New Zealand's International Tax Review

The treatment of foreign dividends and transitional issues

An officials' issues paper

December 2007

Prepared by the Policy Advice Division of Inland Revenue and by the New Zealand Treasury

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Chapter 1

INTRODUCTION

1.1 New Zealand's international tax rules are the subject of a comprehensive reform to remove tax impediments to New Zealand businesses expanding overseas and to help them compete internationally. The central feature of the proposed reform is the exemption of the active income of our controlled foreign companies from domestic income tax, to free New Zealand investors from a tax cost that equivalent investors from other countries do not face. This issues paper, which represents the third round of consultation on the reform, seeks comment on suggested changes relating to the treatment of foreign dividends under the proposed rules and to transitional matters.

1.2 In December 2006, the government released the discussion document *New Zealand's International Tax Review: a direction for change,* for public comment. It sought feedback on proposals to introduce an active income exemption for the offshore operations of New Zealand businesses. Rather than make concrete proposals for the implementation of the exemption, it canvassed the various approaches taken in other countries and indicated the broad direction and approach of the proposed reform.

1.3 Officials then engaged in an extensive consultation process with businesses. This consultation and feedback have been invaluable in enabling the government to assemble a balanced package of reforms that is appropriate for New Zealand.

1.4 In May 2007, *New Zealand's International Tax Review: An Update,* was released to inform businesses about the government's in-principle policy decisions to date, setting out how the various components fit together. Officials have since prepared two issues papers that provide more detailed proposals in support of these in-principle decisions.

1.5 The first issues paper, *New Zealand's International Tax Review: Developing an active income exemption for controlled foreign companies,* was released in October 2007. It provides detailed proposals for the design of the new international tax rules for controlled foreign companies (CFCs).

1.6 The main focus of the present issues paper is the exemption of ordinary dividends[1] received by New Zealand companies from CFCs and foreign investment funds (FIFs)[2] and transitional and consequential matters arising from the move to an active income exemption. They include issues related to the repeal of the conduit rules and the treatment of existing attributed CFC net losses and carried-forward foreign tax credits.

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[1] For the purposes of this paper, ordinary dividends refer to dividends that currently qualify for underlying foreign tax credits (UFTCs).
[2] If the New Zealand shareholder uses the accounting profit or branch equivalent methods.

1.7 Foreign dividends received by persons other than companies, such as individuals and trustees, will continue to be taxed as they are at present.

1.8 The next step will be to analyse submissions on the suggestions presented in the two issues papers and make formal recommendations to the government on how the proposed reform should be developed. The aim is to introduce next year a bill that gives effect to the reforms, which will apply from the 2009–2010 income year.

1.9 In 2008, officials will be seeking taxpayer input on the design of rules to enable the active income exemption to be extended to interests in non-portfolio FIFs – replacing the remaining grey-list exemption for these interests – and branches. The government intends to introduce legislation for these further reforms in 2009, to apply from the 2010-2011 income year.

SUMMARY OF SUGGESTED CHANGES

The suggested changes would apply from the start of the 2009–2010 income year.

Non-portfolio dividends received by New Zealand companies

- Ordinary dividends from CFCs and non-portfolio FIFs received by New Zealand companies will be exempt.
- Dividends that would not qualify for an underlying foreign tax credit (UFTC) under the current rules because the CFC or non-portfolio FIF is allowed a deduction for the dividend in calculating its liability for tax will continue to be taxable.
- The treatment of dividends when the interest is a fixed-rate share will be dealt with in conjunction with the review of non-portfolio FIFs. In the interim, such dividends will continue to be taxable in keeping with the current treatment for UFTC purposes.
- Dividend withholding payment (DWP) will be repealed for most foreign dividends derived by New Zealand-resident companies in the 2009–10 and later income years. Any DWP account balances as at the start of 2009–10 income year can be maintained under current rules for a five-year transitional period, after which they will be converted into imputation credits.
- The repeal of DWP makes the UFTC rules redundant, so they can also be repealed.

Other foreign dividends

- Most foreign dividends from portfolio interests received by companies will be exempt. Dividends derived from entities that are exempt from the FIF rules will continue to be taxed.
- The taxation of foreign dividends received by persons other than companies, such as individuals and trustees, will be unchanged.

Conduit repeal transitional rule

- With the repeal of the conduit rules, conduit tax relief account balances as at start of 2009–10 income year will be cancelled, subject to a transitional anti-avoidance rule.

CFC transitional rule

- Attributed CFC net losses and foreign tax credits accrued under the current rules can be carried forward into the new system, but will continue to be reduced by reference to total CFC net income (including non-attributable income).

1.10 Submissions should be made by 15 February 2008 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.

1.11 Submissions should include a brief summary of their 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.

1.12 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.

