Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

Volume 4

International tax rules
Foreign investment fund (FIF) rules
International Financial Reporting Standards (IFRS) provisions
Partnerships
Miscellaneous remedial amendments

May 2009

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

CONTENTS

International tax rules 1

Overview 3

Direction of reform and scope of bill 7

Issue: Agreement with the direction of reform and its underlying principles 7
Issue: Opposition to the introduction of an active income exemption 8
Issue: Active income exemption should be extended to non-portfolio FIFs and branches as soon as possible 9

Application date of international tax changes 10

Issue: Taxpayers should be given the option to apply either the current rules or those contained in the bill for the 2009–10 income year 10
Issue: Changes to the international tax rules should not have effect until the 2010–11 income year 11
Issue: The international tax reforms should be introduced in stages 12
Issue: Attributed CFC income should be removed from any use-of-money interest calculation for 2009–10 12

Exemptions from requirement to attribute 13

Issue: Accounting-based active business test is too complex 14
Issue: Use of reporting currency in the tax-based active business test 18
Issue: Reliance on audited accounts to show compliance with standards 19
Issue: Anti-avoidance rule for manipulation of accounting test 20
Issue: Financial arrangements with related parties 21
Issue: Size of entity below which there should be no passive income 22
Issue: Simpler test for small and medium-sized enterprises (SMEs) 22
Issue: The active business test threshold should be higher than 5 percent 23
Issue: Audit requirement 24
Issue: Which accounts must be audited 25
Issue: Alternatives to audit requirement 25
Issue: Independence of auditor when audited accounts used 26
Issue: Use of alternative financial reporting standards 26
Issue: Pre-requisites for use of “old GAAP” accounting standards 27
Issue: Requirement to not have IFRS accounts if “old GAAP” standards are to be used 28
Issue: Common ownership requirements for consolidation in the active business test 28
Issue: Accounting pre-requisites for consolidation under the tax-based test 29
Issue: Treatment of nil income in the active business test 30
Issue: Removal of minority interest in consolidation for the test 31
Issue: Conversion of foreign currency amounts into presentation currency in the accounting-based test 32
Issue: Worldwide consolidation of CFCs 33
Issue: Requirement to have consolidated accounts to group CFCs in accounting-based test 34
Issue: Consolidation and liability to tax in the foreign country 35
Issue: Currency of CFCs when consolidating for the purposes of the test 35
Issue: Currency of entities when using the tax-based test and grouping CFCs 36
Issue: Gains and losses of financial instruments / arrangements in the test 37
Issue: Removing expenditure or loss from measures of income in the test 38
Issue: Inclusion of gains on financial instruments in accounting-based test 38
Issue: Gains on derivatives in the measure of total income in the test 39
Issue: Hedges of both passive income and other income in the active business test 40
Issue: Treatment, in the test, of hedges that are not fully effective 42
Issue: Passive income received from other CFCs should be part of total income 43
Issue: Elimination of inter-company transactions in the test 44
Issue: Income from the disposal of revenue account property 45
Issue: Personal services income earned through CFCs 46
Issue: Use-of-money interest if tax underpaid or overpaid on passive income 46

Issue: Alignment of passive income and attributed CFC amount 47
Issue: Treatment of income from agency relationships 48
Issue: Resident CFCs 49
Issue: Non-attributing Australian CFCs – hybrid entities 49
Issue: Section EX 21E – drafting 50
Issue: Miscellaneous drafting issues 50
Issue: CFCs resident in Australia – Australian exemption and consolidated groups 51
Issue: Australian exemption and offshore branches 52
Issue: Australian exemption drafting issue 53
Issue: Scope of Commissioner's determination for active insurance CFCs 53
Issue: Clarification of how the Commissioner's determination will work in practice 54
Issue: Allowing the Commissioner's determination for active insurance CFCs to be applied on a country-consolidated basis 55
Issue: Excluding reinsurance from the Commissioner's determination for active insurance CFCs 55

Attributable income 56

Issue: Passive dividends and treating a CFC as though it were a New Zealand resident 56
Issue: New Zealand dividends paid to a wholly owned CFC 57
Issue: Defining "attributable CFC amount" (section EX 20B) 58
Issue: Heading before section EX 20B(4) 58
Issue: Treatment of short-term sale and purchase agreements 59
Issue: Derivatives entered into in ordinary course of business 59
Issue: Derivatives hedging passive income 60
Issue: Exception for non-derivative arrangement income from an associated non-attributing active CFC 61
Issue: Cash basis person's rules 62
Issue: Royalties from property owned by a New Zealand resident 63
Issue: Widening the scope of the exemption by extending it to any member of the group in a jurisdiction 64
Issue: Pattern of activity and substantial value requirements for the exemption of royalties from attribution 65
Issue: Intellectual property linked to New Zealand 67
Issue: Definition of "royalty" 71
Issue: Miscellaneous royalties drafting issues 71
Issue: Rent 73
Issue: Licence fees 76
Issue: Insurance income – change in revenue account property 77
Issue: Income from a life insurance policy that is not FIF income 77
Issue: Key person insurance 78
Issue: Income from personal service 78
Issue: Revenue account property 79
Issue: Certain income related to telecommunications services 81
Issue: Base company rules – services partly performed in New Zealand 85
Issue: Base company rules – income with a New Zealand source 85
Issue: Base company rules – interaction with the active business test 86
Issue: Holding company exemptions and liability to tax in the foreign country 87
Issue: Rent exemption and liability to tax in the foreign country 88

Net attributable CFC income or loss 90

Issue: Mechanics of the calculation provision 91
Issue: Cross-references in the calculation provision 91
Issue: Interaction between sections EX 20C and EX 21 92
Issue: Non-interest expenditure 92
Issue: Interest expenditure – general approach 93
Issue: Interest expenditure – basis of apportionment 94
Issue: Interest expenditure – on-lending 94
Issue: Interest expenditure – excessively debt funded CFCs 95
Issue: Interest expenditure – active financing entities 96
Issue: Interest expenditure – testing dates 97

Issue: Interest expenditure – accounting standards 98
Issue: Interest expenditure – fixed-rate foreign equity and deductible foreign equity 98
Issue: Interest expenditure – cross-reference to subpart FE 99
Issue: Interest expenditure – miscellaneous drafting issues 100
Issue: Section EX 21 – income from another CFC 100
Issue: Section EX 21 – treatment of subvention payments 101

Interest allocation rules 102

Issue: Outbound interest allocation rules should not be introduced 102
Issue: Outbound interest allocation rules should not apply to New Zealand companies that are owned and controlled by New Zealand residents 103
Issue: Application of interest allocation rules to smaller entities 104
Issue: Interest allocation rules should not apply to individuals resident in New Zealand 106
Issue: There should be a transitional period during which the new rules do not apply to existing financing arrangements 106
Issue: The proposed expansion of a natural person's New Zealand group for the purposes of the inbound interest allocation rules should not proceed 107
Issue: The 75 percent safe harbour should be raised to 80 percent or 85 percent for companies that are mainly New Zealand-owned 107
Issue: The 75 percent safe harbour should be increased for financial institutions 108
Issue: The safe harbour for SMEs should be based on the formula used for the interest allocation rules in the conduit rules, rather than fixed at 75 percent 109
Issue: The exclusion of interests in CFC from the calculation of total group assets should not apply when that CFC income is passive 109
Issue: Internally generated goodwill should be included in total group assets under section FE 16(1) 110
Issue: It should be possible to use the market value for all assets, rather than the value in financial statements, when measuring assets 111
Issue: Fixed-rate shares should be excluded from the scope of the interest allocation rules 111
Issue: Grandparenting rules should be introduced for financing arrangements involving fixed-rate shares and redeemable preference shares 112
Issue: The interest allocation rules need to address the treatment of foreign exchange losses 113
Issue: The treatment of deductible foreign equity under section FE 16(1b) is anomalous 113
Issue: Calculation of debt percentages 114
Issue: Associated persons and interest allocation rules 115
Issue: References in sections FE 6(3)(ab) and FE 15(1)(b) to fixed-rate foreign equity should be replaced with a reference to fixed-rate shares 115
Issue: Drafting of new subparagraph FE 1(1)(a)(i) 116
Issue: Paragraphs FE 3(1)(c) and (2)(c) should be relocated to section FE 5 116
Issue: The outbound interest allocation rules should apply only when the income interest in a CFC is greater than 10 percent 117
Issue: Clarity of drafting in new section FE 4 117
Issue: Reference to "value" in new section FE 16 (1B) 118
Issue: Apportionment under paragraph FE 16(1B)(b) 118
Issue: Omission of "group" in new wording of section FE 18(4) 119
Issue: Identification of New Zealand parent 119
Issue: Identification of members of the New Zealand group 120
Issue: Definition of "worldwide group" 120
Issue: Drafting of section FE 31B(2) 121

Foreign dividend exemption 122

Issue: Taxation of fixed-rate foreign equity and deductible foreign equity 122
Issue: Taxation of fixed-rate foreign equity 123
Issue: Reclassification of fixed-rate foreign equity as a financial arrangement 123
Issue: Reclassification of fixed-rate foreign equity – technical issues 125
Issue: Definition of "deductible foreign equity" 125
Issue: Definition of "fixed-rate foreign equity" 126
Issue: Dividends from grey list FIFs 127
Issue: Drafting matters 127

