necessary to consider whether it is desirable to continue to refund DWP credits to residents or non-residents. At least in relation to passive income, there would seem to be no justification for preserving this feature of the DWP rules. If DWP credits were no longer refundable, it may make sense to remove DWP and include foreign dividends in the company tax calculation.

Grey list

7.12 The existing grey list exempts the income of CFCs in eight countries from New Zealand tax on the grounds that the tax systems of those countries are comparable with New Zealand's tax system. The exemption is provided regardless of whether the CFCs earn active income or passive income. Repeal of the grey list exemption would be consistent with active/passive CFC rules that focus on exempting active income rather than on whether the income has been comparably taxed in the host country.

7.13 The original rationale for the current grey list exemption to the CFC rules was to reduce the compliance costs associated with a comprehensive accrual system. Grey-list jurisdictions have tax systems similar to New Zealand's that can be expected to impose a similar level of tax as would be imposed if the activity were carried on in New Zealand. As New Zealand provides credits for foreign tax paid, the New Zealand tax payable on attributed income from a CFC resident in a grey list jurisdiction, after the application of foreign tax credits, may often be little to none. In such circumstances, it was considered that there was little point requiring compliance with the CFC rules.

7.14 The retention of a grey list exemption would mean that all income (both active and passive) derived from CFC investments into grey list jurisdictions would remain exempt. However, the logic of exempting offshore active income does not extend to passive income, which is to be generally taxed on accrual. This would be consistent with the abolition of the grey list for passive income. Accordingly, all offshore passive income should be taxed on accrual, with a credit allowed for any taxes paid in the foreign jurisdiction. This approach has been taken in a number of countries (such as the United States and Canada).

7.15 On the other hand, some CFC rules applying in other countries do provide relief for passive income depending upon either a comparable level of taxation test or a short grey list (for example, Australia). The Tax Review 2001 implicitly recommended the retention of the grey list for passive income. The concept for such an exemption would, again, be to reduce compliance and administrative burdens. However, the variability of domestic tax rules applying to such income in other countries and the vulnerability of passive types of income to tax avoidance might make maintaining a reasonable grey list difficult over time.

7.16 The Tax Review recommended that an exemption for offshore active income be supplemented with a black list of countries where accrual taxation would continue for all income. Black listed countries would be tax havens with little or no taxation and economic substance. Problems with a black list include the need to update the list as tax systems evolve and the reality that special features in otherwise normal tax systems may give the same tax avoidance effect as a tax haven for certain arrangements. The need for a black list would depend in part on the rules for passive income and base company income, which would be intended to eliminate the tax advantages of typical tax haven arrangements. If they were sufficiently robust a black list approach would not be necessary. The government therefore does not favour the introduction of a black-list.

Conduit rules

7.17 Repealing the current conduit income rules would be consistent with the reform of the taxation of CFCs.

7.18 Conduit reform was introduced in 1998 to remove the income tax liability of New Zealand companies on foreign income to the extent the company was owned by non-residents. That was done because the combined effect of our comprehensive CFC rules and residence rules for companies was, in substance, inconsistent with our policy of not taxing the foreign income of non-residents. In particular, there was a concern that the rules could discourage foreign multinational companies from using a New Zealand-based subsidiary as a regional headquarters for subsidiaries in other jurisdictions.

7.19 If the foreign active income from CFCs is no longer taxable on accrual in New Zealand there is no need for the conduit mechanism in relation to that income.

7.20 On the other hand, there is a strong case for removing conduit in relation to foreign passive income while subjecting it to accrual taxation:

- First, as mentioned, the justification for the conduit rules was linked to the fact that, unlike most jurisdictions, New Zealand taxes the active income of CFCs on accrual, which could discourage using New Zealand entities to hold shares of offshore active subsidiaries. The same concern does not arise with passive income. Providing conduit relief on foreign passive income is not supported by international practice. Australia does

not provide any conduit relief for the foreign passive income earned by non-residents through Australian entities.

- Second, continuing to provide conduit relief on passive income could facilitate the erosion of the New Zealand tax base. It provides an incentive for New Zealand-resident companies with non-resident shareholders to recharacterise domestic income as foreign passive income. While such recharacterisation may contravene the general anti-avoidance provision, the government's preference is to remove the incentive for these arrangements to occur in the first place.

7.21 The removal of the conduit rules would simplify a particularly complex area of our tax laws. This is because providing conduit tax relief as income accrues in the CFC requires New Zealand companies to track this relief until it is passed on to non-resident shareholders. In particular, rules are needed to:

- maintain a memorandum account to track conduit tax relief;
- track distribution of conduit income;
- monitor changes in the shareholding between the time income is derived and distributed; and
- provide for interest allocation for conduit companies.

7.22 Australia does provide conduit relief from non-resident withholding taxes on dividends paid from foreign active income earned through Australian companies and permanent establishments.