Chapter 2

NON-PORTFOLIO DIVIDENDS RECEIVED BY NEW ZEALAND COMPANIES

Summary of suggested changes

- Ordinary dividends from controlled foreign companies (CFCs) and non-portfolio foreign investment funds (FIFs) received by New Zealand companies will be exempt.
- Dividends that would not qualify for an underlying foreign tax credit (UFTC) under the current rules because the CFC or non-portfolio FIF is allowed a deduction for the dividend in calculating its liability for tax will continue to be taxable.
- The treatment of dividends when the interest is a fixed rate share will be dealt with in conjunction with the review of the non-portfolio FIFs. In the interim, such dividends will be subject to tax, in keeping with the current treatment for UFTC purposes.
- Dividend withholding payment (DWP) will be repealed for most foreign dividends derived by New Zealand-resident companies in the 2009–10 and later income years. Any DWP account balances as at the start of 2009–10 income year can be maintained under current rules for a five-year transitional period, after which they will be converted into imputation credits.
- The repeal of DWP makes the underlying foreign tax credit (UFTC) rules redundant, so these rules can also be repealed.

2.1 Current rules for the taxation of foreign dividends are part of a system that has at its heart the comprehensive accrual taxation of offshore income. A complex set of rules for dividend taxation have been established to support this approach. [3]

2.2 In some cases, rules have been provided to relieve the impact of this system. For example, there was a concern that attribution of income and taxation of dividends of CFCs deterred non-resident owned companies from using New Zealand as a base for regional operations. Conduit relief was provided to alleviate this impact. There was also concern that attribution and a full UFTC calculation would impose a significant compliance burden for income earned in, and dividends from, countries with tax systems comparable to New Zealand's – the "grey list"[4], without raising incremental tax. Therefore, for CFCs in those countries, no income is attributable, and a deemed full UFTC for shareholders with a ten percent or greater interest is allowed that effectively exempts dividends from taxation.

[3] For the treatment of dividends received by CFCs see chapter 3 of *New Zealand's International Tax Review: Developing an active income exemption for controlled foreign companies,* published in October 2007.
[4] The grey list consists of Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.

2.3 The International Tax Review has resulted in a fundamental reform of the taxation of offshore income. The government has proposed that active offshore income earned in CFCs should be exempt from New Zealand tax. Passive income, on the other hand, would be subject to attribution, no matter where it is earned.

2.4 The exemption of active income effectively obviates the need for the grey list and conduit relief by removing such income from attribution. To ensure that the attribution of passive income does not impose a compliance burden on fundamentally active businesses that have some incidental passive income, CFCs with less than five percent of their revenues from passive sources will be considered to be active.

2.5 In light of these proposed reforms, the rules for dividend taxation have been reviewed to ensure they complement the changes being made to the taxation of the underlying income.

2.6 As with other parts of the international tax system, changes in this area are based on finding a balanced approach reflecting a number of objectives. The new rules should, as much as possible:

- allow firms to get on with legitimate business activity by removing tax- based impediments for offshore investment;
- minimise compliance costs; and
- maintain a level of protection for the domestic tax base.

The taxation of ordinary[5] dividends

2.7 A number of countries that exempt active offshore income earned in CFCs from accrual taxation tax the dividends upon repatriation with an underlying foreign tax credit. Such systems are complex, often fail to raise significant revenues, discourage the repatriation of earnings, and reduce the benefits of the exemption. The government has chosen not to follow this approach.

2.8 The May 2007 update announced that dividends derived by a New Zealand company from ordinary shares in a CFC would become exempt from domestic tax from the 2009–2010 income year. This exemption will apply regardless of whether the CFC passes the active business test or the dividends are paid out of active or passive income.

2.9 This simplification is possible because other aspects of the international tax reform (such as the replacement of the grey list with the active business test) ensure that passive income would have already been taxed on accrual.

2.10 It is further suggested to extend this exemption, at the same time, to ordinary dividends received by companies from non-portfolio FIFs.[6]

[5] For the purposes of this paper, ordinary dividends refer to dividends that currently qualify for UFTC treatment. The policy on other dividends is discussed later in this chapter.
[6] The exemption will begin from the start of the 2009–10 income year.

Consequential simplification

2.11 We suggest several changes that will greatly simplify the international tax rules for dividends received by companies, such as repealing the DWP, UFTC and BETA rules.

Repeal of DWP

2.12 DWP is generally payable on dividends received by New Zealand-resident companies from foreign companies. Tax credits are available for any underlying foreign tax if the New Zealand company has at least a ten percent interest in the foreign company; there is a UFTC if the foreign company is resident in a grey-list country.

2.13 Most foreign dividends will be exempt from New Zealand tax. Accordingly, DWP will be repealed for such foreign dividends derived by New Zealand-resident companies in the 2009–10 and later income years. The treatment of foreign dividends that do not currently qualify for UFTC is discussed later in this chapter.