Transitional and consequential matters 129

Issue: Transitional loss carry-forward and tax credit rules – general approach 129
Issue: Transitional loss carry-forward and tax credit rules 130
Issue: Transitional loss carry-forward and tax credit rules – technical and drafting matters 132
Issue: Transitional loss carry-forward and tax credit rules – interaction with existing law 133
Issue: Memorandum accounts – CTR account balances 134
Issue: Memorandum accounts – election to stop being a CTR company 134
Issue: Memorandum accounts – transitional period for BETAs 135
Issue: Memorandum accounts – transitional rules for BETAs 135
Issue: Memorandum accounts – application of changes 136
Issue: Memorandum accounts – post-transitional rules 137
Issue: Miscellaneous – attributed repatriations rules 137
Issue: Miscellaneous – requirements for being a qualifying company 138

Repeal of the grey list exemption 139

Issue: The grey list exemption should be retained 139
Issue: The grey list exemption should be retained for SMEs 141
Issue: The grey list exemption should continue to apply for a transitional period 141
Issue: Exemptions based on effective or headline tax rates 142
Issue: Repeal of grey list – drafting error 142

Repeal of conduit tax relief 143

Issue: The conduit tax relief rules should be retained 143
Issue: Retaining the conduit rules and the grey list for finance CFCs 144
Issue: NRWT relief should be introduced for conduit investments 145
Issue: Conduit anti-avoidance rule 145

Miscellaneous submissions 147

Issue: Structure and drafting of the legislation 147
Issue: Section CQ 2 – drafting 147
Issue: Repeal of section EZ 31 148
Issue: Ring-fencing of CFC losses by jurisdiction 148
Issue: Use of FIF losses against CFC income 149
Issue: Tax credits on attributed CFC income 150
Issue: Streaming of imputation credits 150

Foreign investment fund remedial amendments 151

Effect of previous year's quick sale gains on opening values 153
Australian-resident listed company exemption 154
Deemed disposal and re-acquisition when FIF becomes New Zealand-resident 155
Application of quick sale adjustment to FDR calculations for unit valuers 156
Management fee rebate received from an offshore fund which is subject to fair dividend rate (FDR) method 157
Taxpayer should be allowed to change method in first year 158
Comparative value loss restriction 159
Application date of FDR determinations 160
Criteria for using FDR method – hedging requirement 161
Minor drafting issues 162

International Financial Reporting Standards (IFRS) provisions 163

Overview 165

Issue: Reconsider the existing/proposed rules, ground-up rewrite 165
Issue: IFRS operating leases which are finance leases/financial arrangements for tax 166
Issue: Finance leases and mandatory use of yield to maturity 166
Issue: Interest-free loans and loans that are below market value/variations in financial arrangements such as finance company workouts 167
Issue: Anti-arbitrage provisions in the legislation 168
Issue: Transitional provisions and early adopters of the IFRS accounting methods 169
Issue: Change of spreading method transitional adjustments on entry to new tax rules 170
Issue: Interest capitalised to the balance sheet by IFRS financial reporting 170
Issue: Pre-IFRS GAAP financial reporting method 171
Issue: (Pre-IFRS) taxpayer choice of spreading method (including YTM) 171
Issue: General submission – methods, choices and volatility 172
Issue: IFRS financial reporting method – wording clarification 173
Issue: Impaired credit adjustments for financial arrangements accounted for under the (IFRS financial reporting) fair value method – dealers 174
Issue: Impaired credit adjustments for financial arrangements accounted for under the (IFRS financial reporting) fair value method – decline in credit quality 174
Issue: Errors in the accounts 175
Issue: Mandatory use of yield to maturity for some arrangements 176
Issue: Electricity contracts for differences – expected value approach 176
Issue: Amendments to legislation – application to filed returns 177
Issue: Taxation of financial arrangements held by functional currency entities 178
Issue: Modified fair value method 178
Issue: Methodology for calculating taxable income on swaps – Determination G9A 179
Issue: Volatility in some bond group investment funds taxable income 180
Issue: Consistency and a group of companies' elections to use some methods 180
Issue: Drafting matters 181
Issue: Consistency of methods by groups of companies 181

Partnerships 183

Overview 185

Flow-through provisions 186

Issue: Flow-through of activity, status, intention or purpose 186
Issue: Anti-streaming rule 186
Issue: Anti-streaming rule should not apply for husband-wife partnerships 188
Issue: Variable profit-sharing clauses 188
Issue: Measuring partner capacity 189
Issue: Deductions for exiting and entering partners 189

Dissolution 191

Issue: Death of a spouse 191
Issue: Relationship property settlements 191

Disposal of partnership interests 192

Issue: Disposal at market value 192
Issue: Threshold at which partners must account for tax is too low 192
Issue: Thresholds at which partners must account for tax 193
Issue: Clarification of section HG 5 193

Trading stock 194

Issue: Trading stock definition 194
Issue: Clarification 194

Depreciable property 195

Issue: Depreciable intangible property 195

Livestock 196

Issue: Technical issues related to livestock 196

Restructuring partnerships to companies 198

Issue: Partnership structure 198

Issue: Rollover relief 198

Oher issues 199

Issue: Non-resident partner's partnership income 199

Issue: Approved issuer levy 199

Issue: New partnership 200

Issue: Income equalisation schemes 200

Minor drafting issues 201

Miscellaneous remedial amendments 203

ACC payments 205

Fifty-three (53) weekly instalments of Working for Families tax credits in the 2008–09 tax year 206

Company tax rate change consequentials 207

Issue: Transitional imputation penalty 207

Issue: Attribution rule issues 209

Issue: IFRS and R&D expense deductions 210

Schedule 13 depreciable land improvements 211

Correction of cross-reference 212

Application of late payment notification to provisional tax 213

Resident withholding tax on foreign dividends 214

International tax rules

OVERVIEW

The bill introduces a new approach to taxing foreign companies that are controlled by New Zealand residents.

Current international tax rules

New Zealand currently taxes its residents on their share of all income, both active and passive, earned by controlled foreign companies (CFCs) as that income accrues. A credit is provided for any foreign tax paid by the CFC. In addition, dividends paid by CFCs to New Zealand residents are taxed, with credits for New Zealand tax paid earlier on accrual and any foreign withholding taxes.

The only exceptions to this approach are the grey list and conduit exemptions. If the CFC is located in one of eight "grey list" countries, all of its income is exempt.[1] Conduit tax relief reduces tax on CFC income to the extent the CFC is owned by a New Zealand company with foreign (non-resident) shareholders.

There are several problems with the existing international tax rules:

- New Zealand's approach is unique: other countries exempt active offshore income. This creates an incentive for New Zealand businesses with offshore operations to move their headquarters to countries with more favourable tax rules.
- Market growth and investment opportunities are increasingly outside of grey list countries such as China, South America or the Middle East. New Zealand businesses expanding into non-grey list countries may face higher tax and compliance costs than their competitors.
- The grey list and conduit exemptions can be used to build structures that minimise tax on domestic income.

The international tax changes are designed to reduce tax barriers to businesses expanding offshore, while minimising compliance costs and maintaining a level of protection for the domestic tax base.

Changes that would be brought in by the bill

The key features of the proposed new rules are an active income exemption for controlled foreign companies (CFCs), some accompanying measures to protect the tax base, and an exemption from tax on most foreign dividends received by companies.

---

[1] The grey list comprises Australia, the United States, the United Kingdom, Japan, Norway, Canada Germany and Spain.

Active income exemption for CFCs

The bill introduces an active income exemption for CFCs. This means that only passive income will be attributed to New Zealand owners as taxable income. Passive income is defined in the bill as the "attributable CFC amount" (a gross concept) and "net attributable CFC income or loss" (a net concept).

To reduce compliance costs in situations where there is limited risk to the tax base, there are some exceptions from the requirement to attribute passive income. For example, there will typically be no attribution of passive income for CFCs in Australia. There will also be an exception for CFCs that pass an "active business" test – no attribution of passive income will be required for CFCs if the passive income of the CFC is less than 5 percent of total income. The test may be undertaken using tax rules or financial accounting information. It is expected that most active businesses will pass the test, and therefore not have to undertake a full calculation of attributable CFC income.

Base protection measures

To limit the risk to the New Zealand tax base, it is essential that CFCs with significant amounts of passive income are subject to attribution on this income. This is because New Zealand-sourced income can be converted into passive CFC income to reduce a person's tax liabilities. For this reason the existing eight-country grey list exemption and conduit tax relief rules are being repealed.

Another key risk to the tax base arises from New Zealand debt being used to finance investment in CFCs earning non-attributable income. As a consequence of exempting active CFC income, it is necessary to extend the interest allocation rules, which currently apply to foreign-owned companies, to resident companies with CFCs regardless of ownership. These rules place an upper limit on the level of interest deductions that can be taken against income earned in New Zealand. This reflects the fact that offshore active income will be exempt under the new rules. There are several safe harbours in the proposed rules which will apply only if companies with a significant international presence choose to heavily debt-finance their domestic operations but not their foreign ones.

Foreign dividend exemption

The bill introduces a foreign dividend exemption. This complements the active income exemption by reducing tax and compliance costs on companies that repatriate CFC and FIF income back to New Zealand. Most dividends paid by a foreign company will be exempt from income tax when received by New Zealand companies. Dividends that are tax-deductible for the foreign company and dividends on fixed-rate shares will remain taxable, although a deduction will be available against any passive CFC income to mitigate double taxation.

Foreign dividend payment (FDP) accounts and branch equivalent tax accounts (BETA) of companies are unnecessary under the new rules and will be phased out over time.

Key recommendations

Twenty submissions were received on the proposed international tax changes. Submissions generally welcomed the active income and foreign dividend exemptions but were critical of the base maintenance parts of the package.

This report sets out officials' detailed responses to those submissions. It does not recommend changes to the fundamental design and structure of the rules in the bill. We continue to consider that it is in New Zealand's overall interest to move to an active income exemption and to exempt companies from tax on foreign dividends. Equally, we remain of the view that the introduction of interest allocation rules, the repeal of the grey list (except for Australia), and the repeal of the conduit rules are necessary to protect the tax base.