7.23 Under the Australian conduit rules, foreign active income that is not taxable at the entity level can be distributed to non-resident shareholders free of NRWT.[22] This conduit mechanism does not apply to passive income, which is fully taxable on accrual. This reform was introduced as part of a number of reforms designed to promote Australia as a regional headquarter location for foreign multinational companies.

7.24 Matters relating to domestic rates of NRWT on dividends should be considered in conjunction with treaty policy on NRWT rates. This is discussed in chapter 8.

[22] Some examples of conduit foreign income in Australia are foreign non-portfolio dividends received by an Australian company; foreign income and certain capital gains derived directly or indirectly by an Australian company from carrying on business in a foreign country through a permanent establishment; capital gains on the disposal of shares in a foreign company with an underlying active business; and foreign income (such as royalties) and net capital gains included in the assessable income of a corporate tax entity when the Australian tax liability on that income is reduced by foreign tax credits.

Branches

7.25 Currently, investments in CFCs and in foreign branches are both taxed on accrual.[23] In fact, the taxation of CFCs is referred to as the "branch equivalent", or BE, method.

7.26 The move to an active passive/distinction for CFCs may have implications for the way foreign branches are taxed – depending on whether New Zealand adopts the exemption method for dividends.

7.27 Typically, countries such as the United States and United Kingdom that adopt the deferral with a credit method discussed in chapter 2 continue to tax branches on accrual. This makes sense because, although taxable only on distribution, the profits of the CFC are ultimately taxed in the jurisdiction.

7.28 By contrast, Australia extends the exemption for active income of CFCs to active branches. If New Zealand adopts the exemption method, it would be necessary to consider whether we should follow the Australian model and also exempt active branches.

7.29 A key consideration is whether it is desirable to provide the same tax treatment to active branches so that New Zealand residents are not influenced by tax considerations in deciding whether to operate in a foreign jurisdiction through a subsidiary or a branch. In the absence of neutral treatment, firms expecting to make a loss would have an incentive to use the branch structure, whereas firms expecting to make a gain would probably prefer to operate as an exempt CFC.

Taxation of non-portfolio interests in foreign investment funds

7.30 International tax rules frequently distinguish between portfolio investors and non-portfolio investors. In broad terms, portfolio investors are regarded as passive investors, whereas non-portfolio investors are viewed as having a significant stake in the entity in which they invest and some influence over the affairs of that entity, if not a controlling interest.

7.31 The tax treatment of offshore portfolio investments (with investor interests of less than 10 percent) is currently being reformed.[24] The proposals in this discussion document do not affect these reforms in any way.

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[23] This is different from the domestic context because profits earned in domestic entities are not taxed on accrual in the hands of investors, but this is because domestic entities are taxable in their own right.

[24] The Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill 2006, which contains the new tax rules for offshore portfolio investment, was before Parliament at the time of writing.

7.32 For non-portfolio investors in FIFs, the current rules enable the use of the "branch equivalent" (BE) method, which shareholders in CFCs are required to use to calculate their attributed income. However, a FIF investor has the choice of using alternative methods for attribution: the comparative value method, the accounting profits method or the deemed rate of return method. The rules allow non-portfolio investors in FIFs to elect out of the BE calculation because many of them may not have sufficient information to comply with the BE calculation.

7.33 Changes to our CFC rules are likely to have implications for the tax treatment of New Zealand residents who hold non-portfolio interests (of at least 10 percent) in FIFs. Ideally, non-portfolio investors in either CFCs or FIFs would all be subject to the same accrual rules. In principle, non-portfolio investors in FIFs should be able to access the same active/passive exemption applying to investments in CFCs. However, there are the same compliance concerns underlying the choice to opt out of the BE rules: non-controlling investors may not have sufficient information to determine the amounts or nature of the underlying income and activity.

7.34 In practice, countries do distinguish between FIF interests and CFC interests when they implement the active/passive distinction.

7.35 Australia's CFC rules primarily follow a transactional approach to attribution. In contrast, Australia's FIF rules follow an entity approach to attribution. If 50 percent or more of the value of a FIF's assets are active, none of its income will be subject to attribution.[25] Otherwise, all of the FIF's income, including its active income, is subject to attribution.

7.36 Similarly, the United States' CFC rules primarily follow a transactional approach to attribution. However, the United States' passive foreign investment company (PFIC) rules (equivalent to FIF rules) effectively take an entity approach by the method by which a PFIC is defined. A foreign corporation will be a PFIC only if 75 percent or more of its gross income is passive, or if assets representing more than 50 percent of the total value of its assets are passive.

[25] This is the test in terms of the balance sheet method for determining exemption. The balance sheet method is based on a detailed examination of a company's assets to determine whether assets are used in carrying on an active business. The stock exchange listing method, the alternative, is a proxy for the balance sheet method – available for small investors with insufficient information to apply the balance sheet method. If neither method can be applied, the FIF cannot qualify for exemption.

7.37 In its *Final Report,* the Tax Review recommended that, in essence, the CFC rules, with an active/passive distinction, be extended to FIF interests of 30 percent or greater – the logic being that an investor with a 30 percent interest in a FIF should have sufficient information to perform a BE calculation for attribution. Under this approach, an active/passive distinction could still apply to non-portfolio FIF interests of less than 30 percent. Again, the question would be what the rules that apply to FIF interests of less than 30 percent might look like.