Existing DWP balances

2.14 A DWP credit arises in a company's DWP account for any DWP paid by the company (including by way of loss offset). This credit can be attached to a dividend paid by the New Zealand-resident company to its shareholders in the same way as imputation credits are attached. When the shareholders are non-resident the DWP credits can be used to offset the NRWT liability, with any excess credits being refundable to the non-resident shareholder (in contrast to what occurs with imputation credits, which are not refundable). Having DWP credits that are refundable to non-resident shareholders achieves a similar result to that of the conduit rules, except that DWP credits provide the relief when the income is repatriated, while the conduit rules provide the relief when the income is accrued.

2.15 From 1 April 2009, when DWP is abolished, DWP accounts will be maintained for a period of five years to allow taxpayers to use up their DWP credits. At the end of this period any remaining DWP credits would be converted into imputation credits and the accounts closed.[7] This approach will simplify tax law by enabling the complete repeal of all DWP rules at the end of the five-year period.

2.16 We recognise that a potential disadvantage of this approach for taxpayers is that, unlike DWP credits, imputation credits are non-refundable. However, we consider that five years from 1 April 2009 constitutes a reasonable period for taxpayers to utilise their DWP credits. The deadline could be reviewed before the end of the five-year period if it caused significant difficulties in practice for taxpayers.

[7] This is consistent with the current treatment when companies close their DWP accounts voluntarily.

Repeal of the UFTC rules

2.17 Dividends that currently qualify for the UFTC rules will no longer be subject to DWP and will be exempt from income tax. Accordingly, the underlying foreign tax credit (UFTC) rules will not be required as they are relevant only to relieving DWP liabilities. The UFTC rules can therefore be repealed completely from the start of the 2009–2010 income year.

Future role of BETA rules

2.18 The purpose of branch equivalent tax accounts is to prevent the double taxation in New Zealand of the same income: first, when it is attributed from foreign companies to their New Zealand shareholders under the CFC rules,[8] and then again when the foreign company pays a dividend to its New Zealand shareholders. Under the BETA rules, New Zealand shareholders can use a BETA credit arising from tax paid on attribution to offset a DWP liability (in the case of a company shareholder) or an income tax liability (in the case of an individual shareholder) on a dividend paid to them by a CFC.[9] If a dividend is paid by the CFC before its income is attributed, the New Zealand shareholders can use a BETA debit owing from DWP or income tax paid on the dividend to offset their income tax liability on income attributed to them under the CFC rules.

2.19 The proposed changes to the taxation of foreign dividends will render the BETA mechanism largely redundant for companies. Since foreign dividends will be generally exempt, there should not normally be double New Zealand taxation of foreign income. It should therefore be possible to either abolish the BETA mechansim completely or greatly restrict its application, depending on final decisions about the treatment of dividends other than ordinary dividends (discussed in the following paragraphs). Transitional rules would likely be needed to deal with existing balances in BETA accounts.

The taxation of dividends other than ordinary dividends

2.20 Under current rules, certain dividends from a CFC or a portfolio FIF do not qualify for an underlying foreign tax credit. This occurs when:

- the dividend, directly or indirectly, results in a deduction in calculating its liability for tax; and
- the dividend is paid in respect of a fixed rate share.

2.21 The proposed reforms raise the question of the extent to which the dividend exemption should parallel the current restriction of UFTCs to ordinary dividends.

[8] Or under the branch equivalent or accounting profit methods in the FIF rules.
[9] Or a FIF for which the New Zealand shareholder uses the branch equivalent or accounting profit methods in the FIF rules.

Treatment when the dividend is deductible

2.22 Extending the exemption from New Zealand tax to a dividend that gives rise to a deduction for the CFC would facilitate tax arbitrage and result in double non-taxation of the underlying income. Restricting the exemption prevents this by ensuring that the income is taxed in New Zealand.

2.23 For this reason, it is preferable to maintain the effect of the current treatment of deductible dividends in the UFTC rules. It is therefore recommended that such dividends should continue to be taxed under the new system.

2.24 This tax treatment may be criticised as protecting the tax base of the jurisdiction of the activity, rather than relating to the New Zealand tax base. This is not correct.

2.25 As explained in the next section, the anti-arbitrage rules are mechanisms designed to protect the New Zealand tax base. They also support the policy objective of removing the impediments to outbound active investment inherent in New Zealand's current international tax system, without providing an outright incentive for such activity.

Removing impediments to outbound investment

2.26 It is important to be clear what the economic rationale for the active income exemption is and what it is not. It is intended to remove the impediment for outbound investment that arises if New Zealand imposes an incremental level of tax above that applied by the jurisdiction that is the source of the income. It is not intended to provide an outright incentive for such investment by allowing it to escape tax in the jurisdiction of the CFC through an arbitrage transaction.