Nevertheless, the report does recommend some significant technical changes in response to submissions. Our general approach in developing these recommendations has been to accept submissions that simplify compliance as long as we are satisfied that the associated risks to the tax base are not too great. We would not rule out further modification of the rules once officials and taxpayers have more experience of how they operate in practice. However, we consider a cautious approach is appropriate at this stage.

Active business test

The active business test excludes CFCs from the attribution rules if their passive income is less than 5 percent of their total income. Submissions expressed the concern that the test was too complex. For this reason, this report recommends a number of important simplifications. We recommend allowing losses as well as gains from hedges to be netted off against the gains and losses relating to the underlying contracts; this may seem a highly technical change, but it should reduce compliance costs because it more closely aligns the test with the way financial accounts are formulated and presented. We also recommend that IFRS accounts with an unqualified audit should be treated as being in compliance with IFRS accounting standards unless there is evidence of fraud, intent to mislead, or incompetence or lack of independence on the part of the auditor. Finally, we recommend reducing the number of compulsory adjustments to IFRS accounts that are required to take account of differences with tax concepts.

Interest allocation rules

The interest allocation rules in the bill are an integral base maintenance element of the reform package. The bill already has minimum threshold rules for small and medium-sized enterprises (SMEs). In view of submissions about the ability of SMEs to raise finance offshore, some further relaxation of these thresholds seems sensible. As the bill stands, no interest will be denied if the total interest expense in New Zealand is less than $250,000. We recommend increasing that limit to $1 million, with interest denial then being phased in gradually as expenditure increases up to $2 million. At that point, the general interest allocation rules would apply.

Unusual forms of dividend

The bill exempts most foreign dividends received by companies. However, deductible dividends and dividends from fixed-rate shares will continue to be taxed; the bill currently achieves this result by treating such dividends as interest.

Submissions argued against taxing such dividends at all. Even if they were to be taxed, submissions argued for their reclassification as interest. We remain of the view that deductible dividends and dividends from fixed-rate shares should be taxed. However, in response to submissions, we have recommended that the bill be amended so that this is done by treating them as taxable dividends rather than by deeming them to be interest.

Transition from existing rules

The bill includes transitional rules to deal with CFC losses and foreign tax credits accrued before the application of the new legislation. Taxpayers are permitted to carry these "old" losses and credits forward, and to use them in the new system to relieve tax on passive income. However, taxpayers must reduce these amounts by reference to their total CFC income – not just their passive income. This reflects the fact that such losses and credits may, in fact, relate to active CFC income and should not be used to shelter only future passive income. Submissions focused on the complexity of the rules and associated compliance costs. We recommend simplifying the approach, in particular by allowing taxpayers to convert "old" amounts into ordinary CFC losses and credits using a two-year snapshot of their CFC income and by allowing the use of financial accounts to determine total CFC income for the purposes of these rules.

Interest expenditure incurred by CFCs

The bill provides that deductions for interest expenditure incurred by a CFC will be based on the proportion of the CFC's assets that are used to derive passive income. Special rules apply to CFCs that are excessively debt funded, to prevent debt being concentrated in particular CFCs to maximise deductions against passive income. Submissions pointed out that these rules potentially interfere with intra-group financing arrangements, where a CFC performs a group treasury function, borrowing and on-lending to associated CFCs. To address this concern, we recommend amending the bill to allow for appropriate adjustments in such cases.

Application date

Uncertainty caused by late enactment of the bill potentially causes problems for taxpayers. These problems are particularly pronounced for taxpayers with earlier balance dates. This report therefore recommends that the new rules should apply for the 2009–10 income year to taxpayers with balance dates on or after 30 June, with the current rules applying to taxpayers with balance dates before 30 June. The new rules would apply for the 2010–11 income year to all taxpayers.

Issue: Agreement with the direction of reform and its underlying principles

Submission

(24A – NZ Law Society, 26 – Fonterra, 30 – Staples Rodway, 32 – KPMG, 35 – PricewaterhouseCoopers, 40 – Fisher and Paykel Healthcare, 53 – Ernst & Young, 54 – Business New Zealand, 59 – Fletcher Building, 62 – Minter Ellison Rudd Watts, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group, 73 – Seniors Money International, 78 – Seaworks)

The introduction of an active income exemption for controlled foreign companies is overdue. Other jurisdictions have long had such an exemption as an important feature of their tax system, and New Zealand firms have, up to now, been at a considerable disadvantage when competing against companies from these jurisdictions. The active income exemption and the exemption from tax of most foreign dividends will bring New Zealand's tax rules for companies operating overseas much more in line with international norms.

Although the reforms may not go far enough in some respects, and some elements of the package may impose an undue compliance burden on some firms, the guiding principles of the reform are sensible.

Comment

Officials welcome the general consensus in favour of the direction of the reform and its underlying principles. The provisions giving effect to these principles are necessarily complex and seek to balance a range of considerations. But it is reassuring that most submissions support the key principles that should underpin reform and on the broad direction of reform.

Recommendation

That the submission be noted.

Issue: Opposition to the introduction of an active income exemption

Submission

(38 – New Zealand Council of Trade Unions)

An active income exemption for CFCs should not be introduced because it may lead firms to substitute investment in domestic facilities with investment offshore.

Comment

The submission notes that a more favourable tax environment for outbound investment may lead to some investment or production that would otherwise have occurred in New Zealand being relocated offshore. This is a legitimate concern, although there are a number of important offsetting factors which can work in the opposite direction. New Zealand is principally a net importer of capital. For firms that invest capital abroad, there is greater 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 to the demand for products from New Zealand. Investment abroad can also lead to an upgrading of the types of jobs undertaken in New Zealand.

These reforms seek to remove barriers to offshore investment without subsidising firms with offshore operations. This is a careful balance. Suggestions for further liberalising the rules should be considered not only in terms of the possible base maintenance risks but also with a view to their likely impact on investment location decisions. Proposals to further relax or dispense with interest allocation rules are a good example. Interest allocation rules restrict the amount of debt that can be loaded against New Zealand income. This protects the domestic tax base. It also limits the extent to which firms can use interest deductions in New Zealand to obtain an outright tax subsidy for offshore investment.

As the rules are currently designed, officials believe there is no strong reason to expect that the reforms will reduce capital and productivity in New Zealand. Because these reforms provide incentives for firms to locate or stay in New Zealand and to expand and benefit from opportunities offshore, they are likely to have the opposite effect. Even if New Zealand wanted to prevent outflows of capital, it is unlikely that an internationally stringent tax treatment of CFC income would be in its best interests, given world trends for companies and workers to migrate to other countries.

Recommendation

That the submission be declined.

Issue: Active income exemption should be extended to non-portfolio FIFs and branches as soon as possible

Submission
(26 – Fonterra, 32 – KPMG, 35 – PricewaterhouseCoopers, 53 – Ernst & Young, 68 – Corporate Taxpayers Group)

Non-portfolio FIFs (those with shareholdings of between 10 and 50 percent in a foreign company) and branches have not been dealt with in the current changes. This will create a fundamentally different tax outcome between shareholdings of 50 percent (which, in the case of 50:50 joint ventures, are subject to the FIF rules and will continue to be subject to full attribution of income, subject to the grey list exemption) and of 51 percent (which will be subject to the CFC rules and will generally not be taxable in New Zealand). It will also create significant tax differences between foreign branches and 100 percent-owned foreign subsidiaries. Companies will continue to incur compliance costs in relation to non-grey list FIFs until the active income exemption is extended to cover these entities. The rules for branches and non-portfolio FIFs therefore need to be brought into line with the rules for CFCs as soon as possible. The active income exemption could perhaps be extended to non-portfolio FIFs in the current bill.

Comment

Given the complexity of the international tax rules, it makes sense to develop the reforms in stages. The international tax review's fundamental reform is the introduction of an active income exemption for controlled foreign companies. In the second stage of the review, the key priority will be to extend the active income exemption to non-portfolio FIFs. The treatment of financial institutions and branches will also be addressed as part of the second stage of the review. However, non-portfolio FIFs, financial institutions and branches raise various policy and technical concerns which require careful consideration. It is not possible, for example, simply to apply the CFC changes in the bill in their entirety to non-portfolio FIFs. The application of the active income exemption to these entities needs to take account of the fact that the New Zealand investors do not control these entities. However, officials do agree that rules for non-portfolio FIFs in particular need to be aligned with those for CFCs as soon as practically possible.

Recommendation

That the submission be noted.

APPLICATION DATE OF INTERNATIONAL TAX CHANGES

Issue: Taxpayers should be given the option to apply either the current rules or those contained in the bill for the 2009–10 income year

Submission

(24A – New Zealand Law Society, 35 – PricewaterhouseCoopers, 62 – Minter Ellison Rudd Watts, 67 – New Zealand Institute of Chartered Accountants)

The delay in enactment of the bill potentially causes problems for taxpayers, particularly in relation to the international tax changes, which are complex and far-reaching. Although the Committee's report-back on the bill is not due until 30 June 2009, the new rules could apply to some early balance date taxpayers from as early as 1 October 2008. This could create real difficulties for some businesses in working out provisional tax payments. On the other hand, many taxpayers will have planned for the introduction of the new rules from the 2009–10 income year. Taxpayers should have the option to defer application of the new rules until the 2010–11 income year, with taxpayers who wish to do so being able to use the new rules for the 2009–10 income year.

Comment

Officials recognise the potential problems that may result from late enactment of the bill, and have discussed the issues with a range of firms and professional advisers. Allowing taxpayers to use either the current rules or the rules contained in the bill for the 2009–10 income year may appear attractive but there are some significant problems with this option.