Implications for foreign tax credits

7.38 Even though active income would be exempt from taxation, a number of sources of foreign income would continue to be taxable in New Zealand and so would be eligible for foreign tax credits:

- Passive income would be taxable on accrual, and credits would be provided for foreign taxes paid, subject to the limitation that credits should not exceed New Zealand tax otherwise payable on the income.
- Foreign assets, such as loans, held directly by a New Zealand company, but not through an offshore branch, might attract foreign taxes, perhaps withholding taxes, and so would still require foreign tax credits.
- Finally, depending on final policy decisions on the treatment of offshore branches, non-portfolio FIFs and dividends from CFCs and other forms of foreign income that are potentially taxable in the source country might be taxable in New Zealand, so foreign tax credits would need to be provided.

7.39 Experience has shown that the practical application of foreign tax credit systems can be difficult, and considerable care is required to ensure that they do not, in effect, reduce taxes payable on domestic income. As noted in chapter 3, current methods of allocating deductions to the calculation of the foreign tax credit limitations are not fully effective and would require some amendment.

7.40 In many cases, the allocation of interest expenses is the key issue in appropriately limiting foreign tax credit claims. Chapter 6 has outlined possible changes to the thin capitalisation rules which are intended to ensure that interest expense is deductible only to the extent that it is attributable to income which is taxable in New Zealand. However, some foreign income, while technically taxable in New Zealand, is not effectively taxed as any New Zealand tax is offset by foreign tax credits. This situation is not dealt with in the current thin capitalisation rules.

7.41 There are a number of potential ways to attribute interest expenses to the foreign income which would need to be considered.

Submission points

Submissions are sought on the following matters in particular:

- Should we continue to tax dividends from CFCs? If not, why not?

- If an active/passive distinction were to be adopted, the appropriateness of repealing:
  - the grey list;
  - the conduit rules; and
  - the DWP rules or the refundability of DWP.

- The appropriateness of introducing an active/passive distinction for non-portfolio FIFs, and if so:
  - whether that distinction should be the same as that for CFCs;
  - whether that distinction should be made for non-portfolio interests over a certain percentage, say 30 percent, or for all non-portfolio FIF interests; and
  - whether possible alternative methods of calculating FIF income should be retained for non-portfolio investors.

CHAPTER 8

Non-resident withholding tax

Possible changes

1. NRWT on dividends could be lowered through bilateral treaty negotiations, although the case for this is stronger for non-portfolio dividends. The changes would have implications for the foreign investor tax credit (FITC) rules.

2. Reducing NRWT on either interest or royalties is a possibility but may not be justified.

3. A number of technical changes to the NRWT and approved issuer levy (AIL) rules would rationalise information requirements and withholding arrangements across different payments.

8.1 Like many countries, New Zealand imposes non-resident withholding tax (NRWT) on dividends, interest and royalty payments to non-residents. NRWT rates are generally reduced by our double tax agreements. There are also arrangements under domestic law to reduce the impact of NRWT in certain circumstances.

8.2 This chapter considers the case for lowering NRWT rates. The focus is on bilateral treaty reductions, rather than unilateral changes through domestic law, because of the potential benefits of agreeing reciprocal changes with our major trading partners. Submissions are sought, in particular, on whether New Zealand should move away from the current policy of keeping NRWT treaty limits relatively high and using domestic-law mechanisms to reduce total tax on inbound investment. The alternative, discussed in this chapter, is a treaty-based approach that would also benefit New Zealanders investing offshore. Related changes to domestic law are also discussed.

8.3 Changes to NRWT treaty limits have the potential to support the wider objectives of the International Tax Review, complementing the introduction of an active income distinction for CFCs. They would increase New Zealand's attractiveness as a destination for foreign investment by reducing headline rates of tax and bringing us more closely into line with international norms. Securing lower rates of foreign NRWT through treaty negotiations would reduce tax barriers to offshore investment. This would help to increase the competitiveness of our tax system and facilitate the internationalisation of New Zealand businesses. But there are also avoidance risks and other drawbacks associated with lower treaty limits that argue for a measured approach to reform.

Current rules and their rationale

8.4 Table 8.1 compares the rates of NRWT specified in domestic law with the lower limits set by our double tax agreements (DTAs). The DTA rates are reciprocal: by agreeing to limit NRWT on outgoing dividends, interest and royalties, we secure the same limits on payments coming into New Zealand from the other country. The country where the payments have their source is allowed to impose NRWT up to the treaty limit. The country where the recipient is resident can also tax the payments, but if it does so, it must give credits for any NRWT imposed by the source country.