2.27 The following example illustrates how exempting a dividend that was deductible in the jurisdiction of the CFC would create a tax incentive to shift economic activity out of New Zealand and into the offshore jurisdiction.

2.28 Assuming that the worldwide after-tax rate of return is 9%, and that other jurisdictions exempt offshore active income, the before-tax rate of return that must be earned in a jurisdiction to yield an after-tax return of 9% is equal to 9 divided by the difference of one minus the tax rate, when the tax rate is expressed as a proportion.

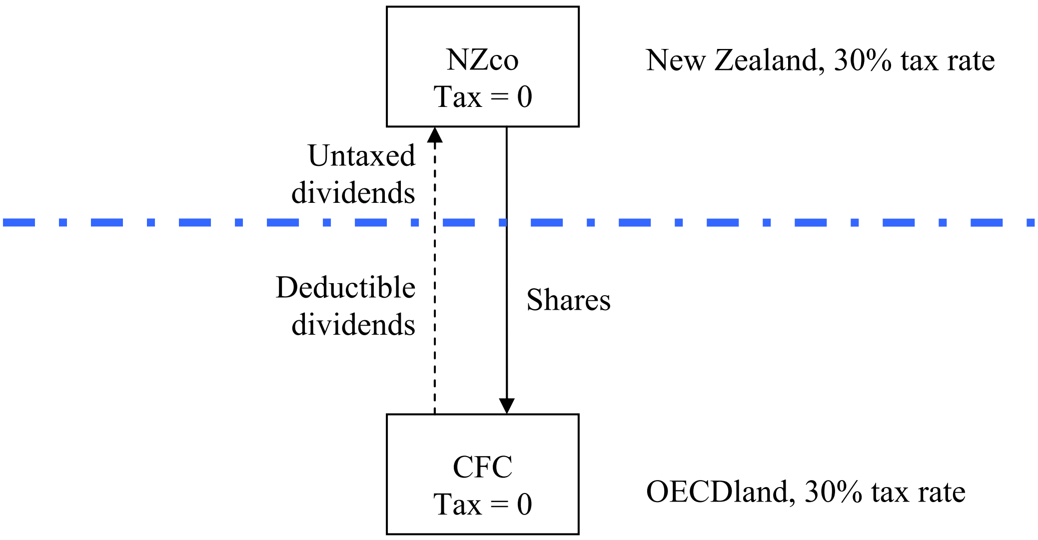
2.29 This means that a business facing a New Zealand tax rate of 30% would need a before-tax rate of return of almost 13% in order to achieve an after-tax return of 9%.[10]

2.30 Figure 1 illustrates what happens in the absence of anti-arbitrage rules if the investment in a CFC is made through shares and the dividends from those shares are deductible in the jurisdiction of the CFC.

[10] That is to say, 9/(1-0.3) = 12.85714

2.31 In the figure, the CFC is in "OECDland", which has a company tax rate of 30 percent, the same as New Zealand's. The before-tax rate of return would therefore be 13% in both countries, to yield an after-tax rate of return of 9%. However, NZco could earn 13% after-tax if it could shift its operations from New Zealand to OECDland and finance the investment through fixed rate shares. Put in concrete terms, a New Zealand company that wished to export to OECDland would have an incentive to shift its operations there in order to increase its rate of return.

FIGURE 1:
DEDUCTIBLE DIVIDEND ARBITRAGE



2.32 The deductible dividend on the share eliminates tax in the CFC, but the dividend is not taxed in New Zealand. In that case NZco earns a 13% after-tax return, which is greater than the 9% after-tax return earned by other companies in OECDland, and is also greater than the 9% after-tax return from investing in New Zealand. It now has a greater incentive to invest in OECDland than its competitors have and, in fact, has an incentive to shift operations from New Zealand, contrary to the policy intent of the reform.[11]

Protecting the New Zealand tax base

2.33 Double non-taxation also provides opportunities for transactions that erode the New Zealand tax base through the establishment of profit traps that can shelter domestic as well as foreign income.

[11] If not all income in OECDland is sheltered (perhaps because of its thin capitalisation rules) the after-tax rate of return achieved may be less than 13% but still greater than 9%.

2.34 Preventing double non-taxation underlies the considerable effort that has been made in the review to ensure that offshore active income is subject to tax in the jurisdiction in which it arises. That is also the reason for seeking to ensure that the income cannot be sheltered from tax by shifting it to a low-tax jurisdiction, or that tax on the income cannot be avoided by taking advantage of arbitrage opportunities arising from asymmetries between tax systems.

Treatment when the dividend is not deductible

2.35 When the dividend is from a fixed rate share but is not deductible, more complex policy questions are raised. Under current law those dividends do not qualify for UFTCs. Under the reformed system, their treatment will depend upon the nature of the investment and the relationship between the holder of the share and the CFC.