An "elective" option would not do away with uncertainty for taxpayers. Taxpayers choosing the bill rules might need to make provisional tax payments before the final shape of those rules is known, and so could face use-of-money interest and possibly penalties if they fail to correctly anticipate the final form of the law. A legislative approach that potentially builds in uncertainty for some taxpayers is not desirable.

A set of rules for an elective mechanism would need to be designed by officials and legislated for in the bill. Matters that would need to be addressed include the form of any election, whether an election could be revoked, how groups of CFCs would be dealt with and the interactions between different CFCs and groups using the old and new rules. Any attempt to design an elective option for such a complex area in a short period could well result in a flawed system that would create ongoing problems for taxpayers and Inland Revenue. But obviously until such a system was designed taxpayers would not be able to take a final view on whether they should elect in.

An elective option also raises compliance cost issues for taxpayers. An elective arrangement would allow taxpayers to opt into the system that provided the best overall result for them. To determine this accurately, taxpayers would need to evaluate their tax position under two different sets of tax rules.

Apart from the practical concerns and compliance problems with an elective option, it is not desirable in principle to allow different sets of tax rules to be applied to taxpayers in identical circumstances. Equity and certainty of treatment between taxpayers in the same situation should underpin the tax system.

Recommendation

That the submission be declined.

Issue: Changes to the international tax rules should not have effect until the 2010–11 income year

Submission
(53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Given the uncertainties caused by the late enactment of the bill, if taxpayers are not given the option to choose between the current rules or the rules contained in the bill for the 2009–10 income year, then the new rules should not apply until the 2010–11 income year.

Comment

Delaying application of the new rules for all taxpayers until the 2010–11 income year is one solution to problems caused by late enactment of the bill. However, the reforms as a whole are intended to help taxpayers with interests in CFCs, and some taxpayers do want the reforms to be introduced as soon as possible. These taxpayers, who have late balance dates, would be able to deal with any potential compliance problems caused by the enactment of the bill. Taxpayers with later balance dates will not need to make their first provisional tax payments for 2009–10 until after the bill's enactment, and they will have a clear idea of the bill's provisions by the time of Committee's report-back, which is scheduled for 30 June. This would make it possible to apply the new rules for 2009–10 only to taxpayers with balance dates on or after 30 June.

Recommendation

That the submission be accepted in part. Officials recognise that the uncertainty caused by late enactment of the bill potentially causes problems for taxpayers. However, these problems are particularly pronounced for taxpayers with earlier balance dates. Applying the new rules to taxpayers with balance dates from 30 June should provide certainty for all taxpayers for the 2009–10 income year and allow at least some taxpayers to benefit from the new rules at the earliest opportunity. Officials therefore recommend that the new rules should apply for the 2009–10 income year to taxpayers with balance dates on or after 30 June, with the current rules applying to taxpayers with balance dates before 30 June. The new rules would apply to all taxpayers for the 2010–11 income year.

Issue: The international tax reforms should be introduced in stages

Submission
(53 – Ernst & Young, 68 – Corporate Taxpayers Group)

The complexity of the international reforms, and uncertainty caused by the late enactment of the bill, mean it would be sensible to introduce the reforms in stages. Introducing the active income exemption for the 2009–10 income year while retaining the grey list and not applying outbound interest allocation rules for that income year would allow firms to familiarise themselves with the new rules and minimise their compliance costs.

Comment

The international tax reforms have been designed as a coherent package. The central feature of the reforms is the introduction of an exemption for active CFC income. This exemption needs to be supported by the other key elements of the package – for example, the introduction of interest allocation rules and the removal of the grey list and conduit rules. It is not possible to pick out certain elements of the package without disturbing the balance of the package as a whole, with a risk of substantial revenue loss to New Zealand.

Recommendation

That the submission be declined.

Issue: Attributed CFC income should be removed from any use-of-money interest calculation for 2009–10

Submission
(67 – New Zealand Institute of Chartered Accountants)

In the calculation of unpaid tax for use-of-money interest, any attributed CFC income should be excluded for the 2009–10 income year if the taxpayer has had no exposure to the CFC rules previously. It would be unfair to charge use-of-money interest in relation to attributed CFC income given the late enactment of the bill.

Comment

Officials recognise that it is difficult for taxpayers to calculate their provisional tax liabilities before the final form of the new rules is known. However, excluding all attributed CFC income from use-of-money interest calculations for some taxpayers would not be appropriate. It is preferable to find a solution that gives all taxpayers with CFCs certainty about their overall tax treatment for the 2009–10 income year. For this reason, we recommend that the rules in the bill should apply to taxpayers with balance dates on or after the date of the bill's report-back – that is, 30 June. This should ensure that there are no significant compliance concerns around provisional tax payments and use-of-money interest.

Recommendation

That the submission be declined.

EXEMPTIONS FROM REQUIREMENT TO ATTRIBUTE

Overview

Under the proposed new rules, the passive income of a controlled foreign company (CFC) is attributed to its New Zealand owners and taxed. However, there will be no attributed income from some CFCs, even if they have passive income. These are:

- CFCs that pass an "active businesses test";
- most CFCs that are resident in Australia; and
- certain CFCs in the business of insurance that have obtained a determination from Inland Revenue.

Active business test (5 percent test)

Under the active business test, a CFC is classified as an active business, and none of its income will be attributed if its passive income is less than 5 percent of its total income. This relieves a taxpayer from the requirement to calculate attributed CFC income if the CFC's passive income is incidental to the CFC's other income. We consider the 5 percent threshold is generous; it would enable a typical active business to have a significant portion of its assets earning passive income.

A CFC's passive income and total income may be measured, for the purposes of the test, using either tax rules or – in most cases – information from audited financial accounts. The option to use financial accounts is intended to reduce the cost of carrying out the test, since much of the necessary information will have already been prepared for non-tax purposes.

It is possible, in many cases, to consolidate CFCs by country for the purposes of the test. This may be an advantage to a taxpayer if there is a holding company in a particular country that receives passive income from other active CFCs in that country. By consolidating the CFCs, the passive income is not counted.

Once enacted, the active business test will be monitored to ensure it is achieving its aims. We expect there will be some changes to the test over time.

CFCs resident in Australia

The "grey list" for CFCs has been repealed as part of the reforms in the bill, but CFCs resident in Australia will continue to be exempt from attribution of passive income.

The Australian exemption is justified because a lot of smaller businesses use Australia as their first option when expanding offshore. For those businesses, the compliance costs of carrying out an active business test are likely to be proportionately higher than for larger businesses, and so a country exemption is particularly beneficial.

The Australian exemption applies if the CFC is subject to tax in Australia, and is not taking advantage of certain tax concessions in Australia, such as those relating to overseas branches.

Insurers that have obtained a determination

Income from insurance business is passive income under the new rules. However, taxpayers can apply for a determination from the Commissioner that an insurance CFC is an active business.

The criteria for obtaining a determination are intended to limit the insurance exemption to cases in which the CFC generates all or nearly all of its income from premiums covering risks in its country of residence and from investment assets used to back the insurance. The exemption is not intended to apply to so-called "captive insurers", which typically insure the risk of only a related party or related parties.

Issue: Accounting-based active business test is too complex

Submission
(35 – PricewaterhouseCoopers, 62 – Minter Ellison Rudd Watts, 66 – Telecom, 67 – New Zealand Institute of Chartered Accountants)

The accounting-based active business test is too complex and too many adjustments to the accounting measure are required.

Comment

The accounting-based active test is supposed to be a relatively low-cost filter that prevents taxpayers with active CFCs from having to complete attributable income calculations for those CFCs.

To make the test low-cost, accounting information can be used. Adjustments are then made to that information to achieve an approximation to tax measures of passive and total income.

Submissions argue that the adjustments are onerous and that the test will not be low-cost if adjustments are required. Officials agree that there will be situations in which the adjustments in the bill will not be straightforward.

We therefore recommend a number of changes to the accounting-based test to reduce the cost of applying the test. These changes should mean that taxpayers can make more use of unadjusted summary financial reporting information. The changes to the legislation appear small, in the sense that they do not require major redrafting. However, we understand they will make a significant difference in practice, particularly in combination with the change recommended in the next submission (which will allow people to place greater reliance on audited accounts).

The recommended changes are that:

- derivative gains and losses be included, rather than just gains;
- derivative gains and losses be included only when they affect the income statement (not when they are temporarily recognised in an equity reserve);
- gains and losses on non-derivative financial assets be included, rather than just gains;

- more gains and losses on derivatives be included in gross income;
- references to “tax calculations” be removed from compulsory adjustments in most cases;
- there no longer be any compulsory downward adjustments to passive income or upward adjustments to total income (with one exception; see the next point on shares);
- net gains on shares not be included in the test unless the shares are held on revenue account (this is not a change, but is mentioned for clarity);
- certain personal services income be removed from the test entirely, but is always taxable.

Derivatives and non-derivative financial asset changes

Allowing the use of net gains and losses on derivatives and non-derivative financial assets simplifies the rules for two reasons. First, ledger accounts are frequently prepared on a net basis and it is therefore more likely they will be able to be used without adjustment. Secondly, it recognises that businesses often hedge risk and report their accounts net of hedging gains or losses. Example 1 illustrates this process.

Example 1: Gains and losses on a derivative instrument

A CFC makes sales in US dollars but plans to convert its sales income to New Zealand dollars and wishes to be sure about the amount it will receive. In the next three years, the CFC expects to make sales of US$100 per year. The CFC enters foreign exchange contracts, at the beginning of each year, to pay US$100 and receive NZ$200 at the end of the year (a forward exchange rate of 0.50 in each year).