TABLE 8.1
NRWT rates in domestic law and NZ double tax agreements

	Dividends		Interest	Royalties
	imputed	*unimputed*		
Domestic law rate	15%	30%	15%	15%
NZ DTA rate[1]	15%	15%	10%	10%

1. Minimum rates accepted by New Zealand in negotiations. Some actual treaties include higher rates.

8.5 For countries like New Zealand that are net importers of capital, source taxation can be important. Without NRWT, all the tax on dividends, interest and royalties sourced here would accrue to the country where the investor was resident. On the other hand, foreign investors may respond to New Zealand taxes by demanding higher pre-tax returns, effectively shifting the tax burden onto domestic users of capital. Debt and portfolio investors, in particular, are likely to respond to tax rates in this way.

8.6 For this reason, New Zealand has taken steps to reduce the total tax impost on certain forms of foreign investment. The policy to date has been to do this unilaterally under domestic law, rather than by reducing NRWT limits in double tax agreements. Two mechanisms are relevant here:

- ***Foreign investor tax credit (FITC)***. FITC reduces company tax on profits distributed as dividends to non-residents. The total tax impost (company tax and NRWT) is currently equal to the company rate of 33 percent.
- ***Approved issuer levy (AIL)***. NRWT on interest paid to an unrelated lender can be reduced to nil provided the borrower agrees to pay a 2 percent AIL.

International trends

8.7 The NRWT limits in New Zealand's double tax agreements are relatively high by international standards. Treaty practice varies widely, but many countries do prefer to include lower limits in their double tax agreements when possible. Lower limits on certain payments are also recommended by the OECD in its model tax convention.

8.8 The key difference between the limits in New Zealand's treaties and those in the OECD model are that the OECD recommends a 5 percent (rather than 15 percent) limit for non-portfolio dividends and a zero (rather than 10 percent) rate for royalties. Consistent with New Zealand's current treaty practice, the OECD model includes a 10 percent limit for interest, although the commentary notes that some countries may prefer a zero rate for certain kinds of interest.[26]

8.9 Australia, the United States and the United Kingdom are three of our key treaty partners. In recent years, these countries have negotiated lower treaty limits on NRWT – with each other and with third countries. A good example of this trend is the 2001 protocol amending the double tax agreement between Australia and the United States, which limits NRWT on non-portfolio dividends to 5 percent. When the investor holds at least 80 percent of the voting power in the company paying the dividend and satisfies certain public listing requirements, a zero rate applies. The limit remains at 15 percent for other dividends. The limit for NRWT on interest generally remains at 10 percent, but has been reduced to zero for interest derived by a government body or financial institution resident in the other country, provided in the latter case that the lender is unrelated to the borrower. The limit for NRWT on royalties has been reduced from 10 percent to 5 percent.

8.10 Table 8.2 compares the NRWT limits generally included in New Zealand's double tax agreements with those recommend in the OECD's model tax convention and with the limits agreed between Australia and the United States in 2001.

TABLE 8.2
NRWT limits in various treaties

	Dividends			**Interest**		**Royalties**
	non-portfolio		***portfolio***	***banks***	***other***	
	> 80% holding	*> 10% holding*	*< 10% holding*			
NZ DTA rate	15%	15%	15%	10%	10%	10%
OECD model	5%	5%	15%	10%	10%	0%
Australian-United States DTA	0%	5%	15%	0%	10%	5%

[26] Model Tax Convention on Income and Capital. (OECD, July 2005). Commentary on Article 11, *Paragraph 7.1 et seq.*

NRWT on dividends and the foreign investor tax credit

8.11 New Zealand's treaty rate of NRWT on dividends is 15 percent. There are arguments both for and against reducing NRWT treaty limits on dividends. The case for doing so is probably stronger in relation to non-portfolio dividends, where the international trend is to reduce rates. Lower treaty limits on portfolio dividends are less common internationally and may often be difficult to achieve in practice, particularly given that the OECD continues to recommend NRWT of 15 percent on such dividends.

Impact on outbound investors

8.12 Although the current treaty rate of NRWT on dividends is 15 percent, when combined with the lower company tax rate resulting from FITC, the total amount of company tax and NRWT on profits distributed to foreign investors is limited to 33 percent. This approach leaves NRWT treaty limits relatively high. One consequence of this is that our treaty partners may impose high rates of NRWT on payments flowing into New Zealand. These high rates of foreign NRWT are perhaps the most serious drawback of current policy settings. While the total tax impost on inbound equity investment has already been reduced through FITC, this has been done without securing reciprocal reductions in NRWT from our treaty partners for New Zealanders investing offshore.

8.13 High foreign rates of NRWT may act as a barrier to offshore investment and to the repatriation of profits when such investment does occur. Increasingly, they may place us at a competitive disadvantage relative to Australia: companies wishing to invest in third countries may prefer to base themselves in Australia to take advantage of the more favourable rates available under its treaty network and, in particular, in its double tax agreement with the United States.

8.14 Having said that, New Zealanders with offshore portfolio investments will often be able to claim offsetting credits in New Zealand, although these credits may be clawed back through the imputation system when individuals invest offshore through a New Zealand company. Even for direct investors, the actual impact of a reduction in foreign NRWT will depend on the domestic law of the treaty partner in question. While some countries (like the United States) do impose NRWT up to the treaty limit, others (like Australia) already exempt most dividends under their domestic law.