2.36 When the fixed rate share is not held by the ordinary shareholder in the CFC, the nature of the interest conveyed by a fixed rate share is different from than that of ordinary equity. The holder of a fixed rate share does not participate unrestrictedly in the profits of the CFC, and the investment may be more in the nature of debt, the income from which is taxable in New Zealand.

2.37 Domestically, this distinction is not critical for the government, as no after-tax difference arises from a switch from debt to equity. All the switch does is change the entity that pays the tax, which has no impact on the total amount of tax revenue collected. Accordingly, relying on the form of the instrument rather than its substance has no cost.

2.38 The switch does matter, however, in the international context. When the form of the funding is switched from taxable debt to exempt equity, New Zealand loses tax revenue. This situation may be of particular concern if the CFC is in a loss position and so cannot make immediate use of its interest deductions.

2.39 On the other hand, if the fixed-rate share forms part of a controlling interest, there is potential for double New Zealand taxation if the dividend is taxed and underlying income is attributed. This could occur under the new rules, for example, if a CFC has sufficient passive income (five percent or more of total income) for it to be taxed in New Zealand under attribution, or if a non-portfolio FIF has attributable income. Even if the income of the CFC is active, and therefore exempt from attribution in New Zealand, taxing the dividend could effectively tax back part of the exemption.

2.40 The treatment of dividends from fixed-rate shares has further implications in determining whether fixed-rate shareholders should have passive income attributed to them and how fixed rate shares should be treated under the interest allocation rules.

2.41 The critical questions in arriving at a judgement of appropriate treatment are:

- whether there is a risk of distorting business behaviour if fixed-rate share dividends continue to be taxed; and
- whether there is a risk to the tax base if the dividends became untaxed.

2.42 These issues could be particularly problematic in situations involving FIF interests. Accordingly, we suggest that the treatment of fixed-rate share dividends be considered in conjunction with the review of non-portfolio FIFs. In the interim, these dividends would remain subject to tax, in keeping with their current treatment for UFTC purposes and the proposed treatment of deductible dividends discussed earlier. Depending on final decisions about the appropriate treatment of these dividends, it may be necessary to have a mechanism to relieve double New Zealand taxation of the underlying income.

Chapter 3

OTHER FOREIGN DIVIDENDS

Summary of suggested changes

- Most foreign dividends from portfolio interests received by companies will be exempt from tax. Dividends derived from entities that are exempt from the FIF rules will continue to be taxed.
- The taxation of foreign dividends received by persons other than companies, such as individuals and trustees, will be unchanged.

Portfolio dividends received by companies

3.1 Dividends received by New Zealand-resident companies from portfolio FIFs are already exempt from tax under the fair dividend rate and comparative value FIF calculation methods. A dividend exemption will also be extended to dividends derived from portfolio FIFs for which the accounting profits and branch equivalent FIF calculation methods are used. These dividends are currently taxable, but any New Zealand tax liability can be offset by BETA credits on attribution.

3.2 Portfolio interests[12] in Australian-resident companies listed on the ASX All Ordinaries index and in Guinness Peat Group plc are exempt from the FIF rules.[13] Dividends from these portfolio interests are currently subject to DWP in the hands of New Zealand company shareholders. As DWP is to be repealed, the dividends derived from these interests from the start of the 2009–10 income year will be subject to income tax.

Foreign dividends derived by persons other than companies

3.3 No change is suggested to the current rules for taxing foreign dividends received by persons other than companies, such as individuals and trustees.

3.4 While dividends paid by CFCs to New Zealand companies will be exempt, the income will be taxed when it is subsequently distributed by the New Zealand company to individual shareholders. In particular, dividends paid by New Zealand companies out of exempt active income derived from their CFCs will not be covered by imputation credits; this means that tax will be paid on such dividends in the hands of individual shareholders. Similarly, foreign dividends received directly by individual New Zealand shareholders from CFCs will need to be taxed.

[12] A portfolio interest is an interest of less than ten percent in a company.
[13] Unless, in the case of the FIF exemption for interests in Guinness Peat Group plc, shareholders have elected for that exemption not to apply.

3.5 This treatment, if unrelieved, could lead to double New Zealand taxation of the passive income of a CFC if it fails the active business test – first, when the passive income is attributed under the CFC rules, and then when income tax is paid on the dividend. Therefore the current BETA rules relieving such double taxation will be retained for dividends received from CFCs by persons other than companies.

Chapter 4

CONDUIT REPEAL TRANSITIONAL RULE

Summary of suggested changes

- With the repeal of the conduit rules, conduit tax relief account (CTRA) balances as at start of 2009–10 income year will be cancelled, subject to a transitional anti-avoidance rule.

4.1 The conduit rules remove the income tax and DWP liability of a New Zealand- resident company on its foreign income from CFCs (and FIFs that use the branch equivalent or accounting profit methods) to the degree that the New Zealand company is owned by non-residents.