In the first year, the actual exchange rate at the end of the year is 0.80 and there is a gain on the exchange contract. In the second year, the actual rate is 0.50. In the third year, the actual rate is 0.40 and there is a loss on the contract. Actual sales in all years are US$100, as expected. Table 1 summarises the outcomes.

Table 1

	Year 1	Year 2	Year 3
Exchange rate	0.80	0.50	0.40
Sales income (NZD)	$125	$200	$250
Hedge gain/(loss)	$75	$0	($50)
Reported sales income (per accounts)	$200	$200	**$200**
Existing test (gross)			
Sales income	$125	$200	$250
Derivative gains (gross)	$75	$0	$0
Total income for test	$200	$200	**$250**
Proposed change (net)			
Sales income	$125	$200	$250
Derivative gains (net)	$75	$0	($50)
Total income for test	$200	$200	**$200**

The sales revenue figure reported in the accounts is NZ$200 in each year, being the actual revenue when converted at the actual exchange rate, plus the gain or loss on the foreign exchange contract.

Under the rules in the bill, which bring in gains on derivatives but not losses, the NZ$200 figure could not be used in the accounting-based active business test in year 3. The taxpayer would have to “unpick” the derivative loss from the reported sales revenue. With the proposed change, the NZ$200 figure could be used in all years, allowing summary reporting information to be used in all cases.

The recognition of derivative gains and losses only when they affect the income statement will reduce the volatility of the passive income and total income measures used in the test.

The change to the treatment of derivatives and non-derivative financial assets will not necessarily make the test easier in all situations. For accounting purposes, hedge accounting can only be used when there is proper documentation of a hedge at the outset. Some businesses, while actively hedging risks, prefer not to incur the overhead of documenting their hedges and do not use hedge accounting. Their hedges will always affect the income statement immediately, and hedge gains and losses may be reported separately from the hedged item (the latter is an accounting policy choice rather than a strict rule). There does not appear to be any way to further simplify the test in these cases, but a taxpayer who feels that undue volatility is introduced by this treatment is free to use the tax-based active business test, which contains alternative options for calculating derivative gains and losses.

As currently drafted, the bill places limits on the derivative gains that can be included in total income for the purposes of the active business test. In particular, the derivative gains must be classified as revenue under the applicable accounting standard. This is inappropriate. Derivative gains and losses should be included where the derivative is in a hedge relationship, which need not be accounted for using hedge accounting, with other components of total income. In most cases, this will mean that all derivative gains and losses are included in total income, other than those relating to hedges of liabilities or expenses. This should considerably simplify the test.

Fewer references to tax calculations

The bill requires adjustments to the basic accounting measures of passive income and total income. Many of these adjustments are calculated using tax concepts and measures, by reference to the tax-based active business test or the calculation of attributed CFC income.

For example, section EX 20E(8)(c) adds, to the basic accounting measure of passive income, "income from the alienation of revenue account property that is included in the attributable CFC amount for the accounting period under section EX 20B(3)(j)". Section EX 20B(3)(j), in turn, refers to "income from the alienation of revenue accounting property […] capable of giving rise to income of the CFC referred to in another paragraph of this subsection [being EX 20B(3)]". Strictly speaking, this requires taxpayers to work out whether revenue-account property would give rise to passive income under the tax-based active business test.

Officials recommend that references to the tax-based test be removed where possible. In particular:

- that derivative income should only be included if it hedges a component of passive or total income[2] under the accounting-based test, if the derivative was not entered into in the ordinary course of business, or if the derivative is held for a business of dealing; and

[2] Derivative income will be included in passive income if the derivative is hedging a component of passive income. Derivative income will be included in total income if it is hedging a component of total income.

- that gains on revenue-account property should be included only if the property is capable of giving rise to passive income under the accounting-based test.

Some references to tax concepts remain. For example, the concept of revenue-account property comes from tax. Officials do not expect that many CFCs, particularly not those engaged in active business, will have revenue-account property that would generate passive income or revenue-account shares, and most CFCs will know if they have.

Adjustments made optional

Officials recommend that the legislation clarify that downward adjustments to passive income and upward adjustments to total income be optional. Many CFCs will pass the active business test without having to make these adjustments. The option to make the adjustments should be maintained, however, because some CFCs that are in substance engaged in active business would not pass the test without it.

Exclusion of most gains on shares

Officials wish to clarify that net gains on shares, which could include a loss, should be excluded from both passive and total income unless the shares are held on revenue account. These are already excluded in the bill, but the change from gross gains on financial assets to net gains (see earlier comments on this submission) makes this requirement even more necessary. Otherwise net losses on share investments could be used to shelter passive income. Most gains on shares are not taxable and most losses are not tax-deductible.

Personal services income

The active business test makes certain personal services income passive income (see section EX 20B(3)(h)). This is intended to apply where the CFC is essentially a vehicle for personal services delivered by a New Zealand resident, with little or no substantial business of its own. The active income exemption is not intended to apply in these circumstances. Officials recommend that the adjustment for personal services income be removed from the accounting-based active business test, but that a New Zealand resident owning a company that has such income will always be taxable. Officials have made a submission on this point.

Limits on change

The accounting-based test, while intended to be a low-cost filter, is also intended to be a reasonable proxy for the result that would be obtained if tax concepts were used. There is a trade-off between the simplicity of the test and the risk that significant tax liabilities could be avoided. If the balance tips too far towards the latter, there is a risk that firms will have greater incentives to move domestic activities abroad purely for tax reasons. The purpose of the international tax reforms is to remove disincentives to overseas business expansion from a New Zealand base; they are not intended to go further and provide a strong incentive to move domestic activity offshore.

Officials do not favour the "safe harbour" option presented in another submission made by the New Zealand Institute of Chartered Accountants. This would be an oversimplified test and would not be a reasonable proxy for a tax-based test.

Increased risk of revenue loss

The simplified test does introduce an element of risk that passive revenue will be sheltered. This passive revenue could include income that is currently taxed as domestic income but is shifted abroad as a result of the new rules.

If such sheltering does occur, and Inland Revenue will be actively monitoring the use of the new rules, it will be necessary to change the test. This may involve more complex rules.

Recommendation

That the submission be accepted, and that the accounting-based active business test be simplified as officials have described.

Issue: Use of reporting currency in the tax-based active business test

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section EX 21(4) should permit a taxpayer to use the reporting currency to determine the active:passive ratio.

Comment

Section EX 21(4), as drafted, would require the use of the CFC's functional currency. This is the currency that would be used under International Financial Reporting Standards.

Officials consider that this poses a revenue risk,[3] and recommend reverting to the existing rules for currency conversion for CFCs. Our comment on the New Zealand Institute of Chartered Accountant's submission about aligning the rules for determining passive income for the CFC attributable amount, provides more information.

Recommendation

That the submission be accepted in part, by reverting to the existing rules for currency conversion for CFCs.

---

[3] The revenue risk is examined in greater detail in the following submission.

Issue: Reliance on audited accounts to show compliance with standards

Submission

(32 – KPMG, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

Financial reports prepared under International Financial Reporting Standards (IFRS) or their equivalent (IFRSE), or Generally Accepted Accounting Principles (GAAP) should be taken as correct for the purposes of the active income test.

Comment

The new rules require compliance with IFRS, IFRSE or GAAP if the accounting-based test is being used. If a set of audited accounts is found not to comply with the relevant standards, because of an oversight by the auditor or for other reasons, then this requirement will not be met. This may lead to a taxpayer having to undertake detailed calculations and could lead to shortfall penalties if those calculations reveal that tax should have been paid.

The submission states that accounting information used to prepare financial reports should be taken as being correct.

The policy intent is that taxpayers that use the accounting-based active business test should normally be able to rely on accounting information that has been used to prepare audited financial reports.

The explanatory memorandum for Australia's recent Taxation of Financial Arrangement reforms states (paragraph 5.23):

> Whether or not a taxpayer's financial reports have been prepared in accordance with relevant accounting standards is a question of fact. However, where an entity purports to have prepared a financial report in accordance with relevant accounting standards and there is an unqualified auditor's report in respect of the financial report, the auditor's report will ordinarily be indicative of, but not necessarily conclusive of, the fact that the financial report has been prepared in accordance with the relevant accounting standards.

Officials expect that an unqualified auditor's report would carry similar weight in the new rules and recommend that this observation be reflected in the legislation. The audit requirement has been introduced specifically to provide Inland Revenue with greater confidence that financial accounting standards have been met. Accordingly, an unqualified audit opinion should be taken as strong evidence of compliance.

However, officials do not recommend a blanket rule that audited accounts are always to be taken at face value. There could be situations, particularly in countries with lax regulation of the accounting profession, in which the lack of compliance leads to a significant misstatement of the true position.

Officials recommend instead that an unqualified audit opinion be taken as evidence of compliance with applicable accounting standards unless there is a reasonable suspicion of fraud, intent to mislead, lack of auditor independence, or auditor incompetence. Inland Revenue may develop administrative guidance, such as a standard practice statement, to provide further certainty for taxpayers.

An audit may be carried out at the individual CFC level or, when information from consolidated accounts is used, at the consolidated level. In the latter case, it is acknowledged that auditors will sometimes not audit an individual CFC if it makes a very small contribution to the overall entity (that is, it is immaterial). This does not, on its own, disqualify the entity from using the accounting-based active business test.

In conjunction with the recommended change (to increase reliance on audited accounts) we further recommend that the accounting-based active business test be able to be used only for accounts that have received an unqualified audit opinion.