Impact on inbound investors

8.15 A necessary step in reducing NRWT treaty limits on either portfolio or non-portfolio dividends, would be to remove the FITC mechanism for the relevant class of dividend. To avoid an increase in the total New Zealand tax impost on inbound equity investment, an exemption from NRWT would be introduced under domestic law for fully imputed dividends paid to non-residents. Australia has a similar exemption from NRWT for franked dividends paid to non-resident shareholders.

8.16 It would, of course, be possible to introduce such changes irrespective of our treaty policy. The FITC mechanism does have drawbacks. In certain circumstances it can increase compliance costs for New Zealand companies wishing to pay dividends to foreign shareholders. In addition, while FITC reduces total New Zealand tax on inbound investment, it does so without transparently reducing headline rates of tax. Anecdotal evidence suggests that headline rates can affect investment location decisions.

8.17 One problem with replacing FITC is that this would make New Zealand taxes less creditable overall, without reducing the total tax impost. The result would be to increase the effective rate of New Zealand tax for some foreign investors. This would mainly affect portfolio investors, who generally cannot claim credits for underlying foreign company tax.

8.18 For many investors, however, FITC will offer little practical advantage. This is generally true for direct investors, who are likely either exempt at home on foreign dividends or able to claim credit for underlying company tax. Around three-quarters of inbound equity investment is direct. In addition, FITC offers no particular advantage, even for portfolio investors, when the investor has surplus foreign tax credits at home, is in a loss position, or is exempt from tax. Some countries – such as Hong Kong – exempt all foreign-sourced dividends, including portfolio dividends, from domestic taxation.

Avoidance issues

8.19 Current levels of NRWT provide some measure of protection against the avoidance of tax by non-residents. Reducing NRWT therefore risks exposing the tax base to increased avoidance activity. There are two main risks:

- ***Imputation credit streaming***. Under current policy, FITC is available only to the extent that dividends are imputed. This helps to reduce incentives for companies to stream imputation credits to resident shareholders because those credits also have a value to non-resident shareholders. With a lower rate of NRWT on dividends, that value would be reduced and the incentive to stream credits would increase accordingly.
- ***Repatriation of untaxed profits***. Under current policy, even if foreign equity investors manage to structure their affairs so as to avoid paying company tax in New Zealand, in principle they will still be liable to NRWT at 15 percent upon seeking to repatriate those untaxed profits as dividends. NRWT on dividends therefore provides a backstop against avoidance activities.

8.20 These risks are material. Accordingly, any move to a policy of seeking to negotiate lower NRWT treaty limits would need to be accompanied by other changes reducing the scope for avoidance activity. In particular, a reduction in NRWT on dividends would need to accompanied by stronger rules to combat imputation credit streaming.

NRWT on interest and royalties

8.21 New Zealand's treaty rate of NRWT is 10 percent for both interest and royalties. Reducing NRWT on either interest or royalties is likely, in particular, to have material fiscal and avoidance implications and may therefore not be justified.

High effective rates

8.22 Imposing NRWT on interest and royalties can be problematic (particularly for payments between unrelated parties) because the tax is imposed on gross income. Even though NRWT is generally limited to 10 percent, this can represent a high effective rate if the non-resident incurs expenses in deriving the income.

8.23 The AIL rules already operate to exempt interest on third-party loans, provided the borrower pays AIL of 2 percent. The policy rationale behind AIL is that the borrower can choose to pay the levy when the lender is unable or unwilling to obtain credits for NRWT. Interest payments between related parties continue to attract interest of 10 percent. The AIL mechanism substantially reduces the effective rate of New Zealand tax on non-residents in the business of borrowing and on-lending. That said, even small taxes may have an effect. As foreign lenders do not receive a credit for the payment of AIL, the economic incidence is likely to be borne by the borrower, increasing the cost of borrowing.

8.24 A high effective tax rate on royalties will not matter to the extent that royalty payments reflect economic rents, or when the non-resident owner of the intellectual property has already offset R&D costs and is receiving pure profits from New Zealand. When payments do not reflect rents or pure profits, however, the economic incidence of NRWT may either be passed back to the New Zealand user of intellectual property through higher prices or borne by the foreign owner, reducing the level of intellectual property licensed to New Zealanders. It is common for contracts licensing intellectual property to include clauses grossing up charges on account of NRWT. However, it is almost impossible to tell what prices would be in the absence of NRWT, and therefore the extent to which these gross-up clauses indicate an actual transfer of tax costs to New Zealand residents.

Fiscal cost

8.25 For New Zealand, as a net importer of capital and intellectual property, reducing NRWT on interest or royalties would be likely to involve material fiscal cost, despite offsetting savings on inbound payments through a reduced need to give credits for foreign withholding taxes. The precise cost would obviously depend on the size of any reduction. It would also depend to some extent on the number of treaties affected.