4.2 The government announced in the May 2007 update that the conduit exemption from the CFC and FIF rules will be repealed from the 2009–2010 income year.

4.3 As explained in the update, the conduit rules become unnecessary for active income, since the conduit exemption is, in effect, being replaced by the active income exemption and the exemption for dividends from CFCs and FIFs. The case for continuing to provide conduit relief for passive income only is much weaker. Furthermore maintaining the conduit rules would involve a continuing risk to the tax base.

4.4 The repeal of conduit tax relief raises the transitional issue of what to do with existing conduit tax relief account balances.

Operation of the conduit tax relief account

4.5 New Zealand companies with foreign shareholders are entitled to elect conduit relief for income earned in CFCs. Every company that elects to become a "conduit tax relief company" must maintain a conduit tax relief credit account (CTRA). The purpose of the CTRA is to ensure that conduit tax relief is passed through to the non-resident owners of the New Zealand company. It achieves this result by tracking the amount of conduit tax relief provided to the conduit tax relief company. Specifically, CTR credits arise in the account as conduit tax relief is extended to the conduit tax relief company This credit balance is reduced when the conduit relieved income is repatriated (as expected) through to the foreign shareholders by way of a dividend.

4.6 Consequently, a positive balance in the CTRA reflects the fact that income has been relieved from income tax but not yet been paid through to the foreign shareholders of the conduit tax relief company. That credit balance can crystallise into a current year tax liability (in whole or in part) if the New Zealand entity significantly increases its level of New Zealand shareholders.[14] That is because it would be contrary to the policy objectives underpinning conduit for the tax relief to be accessible to New Zealand shareholders.

4.7 In this sense, a positive credit balance in the CTRA represents a contingent tax liability that could arise if the New Zealand company experiences a significant increase in the level of New Zealand shareholding. Conduit companies have an incentive to keep conduit balances low by passing through the conduit tax-relieved income to their foreign shareholders, to avoid an unexpected crystallisation of this potential New Zealand tax liability.

Existing CTRA balances

4.8 The repeal of the conduit rules raises the question of how the government should deal with existing positive balances in the CTRA.

4.9 Crystallising the contingent tax liability on cancellation of the credits would result in the claw-back of prior conduit relief that was not part of the rules when they were in force. It would be possible to provide firms with a transitional period (say, ten years) for conduit companies to pass through the income before crystallising the tax liability in relation to any outstanding conduit income. However, even that approach could be viewed as more restrictive than the present approach, which sets no specific time constraint on passing through the conduit tax-relieved income to foreign shareholders.

4.10 The government could leave the current rules in place for passing through conduit tax relief credits until all have been distributed to foreign shareholders. Alternatively, the government could simply cancel the credits upon the repeal of the rules.

4.11 Cancelling conduit balances would not remove the withholding tax liability on any conduit-relieved income that was subsequently repatriated. That is because the retained conduit income would give rise to unimputed dividends. Therefore withholding tax would still be payable on any subsequent distributions. The amount of any tax liability that would have crystallised from a breach of shareholder continuity or migration of the New Zealand company is difficult to predict. Also the actual quantum of any revenue forgone mainly relates to the timing of tax receipts.

[14] This rule enables the government to recover DWP on any undistributed conduit income in situations where the conduit company becomes substantially New Zealand owned (a 34 percentage point or greater more increase in resident shareholding) or migrates offshore. These rules were intended to discourage companies from using a conduit arrangement to shelter income that was, in fact, being earned on behalf of New Zealand residents. They also provide an incentive (although no obligation) for New Zealand conduit companies to pass relieved income back to their foreign shareholders in order to reduce their potential liabilities.

4.12 There is considerable attraction in removing all the conduit legislation from our statute books immediately. Otherwise these rules must remain on our statute books for an indefinite period of time – until the last conduit tax relief credit is extinguished. Moreover, it would require the government to maintain and administer rules that have no substantive application beyond the 2009–2010 income year.

4.13 On balance, it would seem preferable to cancel the conduit tax relief credits upon repeal of the conduit tax rules. Cancelling all conduit tax relief credits may, however create tax-planning opportunities in the interim period between the announcement that credits are to be cancelled and the repeal of the conduit rules. For instance, it would not be acceptable simply to cancel conduit balances in relation to conduit transactions entered into to take advantage of a government proposal to cancel such balances on repeal of the conduit rules. Of particular concern would be a structure created after the release of this paper that had the purpose or effect of passing conduit relief through to New Zealand shareholders following the repeal.

4.14 For this reason, transitional anti-avoidance rules would be considered for arrangements entered into between the release of this paper and the termination of the conduit rules. In particular, if the government decides to cancel credit balances, the terminating legislation would need to include an anti- avoidance rule to the effect that conduit credits arising from transactions entered into in anticipation of the repeal of the conduit rules will give rise to an immediate tax liability upon the cancellation of those credits.