The provisions in the bill would also allow "except for" opinions. "Except for" audit opinions were originally included because these are sometimes given to smaller organisations that deal in cash, simply because it is not possible to give assurance that all cash has been properly accounted for. For example, clubs and societies that charge event entry fees "at the door" may be in this situation. However, it seems unlikely that many CFCs would be in such a situation, and those who are may use the tax-based active business test.

There are domestic and overseas precedents for requiring an unqualified opinion when audited accounts are used for tax purposes.

Recommendation

That the submission be accepted, subject to the limitations and conditions outlined above.

Issue: Anti-avoidance rule for manipulation of accounting test

Submission
(Matter raised by officials)

An anti-avoidance rule should be introduced to prevent taxpayers manipulating the accounting-based active business test.

Comment

Our assessment is that changes recommended to the accounting-based active business test increase the potential for loss of tax revenue owing to manipulation of the test. For example, allowing net losses on derivatives or non-derivative financial assets to be used in the test could permit other sources of passive income to be sheltered by artificial transactions.

We recommend that a specific anti-avoidance rule be added to the legislation to discourage such manipulation. This would apply only when an arrangement was entered into with the purpose of enabling a CFC to satisfy the active business test under calculations using the financial accounts. It is aimed at serious abuse of the new rules.

The effect of the rule, if it applied, would be to require a full tax calculation for the CFC in question.

We would not expect the rule to apply when a transaction was undertaken in the ordinary course of an active business, because the purpose of such a transaction would not be to enable a CFC to pass the accounting-based test.

Recommendation

That the submission be accepted.

Issue: Financial arrangements with related parties

Submission
(Matter raised by officials)

An anti-avoidance rule should be introduced to prevent taxpayers using loans between related parties with different functional currencies to shelter passive income.

Comment

A specific weakness of the accounting-based active business is exposed when one CFC provides a loan to an associated CFC (or to an associated New Zealand resident) that is denominated in the functional currency of one of the CFCs (or New Zealand dollars, in the case of the resident) and not in the functional currency of the other party. The loan may be a back-to-back loan via a third party. In this situation, there can be an overall net loss for New Zealand tax purposes, even though there may be no economic loss. This loss can be offset against (used to shelter) passive income.

Requiring taxpayers to revalue all significant financial arrangements in New Zealand dollars, which is the recommended treatment under the tax-based test, is not a practical option in the accounting-based test, because the test is supposed to be simple to apply, using existing financial accounting information.

Instead, we propose a specific anti-avoidance rule that applies to such transactions when there is an intent to defeat the application of the CFC rules. The rule would force a full tax calculation.

The effectiveness of the rule in preventing abuse requires monitoring over time.

Recommendation

That the submission be accepted.

Issue: Size of entity below which there should be no passive income

Submission
(67 – New Zealand Institute of Chartered Accountants)

A minimum threshold for small businesses should be included in the provisions, below which passive income does not arise.

Comment

The submission proposes that taxpayers with CFCs should not have to pay tax on any attributed CFC income, regardless of the activities of the CFC, if the amount of passive income is small in absolute terms, or small relative to the taxpayer's New Zealand income.

This could enable taxpayers to shift passive investments into foreign investment vehicles they own to escape New Zealand tax. This is not the purpose of the international tax changes and would undermine the New Zealand tax base.

Recommendation

That the submission be declined.

Issue: Simpler test for small and medium-sized enterprises (SMEs)

Submission
(67 – New Zealand Institute of Chartered Accountants)

There should be a simpler definition of "passive income" and a simpler "active business" test for SMEs.

Comment

The submission argues for a simpler test for smaller entities. It suggests that passive income be limited to interest, royalties, rent, dividends and base company income. This would not necessarily make it easier for a small entity to undertake the test. For example, the line item "interest revenue" in financial reports may include hedging gains or losses. By not including derivative income in the test, summary accounting information could not be used in this case. Officials prefer a single accounting-based test, for businesses of any size, that is as simple as possible.

Recommendation

That the submission be declined.

Issue: The active business test threshold should be higher than 5 percent

Submissions

(35 – PricewaterhouseCoopers, 38 – Council of Trade Unions, 66 – Telecom, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

The complexity of the active business test calculations should be weighed against the active income threshold and/or the threshold should be raised from 5 to 10 percent. *(PricewaterhouseCoopers, Telecom, New Zealand Institute of Chartered Accountants, Corporate Taxpayers Group)*

The threshold should not be increased above 5 percent. *(Council of Trade Unions)*

Comment

Most of the submissions recommend that the threshold should be higher. Alternatively, it is argued that the threshold should be higher if the test is more complex or requires a greater level of accuracy.

Officials acknowledge the concern about the complexity of the test, but our preference is to simplify the test rather than increase the threshold. This is because:

- There is a relatively narrow definition of "passive income", with numerous optional exclusions, which makes it less likely that the threshold will be exceeded.
- While the figure of 5 percent may seem low, this threshold would allow a typical business to have a substantial portion of its assets earning passive income, because the gross return on typical passive investments is much lower than the gross return on typical active investments.[4]
- The 5 percent threshold level is comparable with thresholds in Australia and the United States.
- Even if a CFC fails to meet the 5 percent test, only passive income is attributable (there is no tax on the active income of the CFC). One submission noted that the effective threshold is higher than 5 percent in the United Kingdom. However, in the United Kingdom, if a CFC fails to qualify as an active business, then *all* its income is attributable.
- A threshold of more than 5 percent could move away from the whole purpose of the reform, which is to remove impediments to expanding businesses based in New Zealand, to one that encourages "off-shoring" of domestic activity (a point that the Council of Trade Unions makes in its submission).

Recommendation

That the submissions be declined.

---

[4] For example, if the active business activities of the CFC generate a gross return of 75 percent on assets employed in those activities, and the passive investments of the CFC generate a return of 10 percent, up to 28 percent of the CFC's assets could be passive investments before it would fail the active business test. The 75 percent assumption is considered realistic – the average gross returns for non-financial private sector New Zealand businesses, including both passive and active returns, were 80 percent, 77 percent and 77 percent in the years 2004, 2005 and 2006 respectively.

Issue: Audit requirement

Submission

(35 – PricewaterhouseCoopers, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

A taxpayer should not be required to have audited accounts to calculate the active business test.

Comment

The proposed rules require taxpayers to meet certain requirements before they can use the active business test based on financial accounting information. One of those is that the accounts must have been audited by a chartered accountant (there is no such requirement if using the active business test based on tax concepts). The audit must result in an unqualified audit opinion, or another opinion that is neither an adverse opinion nor a disclaimer of opinion. If the accounts were prepared overseas, overseas equivalents to "chartered accountant", "unqualified opinion", "adverse opinion" and "disclaimer of opinion" are acceptable. The audit requirement applies whether the accounts are prepared in compliance with IFRS or in compliance with pre-IFRS (old GAAP) New Zealand accounting standards.

The audit requirement is included to give Inland Revenue confidence that numbers used in the accounting-based active business test meet certain standards. It would be inefficient and costly for Inland Revenue auditors to attempt to police compliance with financial accounting standards.

Audit requirements are present in some other tax legislation.

In New Zealand, the use of the accounting profits method for calculating foreign investment fund income (see section EX 46(2)) is only permitted if the accounts have been audited and the result is an unqualified audit opinion.

In Australia, amendments relating to the taxation of financial arrangements were recently enacted. These require an audit in accordance with auditing standards before several methods based on financial information can be used (see section 230–210(2) of the Income Tax Assessment Act 1997, *Fair value election*, for example). These new rules also require an unqualified audit opinion in some cases (see section 230–215, *Fair value election, where there are differing income and accounting years*, for example).

It is a requirement of the Companies Act that accounts are audited by a chartered accountant, but most closely held New Zealand-owned companies can elect – by unanimous vote of all shareholders – not to have an audit.

One submission notes that some taxpayers, and particularly those with smaller businesses, may make this election not to have their accounts audited because the audit is not perceived to add value to the business. These taxpayers, as the submission also notes, can use the tax-based active business test. Smaller businesses would typically be expected to have relatively uncomplicated structures, which will reduce the cost of applying the tax-based test.

Officials note that there is a further submission from the New Zealand Institute of Chartered Accountants on this issue, suggesting a less costly alternative to a full audit. Officials have recommended that the alternative be investigated for possible inclusion in a future tax bill.

Recommendation

That the submission be declined.

Issue: Which accounts must be audited

Submission
(32 – KPMG)

Proposed section EX 21E(2)(d) provides that the CFC test group accounts must be audited. The legislation should accept that it is sufficient if the New Zealand group accounts, which include the CFC test group, are audited.

Comment

Section EX 21E(2)(d) requires that audited and consolidated accounts that include the accounts of the CFC are prepared. Officials have recommended clarification of this point in response to another submission. As a result of that recommendation, New Zealand group accounts, containing the accounts of the CFC group and possibly the accounts of other entities, should be acceptable if they are audited.

Recommendation

That the submission be accepted in part, and that the legislation be clarified.

Issue: Alternatives to audit requirement

Submission
(67 – New Zealand Institute of Chartered Accountants)

An audit certification approach could be considered rather than a full audit.

Comment

The submission suggests that an auditor could sign a certificate confirming the basis on which the accounts of the CFC have been prepared and that they meet the requirements of the applicable accounting standards.

If an audit certification could give reasonable assurance of compliance with financial accounting standards, but at a lower cost to the taxpayer than a full audit, this might be acceptable. However, at present it is unclear how much assurance could be provided by a certification approach. Officials recommend that this approach be investigated in the second phase of the international tax review.

Recommendation

That the submission be noted, and that an audit certification approach be investigated in the second phase of the international tax review.