Avoidance concerns

8.26 Because interest and royalty payments are deductible, they may be used inappropriately to reduce taxable profits, with debt or intellectual property being shifted offshore to generate deducible payments that can reduce profits taxable in New Zealand. NRWT currently reduces the incentive for such structures by imposing tax on outbound interest and royalty payments. With a lower rate of NRWT, the incentive to engage in avoidance activity of this sort would increase.

8.27 In certain instances, the AIL rules are already being used inappropriately to avoid NRWT on interest payments which, in economic terms, are made between related parties. Structures also exist to avoid NRWT and AIL on cross-border interest payments altogether. Options will be examined to tackle the avoidance of AIL and NRWT on interest, and the inappropriate use of AIL.

Taxation of debt versus equity financing

8.28 NRWT on interest is an important component in determining the relative taxation of debt versus equity financing in New Zealand, particularly on related party lending (for which AIL is unavailable). Foreign debt investment into New Zealand is already taxed more lightly than equity investment. Ideally, taxation should not influence how foreign investors fund their New Zealand business operations. Excessive debt investment also raises base maintenance concerns because, as noted earlier, interest payments (unlike dividends) are deductible. A reduction in NRWT on interest would exacerbate the existing bias in favour of debt investment and put further pressure on the thin capitalisation rules.

Technical issues relating to NRWT and AIL

8.29 The following paragraphs outline some possible technical changes to our domestic rules on NRWT and AIL. These changes would rationalise information requirements and withholding arrangements across different payments. This section is largely independent of the preceding discussion about NRWT treaty limits and FITC.

Obligations on borrowers to supply information about AIL

8.30 New Zealand borrowers who deduct NRWT from interest paid to foreign lenders are required to file a non-resident withholding tax deduction certificate and an annual reconciliation statement. There are no equivalent information requirements in the AIL rules. Even so, information on interest payments covered by AIL is as relevant as information on interest payments subject to NRWT. The current lack of reporting requirements makes it difficult to verify the correct application of the AIL rules. Lack of information about AIL also compromises our ability to exchange full information with treaty partners.

8.31 Therefore, New Zealand borrowers who elect to pay AIL on outbound interest would be subject to the same information requirements as currently apply in relation to NRWT.

Rationalising the withholding rules

8.32 The imposition of withholding tax on interest, dividends and royalty payments is inconsistent across different payments, and the government sees a case for rationalising the arrangements.

NRWT may be final tax or minimum tax

8.33 Under domestic law, NRWT may be either a final tax or a minimum tax. On most payments, NRWT is a final tax under domestic law. But on industrial royalties, and on interest and investment society dividends from an associated person, domestic law provides that NRWT is effectively the minimum rate of tax. For countries with which we have a double tax agreement, NRWT is generally a final tax on these payments, too, because most of our treaties limit withholding tax on these payments to 10 percent or 15 percent.[27] Even when no treaty limit applies, additional tax would normally be payable only if income tax liability calculated on a net basis exceeded NRWT on gross payments.

Royalties may be subject to NRWT or NRCWT

8.34 Payments relating to equipment leases are within the definition of "royalties" in New Zealand's double tax agreements. However, they are not royalties under domestic law. They are therefore subject to non-resident contractor withholding tax (NRCWT) rather than NRWT. The domestic rate for NRCWT is 15 percent. Unlike NRWT, NRCWT is neither a final tax nor a minimum tax under domestic law. It is simply a withholding mechanism, equivalent to PAYE.

Income from renting films not subject to NRWT

8.35 Amounts derived by non-residents from renting films in New Zealand are not currently subject to NRWT. Ten percent of gross receipts is instead subject to income tax, giving an effective tax rate of 3.3 percent. This concessionary treatment is a historical anachronism for which there is no longer a sound policy rationale. Neither the fiscal cost nor the additional complexity associated with having separate rules for non-resident rental income from films seems justified.

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[27] The exceptions are our double tax agreements with Fiji, Malaysia and Singapore, which all allow unlimited source taxation of interest between associated persons, and our agreement with Japan, which makes no provision on either interest or royalties.

The case for rationalisation

8.36 There is a case for rationalising these arrangements, subjecting all payments to NRWT and making this a final tax in all cases. That would involve the following changes:

- For industrial royalties, or interest or investment society dividends from an associated person, NRWT would become a final tax rather than a minimum tax under domestic law.
- Payments relating to equipment leases would be brought within the domestic law definition of royalties and subject to NRWT as a final tax.
- Gross royalties derived from renting films would be made subject to NRWT.

Points for submission

- Does a policy of trying to reduce NRWT treaty limits on portfolio/non-portfolio dividends seem attractive?
- Is the FITC mechanism helpful in attracting inward equity investment, and does this justify the associated compliance costs? Or is there a case for removing FITC on portfolio/non-portfolio dividends irrespective of our treaty policy on NRWT?
- Have the key issues in relation to maintaining NRWT rates on interest and royalties been correctly identified?
- Submissions are also invited on the possible technical changes to rationalise information requirements and withholding arrangements.