Chapter 5

TRANSITIONAL RULES FOR ATTRIBUTED CFC LOSSES AND FOREIGN TAX CREDITS

Summary of suggested changes

- Attributed CFC net losses and foreign tax credits accrued under the current rules can be carried forward into the new system, but will continue to be reduced by reference to total CFC net income (including non-attributable income).

5.1 The earlier issues paper, *New Zealand's International Tax Review: Developing an active income exemption for controlled foreign companies,* released in October this year, signalled that further consideration would be given to the treatment within the new system of attributed CFC net losses and foreign tax credits arising under existing rules. This chapter discusses the need for transitional rules to deal with these amounts, reflecting the fact that only a subset of the income of CFCs will be subject to attribution once the active income exemption is in place.

Attributed CFC net losses

5.2 A net loss incurred by a CFC is attributed to its shareholders under subpart DN of the Income Tax Act 2004. Section DN 4 provides that an attributed CFC loss may be offset against attributed CFC or branch equivalent FIF income for CFCs and FIFs in the same jurisdiction. Any excess becomes an attributed CFC net loss that may be carried forward and used under section IE 1 (by virtue of section IE 3), or used against current or future income of another company in the same group under section IG 4. Such losses are subject to the jurisdictional ring-fencing rules, which are not expected to change.[15]

5.3 As noted in the October issues paper, once the exemption for offshore active income is in place, any net loss arising to a CFC and attributable to its New Zealand shareholders will necessarily represent an excess of deductions relating to passive income exceeding such income in a particular year. There should be no need for special rules distinguishing active net losses from passive net losses.

[15] Jurisdictional ring-fencing ensures that the relief given corresponds to the effective rate of New Zealand tax on attributed income once foreign tax credits are taken into account.

5.4 Under the new rules, income earned by the CFCs of wholly active businesses will be fully exempt from New Zealand tax. Such businesses will therefore have no use for attributed CFC net losses arising under the existing rules. New Zealand residents deriving attributable passive income through CFCs, on the other hand, may wish to carry these existing losses forward into the new system.

5.5 Such losses may reflect expenditure relating to the derivation of either active or passive income, or both. Allowing unrestricted relief for these carried-forward historical losses in the context of a reformed system under which only passive income is subject to attribution would be problematic.

5.6 As a basic principle, there should be a nexus between expenditure and assessable income for an amount to be allowed as a deduction and for a net loss to arise. Once offshore active income is effectively exempt, no such nexus will exist for related expenditure. To the extent that losses are a reflection of such expenditure, therefore, they should not be allowed. Looked at another way, full relief from New Zealand tax will already have been given on the income to which these active net losses relate; there is no reason to provide further relief against other income.

5.7 Unrestricted relief for historical losses under the new rules would also impair the proper taxation of offshore passive income during the transitional phase, contrary to the policy intent. As noted in earlier documents, continuing taxation of offshore passive income on accrual is regarded as a necessary and appropriate feature of the new system, not least to protect the domestic tax base. It would be relatively straightforward for a predominately active business to use unrestricted historical losses to shelter passive income earned offshore from New Zealand tax.

5.8 Requiring taxpayers to identify and strip out the active component of historical losses at the point of transition is not recommended. Conceptually, this would involve imposing the methodology of the new system on past transactions. Taxpayers are likely to find it difficult to identify the active element of any historical losses, given that no such distinction is required under existing law.

5.9 Instead, we suggest that historical losses be carried forward without restriction, but that transitional rules require those losses to continue to be offset against broadly the same measure of income as is used for the purposes of attribution under the current system. This would ensure that historical losses continue to be dealt with in a way that is consistent with the rules applying when those losses accrued.

5.10 In practical terms, this will mean abating a taxpayer's historical losses from a given jurisdiction over time, taking account of non-attributable CFC income from that jurisdiction, as well as any actual offset against attributable passive (or branch equivalent FIF) income.[16]

5.11 For historical losses to be correctly abated, the amount of non-attributable CFC income derived by a taxpayer will need to be determined. This presents some practical problems because taxpayers will not be required to calculate this income for the purposes of attribution. However, it may be possible to follow the general approach suggested for the active business test in Chapter 3 of the October issues paper, allowing taxpayers to draw on their IFRS-compliant accounts.

5.12 For a given CFC (or a sub-consolidated group of CFCs within the same jurisdiction), the starting point would be the total net income figure drawn from audited financial accounts prepared in compliance with NZ IFRS or IFRS, or calculated in accordance with New Zealand tax rules.

5.13 If the CFC (or sub-consolidated group) satisfies the active business test, it will not be subject to attribution on any of its income. This net income figure will therefore be applied for the purposes of abating the taxpayer's historical losses from the relevant jurisdiction.