Issue: Independence of auditor when audited accounts used

Submission
(Matter raised by officials)

The audited accounts required for the accounting-based active business test should be audited by an independent auditor.

Comment

Accounting information used in the accounting-based active business test must be taken from audited accounts.

There should be a requirement that the auditor is independent of the CFC, related CFCs and the taxpayer. Officials understand that such independence would typically be required by New Zealand audit standards.

Recommendation

That the submission be accepted.

Issue: Use of alternative financial reporting standards

Submission
(30 – Staples Rodway, 67 – New Zealand Institute of Chartered Accountants)

Accounting standards specific to the CFC's country should be able to be used in the active business test.

Comment

For most large organisations, only accounts that comply with International Financial Reporting Standards (IFRS) may be used in the accounting-based active business test.

For many smaller companies, pre-IFRS New Zealand accounting standards ("old GAAP") are also permitted.

Submissions were made before the introduction of the legislation, asking that other standards such as US GAAP also be permitted. Officials recommended against this at the time. Allowing the use of further standards risks complicating the new rules, would be expensive and would require ongoing monitoring of those standards to ensure no large gaps between the accounting-based amount of passive income and the amount that would be calculated if the tax-based measure were used.

IFRS is either a required or permitted set of accounting standards in over 100 countries. In addition, companies in New Zealand that have CFCs will commonly prepare consolidated financial accounts that comply with IFRS and include the accounts of CFCs, even when the CFCs themselves are not required by the law in their jurisdiction to produce IFRS-compliant information. Information from these consolidated accounts is normally allowed to be used for the active business test. Finally, if IFRS and "old GAAP" accounts are not available, the taxpayer has the option to use the tax-based active business test.

Recommendation

That the submission be declined.

Issue: Pre-requisites for use of "old GAAP" accounting standards

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

In section EX 21C(6), the requirements to use "generally accepted accounting principles (GAAP) without IFRS" should be linked to ASRB 9.

Comment

Financial information used in the accounting-based active business test must be compliant with relevant financial standards. Typically this means compliance with IFRS, but a concession was made for most small and medium-sized companies (SMEs). These companies are not required to adopt IFRS as a result of the government's review of reporting requirements for SMEs and can use pre-IFRS New Zealand financial reporting standards (old GAAP). ASRB Release 9 sets out the companies that are not required to adopt IFRS for this reason.

ASRB Release 9 is insufficient on its own. The bill sets out the minimum conditions that must be met. Setting out the conditions in legislation rather than incorporating them by reference will ensure that the conditions still apply if the ASRB release is updated to remove requirements. The legislation also imposes some additional requirements: because old GAAP has significant gaps in its coverage, relative to IFRS, the use of IFRS is strongly preferred when possible. The legislation therefore

requires companies to use IFRS if they have IFRS information available, even if they are covered by ASRB Release 9 (some SMEs will voluntarily adopt, or have voluntarily adopted, IFRS).

The commentary to the bill explained that the use of old GAAP is intended to be a temporary measure.

Recommendation

That the submission be declined.

Issue: Requirement to not have IFRS accounts if "old GAAP" standards are to be used

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section EX 21C(6)(f) is superfluous given section EX 21C(6)(e).

Comment

The requirements are different, but we accept that if a person is required to prepare accounts using IFRS, they will usually prepare them. In this case, section EX 21C(6)(f) is redundant. We recommend that sections EX 21C(6)(f) and EX 21C(7)(f) be removed.

Recommendation

That the submission be accepted.

Issue: Common ownership requirements for consolidation in the active business test

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

The common ownership threshold for consolidation in the active business test should be clarified, and based on income interests rather than voting interests.

Comment

The rules in section EX 21D allow the taxpayer to consolidate certain CFCs for the purpose of the tax-based active business test.

Consolidation is permitted only when the taxpayer has a voting interest of more than 50 percent in each of the CFCs to be consolidated.

This means that where a CFC has two (or more) New Zealand owners, at most one of them will be able to consolidate the CFC for the purposes of the active business test. For the time being, this is the intended result. If more than one person could consolidate a CFC, there is potential for complex interactions that have not yet been analysed. If the two owners feel that consolidation is necessary, forming a company in New Zealand and selling the CFCs to be consolidated to that company is one option they could pursue.

Officials agree that we should use "income interest" rather than "voting interests" to determine whether or not the taxpayer has an interest of more than 50 percent.

Recommendation

That the submission be accepted in part, by substituting "income interest" for "voting interests".

Issue: Accounting pre-requisites for consolidation under the tax-based test

Submission
(26 – Fonterra, 35 – PricewaterhouseCoopers, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

There should be no requirement to produce consolidated financial accounts in order to group CFCs in the tax-based test.

Comment

The New Zealand taxpayer may choose to consolidate certain CFCs for the purpose of the tax-based active business test. This is purely optional.

There is no requirement in section EX 21D that the CFCs are also consolidated for financial reporting purposes. However, section EX 21D(1)(c) states that if CFCs are consolidated for tax purposes, the tax consolidation must use uniform accounting policies for similar transactions and for other events in similar circumstances. "Accounting policies" in this context means tax accounting choices, but officials accept that this may be unclear and should be clarified.

As an example of an accounting policy choice in the context of the tax-based active business test, two CFCs to be consolidated might be parties to the same financial arrangement. Both would need to use the same option for accounting for that arrangement under subpart EW.

In other words, section EX 21D(1)(c) is an explanation of how the tax consolidation is to be done, rather than a requirement that there also be consolidation in financial accounts. (There are existing tax consolidation rules in the Income Tax Act 2007, but they relate to New Zealand-resident companies, are relatively complex, and have specifically not applied to CFCs in the past.)

Recommendation

That the submission be accepted in part, and that the meaning of "accounting policies" in the context of the tax-based test should be clarified.

Issue: Treatment of nil income in the active business test

Submission
(35 – PricewaterhouseCoopers, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

Businesses should not fail the active business test merely because they have nil income. There should be consistent treatment in both the tax-based and accounting-based tests.

Comment

Sections EX 21D(2)(b) and EX 21D(3)(f) effectively treat a CFC as not being an active business if the denominator in the tax-based test statistic – passive income divided by total income – is nil.

Submissions argue that this should not happen.

With the current active business test based on gross amounts (no losses or expenses are taken into account) passive income should never be less than total income. Therefore, total income can only be nil if active income is also nil, unless there is an unexpected oversight in the rules. If active income and passive income are both nil, there is a strong likelihood that the entity is dormant. It is therefore not engaged in an active business. There will probably, but not definitely, be no passive income to attribute.[5] It should not be hard to determine this. If there is an unexpected oversight in the rules, it is intended that a full tax calculation should be undertaken.

Example

A CFC has no income (no gains on financial arrangements and no other income). It does not pass the active business test, since it has no active business. The attribution calculation in this case is trivial – the CFC has nil passive income under section EX 20B.

[5] If a CFC is allowed deductions under section EX 21D there may be a net attributed loss.

Sections EX 21E(2)(c) and EX 21E(4)(h) effectively treat a CFC as not being an active business if the denominator in the accounting-based test statistic is nil. The same arguments apply in this case, but are academic if other submissions relating to the use of net amounts (bringing in some losses) are accepted. In that case, both passive income and total income can be nil or negative, and different rules are required.

Recommendation

That the submission be declined.

Issue: Removal of minority interest in consolidation for the test

Submissions
(32 – KPMG, 35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

Minority interests should not have to be removed when consolidating CFCs for the active business test, or alternatively should not have to be removed unless they are substantial.

The term "minority interest" is inappropriate in the tax test. *(PricewaterhouseCoopers)*

Comment

Section EX 21D allows the consolidation of certain CFCs for the purpose of the tax-based active business test. Section EX 21E allows similar consolidation for the purposes of the accounting-based active business test.

Minority interests are removed to prevent the sheltering of passive income by a larger amount of active income that is not truly referable to the taxpayer undertaking the consolidation. All minority interests are required to be removed. Having a minimum threshold would facilitate a certain level of sheltering of passive income, which is not the intention of the new rules.

The term "minority interest" is a financial accounting term. Removal of the minority interest means that only part of the CFC's income is included in the test. For the purposes of the tax test, the part of the CFC's income to be included is the part that relates to the person's income interest. Officials recommend that the tax-based test be altered to use the term "income interest".

By definition, no removal of any minority interest will be necessary when the CFCs to be consolidated are 100 percent owned by a single entity, as will commonly be the case.

When there is a minority interest, explicitly requiring its removal provides more certainty than a specific anti-avoidance rule (such as a rule that requires removal of the interest only when there is an overriding intent to shelter passive income).

We are not aware of any specific examples where removal of a minority interest would be impractical. However, if explicit removal proves too difficult, it is noted that consolidation of CFCs is not compulsory. No removal of minority interests is necessary if there is no consolidation, since the test statistic is unaffected by the income interest of the taxpayer.

Recommendation

That the submissions be accepted in part, by replacing the test based on "minority interest" with one based on "income interest".

Issue: Conversion of foreign currency amounts into presentation currency in the accounting-based test

Submission
(67 – New Zealand Institute of Chartered Accountants)

The rules for currency conversion when using consolidated accounts in the accounting-based active business test should be alternatives (use average rates for the period or rates specified by the applicable standard).

Comment

Most entities within a jurisdiction will use the same functional currency (often the local currency), but in a minority of situations this may not be the case.

When accounts of different entities are consolidated using IFRS, and those entities have different functional currencies, foreign exchange differences will arise when amounts are translated from those functional currencies into a common presentation currency.[6]

To avoid these differences contaminating the active business test, section EX 21E(4)(g) specifies conversion of amounts from the functional currency to the presentation currency at an average exchange rate. That section also specifies that if amounts are to be converted into the functional currency before translation to the presentation currency, the normal rules in the applicable accounting standards apply to that earlier conversion. This is the intended treatment.