TABLE 1: CFC Rules: "Passive" income under a transactional approach

Country	Interest	Rents	Royalties	Dividends	Other
Australia	• interest income and amounts in the nature of interest; • accrued interest on discounted and other deferred interest securities issued after 16 Dec 1984; • income from property financing transactions;[28] • interest deemed to be derived where a CFC assumes the rights of a lender through the purchase of securities through a secondary market;[29] • factoring income. Interest derived by a CFC that is a subsidiary of an Australian Financial Institution (AFI) is active income (but the interest income of an AFI may still be tainted income if it is tainted services income).	• rent in respect of a lease with an associate or paid to the CFC by an associate; • income from leases of land except where the land is located in the same country as the CFC is resident if a substantial part of the income is related to the provision of labour-intensive property management by the CFC; • income from the lease of a ship or aircraft, a cargo container for use on ships or aircraft or plant or equipment for use on board ships, unless related to the provision of operating crew in relation to ships and aircraft or maintenance or management services by the CFC. Exclusions for rent which is: • derived from an associated CFC resident in the same country; • subject to the normal company rate of tax in that country; and • did not give rise to a notional allowable deduction for the associated CFC.	Royalties – except for: • royalties received from a non-associate in the course of carrying on a business where either: – the property or right in respect of which the royalty is paid originated with the CFC; or – the CFC substantially develops or improves the property or right for which the royalty is paid.	Dividends, including: • unit trust dividends; • a distribution made by a liquidator which is deemed to be a dividend. But: • non-portfolio dividends paid to a CFC from a non-Australian resident are notionally exempt; • dividends paid by a company resident in a listed country to a listed country CFC are exempt.	• annuities; • consideration for the assignment of any copyright, patent, design, trademark or other like property or right; • income derived from trading in tainted assets (investment type assets); • net gains from the disposal of tainted assets; • net tainted commodity gains, which arise from the disposal of tainted commodity assets (a future or forward contract, or right or option in respect of such a contract). Exception if: – the CFC carries on business of producing or processing the commodity, or uses the commodity as a raw material and the right or contract relates to the carrying on of that business; or – the contract was entered into to eliminate/reduce the risk of adverse financial consequences that might, under another contract, from fluctuations in the price of the commodity and the CFC does not derive tainted sales income from a transaction under that other contract; • net tainted currency exchange gains and losses unless the underlying transaction was: • for the purchase of goods from a non-associate;

[28] Income from property financing transactions is only passive for the purposes of the active income test.
[29] Such deemed interest is only passive for the purposes of the active income test.

					• for the purchase or sale of depreciable plant or equipment used mainly to produce income that is not passive, or tainted sales or services income; • a hedge for one of the preceding transactions. ➢ also exclusion for a CFC carrying on as a currency trader and no other party to the transaction is an associate or Australian resident.
United States	Interest – except for: • qualified banking or financing income. The CFC must be predominantly engaged in the active conduct of a banking business and conduct substantial activity with respect to that business. Seventy percent of the CFC's gross income must be derived from the banking business, be an institution licensed to be a bank in the United States or be a registered United States securities broker or dealer. The activities must be conduced in the CFC's home country unless its branch activities meet the substantial activity requirements; • interest derived by a CFC engaged in a banking business for "export financing interest" – interest from financing a sale for use or consumption outside the United States of goods manufactured in the United States; • interest received from a related person which is a corporation organised under the laws of the same foreign country as the recipient and such related person has a substantial portion of its business located in the same foreign country except where the payment reduces the subpart F income of the payer.	Rents and royalties – except for: • rent or royalties derived by a CFC in the active conduct of a trade or business which is not received from a related party ("active trade or business exception"); • rent from a related corporation for use of property within the CFC's jurisdiction; • royalties received from a related corporation for the use of property within the CFC's jurisdiction.		Dividends – except for: • dividends received from a related corporation in the same jurisdiction with a substantial portion of its business located in the same jurisdiction. However: • the exception does not apply to a dividend attributable to earnings accumulated during any period during which the CFC receiving the dividend did not hold stock directly or indirectly.	• capital gains from the sale of an asset which gives rise to dividends, interest, rents or royalties or gives rise to no income at all is tainted (but gains from the sale of property used in active trade or business are excluded, as are gains from the sale of an asset that gave rise to rent or royalty income excluded under the active trade or business exception); • net foreign currency gains; • net gains from commodities transactions (unless part of hedging transactions connected to the CFC's business); • amounts received under a personal services contract, and from the sale of the contract, in certain circumstances related to the individual designated to perform the services; • insurance income (special rules similar to active banking rules may apply); • income from the operation of ships and aircraft, activities on the high seas, outer space and similar activities; • income from the processing of minerals extracted from oil into their primary products, the transportation of such minerals or products, and the distribution or sale of such minerals or products for use outside the CFC's country of incorporation;

				• income from operations in countries participating in international boycotts; • an amount equal to bribes and kickbacks paid to a government or its employees or agents.