5.14 If the CFC (or sub-consolidated group) does not satisfy the active business test, the amount of the abatement will be the non-attributable component of this net income figure. This can be determined by simply deducting from the CFC's total net income its passive income (if any) calculated under the tax rules for the purposes of attribution. Once abatement has occurred, any remaining historical losses can be offset against this or any other attributable passive income or branch equivalent FIF income from the same jurisdiction.

5.15 The following example illustrates how all this might work in practice.

Example: Reducing historical losses by reference to total net income

Aco, a New Zealand-resident company, has attributed CFC net losses from State B of $30,000 to carry forward from the 2008–09 pre-reform income year ("historical losses").

In the 2009–10 income year, Aco has a CFC in State B that does not satisfy the active business test. The net passive income of the CFC calculated under New Zealand tax rules for the purposes of attribution is $7,000. According to its NZ IFRS accounts, the CFC has total net income of $18,000, giving it non-attributable net income of $11,000 ($18,000 less $7,000). Aco's historical losses from State B are therefore abated from $30,000 to $19,000. Aco then uses $7,000 of the remaining historical losses to offset its attributable passive CFC income from State B, leaving $12,000 to be carried forward.

[16] Only attributable passive income will be subject to attribution in the new system. Amounts not within the definition of passive income ("active/disregarded income") will not be subject to attribution. Passive income derived by a CFC that satisfies the active business test ("non-attributable passive income") will also escape attribution. See paragraph 10.3 of the October issues paper for a fuller description of these broad categories of income derived by CFCs under the new rules.

5.16 Submissions on the suggested approach are invited. Taxpayers would be free to elect not to carry forward historical losses if they preferred not to do so (for example, because they did not anticipate deriving any attributable CFC income under the new system). No restriction of attributed CFC net losses already assimilated to general net losses under section IE 3(5) is proposed.

Foreign tax credits

5.17 Section LC 4 of the Income Tax Act 2004 provides, broadly, that a person who has attributed CFC income is allowed a credit for tax paid on that income. Surplus credits may be carried forward under section LC 4(4) to (6), subject to jurisdictional ring-fencing. Section LC 5 allows surplus credits, including credits carried forward from earlier years, to be transferred within the same wholly owned group, subject again to jurisdictional ring-fencing. The October issues paper noted that section LC 4(3) would need to be amended to ensure that, in future, credits are available for foreign tax paid or payable by a CFC only in respect of its *passive* income.

5.18 Similar transitional concerns arise for foreign tax credits carried forward from the existing system under section LC 4. Allowing credits that may relate to foreign tax on either active or passive income under current rules to be carried forward and applied without restriction to relieve New Zealand tax on a subset of CFC income would not be appropriate. It would be inconsistent with the general principle that credits under subpart LC are available for foreign tax paid on income that is also assessable in New Zealand, up to the amount of the New Zealand tax liability on that income. The consequence would be to allow offshore passive income to be sheltered from domestic taxation.

5.19 We therefore suggest that transitional rules will also be needed to restrict the use of historical foreign tax credits under the new rules. In our view, historical credits should be carried forward in full, but abated over time by reference to a notional New Zealand tax liability on taxpayers' non-attributable CFC income as well as any actual offset against their actual tax liability on attributable passive (or branch equivalent FIF) income. This is, effectively, an extension of the approach described earlier for dealing with historical losses. We think that notional tax liability for these purposes could be determined using non-attributable CFC income calculated in accordance with the methodology already set out for that option.

5.20 Again, submissions on the suggested approach are invited.

Appendix

SUMMARY OF CHANGES TO TAX TREATMENT OF FOREIGN DIVIDENDS

	Current tax treatment	Proposed tax treatment from 2009-2010 income year
Ordinary dividends received by a NZ company		
CFC to NZ company	Subject to DWP (offset by UFTC / BETA credits)	Tax-exempt (No DWP or income tax)
Non-portfolio FIF to NZ company	Subject to DWP (offset by UFTC / BETA credits)	Tax-exempt (No DWP or income tax)
Portfolio FIF to NZ company	Dividend exempt from DWP under FDR and CV methods; subject to DWP(offset by BETA credits) under AP and BE methods if deductible.	Tax-exempt (No DWP or income tax)
Other dividends received by a NZ company		
Foreign dividends that are currently ineligible for UFTC (when the share is a fixed-rate share or the CFC or FIF is allowed a deduction for the dividend in calculating its tax liability)	Subject to DWP	Subject to DWP
Dividends received from a portfolio interest in an Australian-resident company listed on the ASX All Ordinaries index or Guinness Peat Group plc.	Subject to DWP	Subject to income tax
Dividends received by a NZ individual or trustee		
CFC to NZ individual	Subject to income tax (offset by BETA credits)	No change
Non-portfolio FIF to NZ individual	Subject to income tax (offset by BETA credits)	No change
Portfolio FIF to NZ individual	Dividend exempt from income tax under FDR and CV methods	No change