TABLE 2: CFC Rules: "Base company income" under a transactional approach

Country	Base company sales income	Base company services income
Australia	Income from the sale of goods by a CFC when an Australian-resident associate or an Australian permanent establishment of a non-resident associate either purchases the goods from the CFC or supplies goods to the CFC. Exclusions for: • hospitality – broadly, sales arising from the tourism and hospitality industry; • where a CFC substantially alters, manufactures or produces the goods sold.	Income from the provision of services by a CFC to an Australian resident, or an Australian permanent establishment of a non-resident. Exclusions for: • hospitality – broadly, services that arise from the tourism and hospitality industry; • where the service relates to goods substantially altered or manufactured by a CFC. Also does not include: • royalties; • any income in respect of a lease of land; • any income from trading in assets; or • gains from currency exchange rate fluctuations, commodity investments and assets. Income from services provided indirectly to certain Australian residents or Australian permanent establishments will also be tainted services income if: • the services are provided by the CFC to an associate are received by another entity that is an Australian resident or Australian permanent establishment; • the services are provided under a scheme; and • the income from the services would have been tainted if provided directly by the CFC to the ultimate recipient.
United States	Sales income if: • a CFC purchases goods from a related person and sells those goods to any person; or • a CFC purchases goods from any person and sells to a related person. Exclusions for: • the property purchased was manufactured in the CFC's jurisdiction or substantially transformed in the CFC's jurisdiction; • the property sold is used or consumed in the CFC's country of incorporation; • the CFC is the manufacturer, regardless of where the manufacturing is done (although the special branch rules (see below) would apply). If goods are acquired from or sold to a related company resident in the United States, the income may still be foreign base company sales income unless the CFC is engaged in a United States trade or business and its income is subject to United States corporate income tax. If the related company to whom the CFC sells the goods is resident in the same country as the CFC, there is an exclusion if the related party uses or consumes the property in the same country that the CFC is incorporated. If not, the sales income will be included. Special branch rules apply in the case of branches of a CFC engaged in either manufacturing or selling activity outside the CFC's country of incorporation.	Services income if: • a CFC performs services for or on behalf of any related person, and the services are performed outside the CFC's jurisdiction. Exclusion for: • services directly related to the sale or exchange by the CFC of property manufactured by it and which are performed before the time of the sale or exchange, or which are related to an offer or effort to sell or exchange such property. Also included if a related United States-resident party provides substantial assistance to a CFC which is performing services itself.

TABLE 3: CFC Rules: Features of an active business exemption under an entity approach

Country	Substantial presence	Effective management	Main business		
United Kingdom	The CFC must have a business establishment in its territory of residence: premises occupied and used (or intended to be used) with a reasonable degree of permanence, and from which its business in that territory is wholly or mainly carried on.	The CFC's business must be effectively managed in its territory of residence. Satisfied if: • sufficient employees in that territory to deal with the volume of its worldwide business; and • substantially all services provided by the CFC for persons resident outside its territory of residence are performed outside the United Kingdom – unless provided through another person for arm's length consideration or through a United Kingdom branch which is subject to United Kingdom tax.	The CFC's main business must not be "investment business" (holding securities or intellectual property, dealing in securities other than as broker, leasing of any property or rights, and "money-box" functions).	The CFC's main business must not be dealing in goods: • for delivery to or from the United Kingdom; or • for delivery to or from connected persons; unless the goods are physically delivered into the CFC's territory of residence. Dealing implies buying and selling in unchanged form. If the CFC manufactures or processes the goods, it main business is probably not dealing.	If the CFC's main business is wholesale, distributive, financial or service business (dealing in goods wholesale, shipping or air transport, banking, deposit-taking, money-lending or debt factoring or similar, trust administration, dealing in securities as a broker, dealing in commodity or financial futures, insurance (whether long-term or general) and the provision of any other services), it must derive less than 50 percent of its gross trading receipts from that business from connected persons and certain specified unconnected United Kingdom companies and individuals. If a CFC is mainly engaged in banking or similar business, the 50 percent gross trading receipts test is modified. In particular, the CFC must satisfy a complex 15 percent "capital structure test", looking at the amount of its share capital and funds provided by connected persons, and loans to connected persons. The 50 percent gross receipts test is also modified for CFCs engaged in insurance business. A captive insurance company cannot satisfy the test if 50 percent or more of its business is derived from carrying the risks of connected persons.
Japan	The CFC has a fixed establishment necessary for carrying out its main business in the jurisdiction concerned.	The CFC has its own effective management or control and operation in respect of its main business in the jurisdiction concerned.	The CFC's main business is business other than holding stocks or bonds and debentures; providing patents, and other rights regarding technology or a secret process or formulae, or know-how or copyrights; or leasing ships or aircraft.	If the CFC's main business is any business other than wholesale, financial, shipping or air transportation, that business must be conducted primarily (more than 50 percent) in the CFC's jurisdiction.	If the CFC's main business is wholesale, financial (banking, trust services, or insurance), shipping or air transportation, its main business must be conducted primarily (more than 50 percent) with unrelated parties.