The effect of translation from the functional to presentation currency at an average rate is that, in substance, the functional currency is always used.

Recommendation

That the submission be declined.

[6] This can also occur if the entities have the same functional currency but a different presentation currency is chosen.

Issue: Worldwide consolidation of CFCs

Submission

(30 – Staples Rodway, 40 – Fisher & Paykel Healthcare, 68 – Corporate Taxpayers Group)

Worldwide consolidation for the 5 percent test (as opposed to the current jurisdictional approach) should be allowed.

Comment

Sections EX 21D(1) and EX 21E(2) allow CFCs to be consolidated for the active business test if certain requirements are met. One requirement is that the CFCs are resident in the same country or territory. The submission is that this requirement should be removed.

Allowing worldwide consolidation would effectively sanction the sheltering of up to 5 percent of a group's total income in tax havens. The ability to consolidate is not provided for this purpose. Rather, consolidation is allowed as a measure to reduce the costs of undertaking the active business test.

Allowing worldwide consolidation also poses other problems. For example, a passive transaction between a CFC in a high tax jurisdiction and a CFC in a low tax jurisdiction could be tax deductible to the first CFC under the tax rules in its jurisdiction but not taxable to the second CFC under the different rules in its jurisdiction. Consolidation across countries would mean the New Zealand rules would "not see" the transaction and would ignore it, but it would have produced a tax advantage for the CFC. This would go further than the aim of the reform, which is to remove impediments to the global expansion of business from a New Zealand base. Instead, such consolidation would actively encourage "off-shoring" of domestic activity.

Tax treatment is much more likely to be symmetrical between CFCs in the same jurisdiction.

Recommendation

That the submission be declined.

Issue: Requirement to have consolidated accounts to group CFCs in accounting-based test

Submission

(26 – Fonterra, 32 – KPMG, 68 – Corporate Taxpayers Group)

CFCs should not need to be consolidated for financial reporting purposes in order to be grouped for the purposes of the accounting-based active business test.

Comment

Section EX 21E allows a taxpayer to consolidate certain CFCs into a "test group" for the purpose of the accounting-based active business test. This simplifies the application of the test when pre-prepared accounting information is available at a consolidated level, such as when a group produces segmental reporting by country.

Section EX 21E(2)(a) requires that CFCs included in a test group are required to be consolidated under the applicable accounting standard. Section EX 21E(2)(d) requires that consolidated and audited accounts that comply with applicable standards are actually produced for the test group.

The consolidation rules in both IFRS and old GAAP generally require consolidation of entities that are under common control. Since CFCs are, by definition, controlled by the taxpayer, it will be common for two CFCs of the taxpayer to be able to be included in a test group (when they are in the same country), as long as consolidated accounts are actually produced.

There might be situations in which consolidated accounts that include the accounts of the test group and other entities are prepared. Information from these accounts is adequate for the purposes of the test. It is not a requirement that consolidated accounts be prepared for only the members of the test group. Officials recommend that this be clarified.

There could also be situations in which the accounts from which information for the test is taken, are not required to be consolidated. For example, if an individual New Zealand resident directly owns two CFCs in a foreign country (not through a resident company, with neither CFC being a subsidiary of the other), IFRS accounts may be prepared for each CFC, but there is no reporting entity that would be required to produce IFRS consolidated accounts. This is in contrast to the cases in which (1) the New Zealand resident owns the CFCs through a resident company or (2) one of the CFCs owns the other. Officials would expect these situations to be relatively uncommon.

Recommendation

That the submission be accepted in part, by clarifying that consolidated accounts prepared for a wider group than a test group are acceptable as a basis for consolidation of the relevant CFCs.

Issue: Consolidation and liability to tax in the foreign country

Submission
(Matter raised by officials)

Consolidation for the purposes of the active business test should be allowed only for CFCs that are liable to tax in the same jurisdiction.

Comment

CFCs may be consolidated for the purpose of the active business test if certain conditions are met. One of those conditions is that:

> Each [CFC to be consolidated is] subject to the laws of the same country or territory under which—
>
> (i) the company is liable to income tax on its income because of its domicile, residence, place of incorporation, or centre of management [and/or]
>
> (ii) persons holding income interests in the company are liable for the income tax on its income and the country or territory is the source of 80% or more of that income" (see sections EX 21D(1)(a) and EX 21E(2)(b)).

We consider that the second limb of the residence test in the definition should be removed. If it remains, income of an active business may not be taxed in any jurisdiction.

The same general issue is discussed in further detail in the recommendations on attributable income (see "Holding company exemptions and liability to tax in the foreign country").

Recommendation

That the submission be accepted.

Issue: Currency of CFCs when consolidating for the purposes of the test

Submission
(Matter raised by officials)

Consolidation should be possible only when consolidating entities have the same functional currency (in the accounting-based active business test) or the same currency under section EX 21(4) (in the tax-based active business test).

Comment

Taxpayers are permitted to consolidate certain CFCs in the same jurisdiction for the purposes of the active business test.

When using the tax-based test, CFCs will be required to choose a currency conversion rule according to sections EX 21(4) and EX 21(7), if an earlier recommendation of officials is accepted. If CFCs that choose different methods are allowed to consolidate, currency differences can arise when transactions between the entities are eliminated. This could bias the test. It might also be possible to manipulate the test by a suitable choice of reporting currency (indeed, this has happened in the past in a different context, leading to the enactment of section EX 21(7)).

When using the accounting-based test, CFCs will use their functional currencies, being the currencies of their primary economic environments. As with the tax-based test, when eliminating transactions between entities with different functional currencies, exchange rate differences can arise that can bias the test. There is less risk of manipulation of the test when functional currencies are used, but there is still the possibility of setting up a special-purpose entity with a particular functional currency.

Officials acknowledge that there may be situations in which the recommended limitation means CFCs in a jurisdiction cannot be consolidated. It is hoped that CFCs operating in the same country will usually make the same choice of currency conversion rule, or use the same functional currency.

Recommendation

That the submission be accepted.

Issue: Currency of entities when using the tax-based test and grouping CFCs

Submission
(32 – KPMG)

CFCs should be able to designate a common functional currency for a "test group", when consolidating for the purposes of the tax-based active business test.

Comment

The submission argues that when CFCs in the same jurisdiction have different functional currencies, the taxpayer should be able to designate a common functional currency to enable consolidation.

The use of a "functional currency", with the definition of this term being similar to the definition under IFRS, was intended to prevent a CFC from freely choosing a currency and instead requires it to use the currency of its primary economic environment. This was aimed at preventing the exploitation of exchange rate movements by a calculated choice of currency. Allowing the test group to freely choose a currency would be a move away from this principle.

Furthermore, even the restrictions imposed by a functional currency requirement are likely to be insufficient to prevent problems. Therefore, and in response to another submission, officials have recommended that the existing currency conversion rules in section EX 21(4) be used instead of the rules in the bill. Officials have also recommended, in another submission, that CFCs only be allowed to consolidate when they use the same currency under section EX 21(4).

Recommendation

That the submission be declined.

Issue: Gains and losses of financial instruments / arrangements in the test

Submissions
(30 – Staples Rodway, 32 – KPMG, 40 – Fisher & Paykel Healthcare, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

Both gains and losses on financial instruments / arrangements should be included in the test calculations. Alternatively, foreign exchange gains should not be included.

Comment

Some submissions relate to the tax-based active business test. The current drafting delivers the intended result in the case of that test. For a particular financial arrangement, there is either income for the period (typically taxable) or expenditure for the period (typically deductible), never both. Income is brought in under section EX 20B(4). Expenditure (including losses on financial arrangements) is brought in under section EX 20C. This is in line with the general scheme of the Income Tax Act, which requires calculation of income and deductions separately.

The rules in section EX 20B are also used for calculating passive income in the tax-based active business test (as recommended in another of the New Zealand Institute of Chartered Accountants' submissions). In this case, recognising only income and not expenditure gives a better indication of the character of a business.

For example, a CFC that trades derivatives as its only business could make a net loss on those trades, comprising gains on some and larger losses on others. The fact that it has made a net loss overall does not change the fact that it is engaged in a primarily passive business. The drafting of section EX 20B(4) would pick up the gains only, and so the CFC would not pass the active business test. As a positive side-effect, the CFC would then be able to calculate a loss – using both sections EX 20B(4) and EX 20C – to carry forward and offset against future passive income.

In respect of the accounting-based active business test, officials have made another submission that, if accepted, would allow net amounts to be used (that is, net of losses). This concession is made solely to enable the use of summary accounting information, such as an "interest revenue" figure in the income statement that includes a hedge gain or loss. When the tax-based test is used, the concession is not appropriate.

Foreign exchange gains on financial instruments or arrangements do need to be included in the measure of passive income. Otherwise there would be incentives to invest in assets denominated in certain low-interest rate currencies, substituting interest income (which would be passive income) for expected exchange rate gains (which would not).

Recommendation

That the submissions be declined.

Issue: Removing expenditure or loss from measures of income in the test

Submission
(53 – Ernst & Young, 68 – Corporate Taxpayers Group)

Proposed subparagraph EX 21D(5)(c)(i) should be deleted because the test is based on gross amounts.

Comment

In the tax-based active business test, only income is included (there is no "netting off" with expenditure and losses). Section EX 21D(5)(c)(i) then requires the removal of any expenditure or losses. The submission is correct in its assumption that there should be no expenditure or loss. However, the provision should remain. It is a revenue-protection measure, intended to apply if expenditure or loss has mistakenly slipped into the measure of passive income under the tax-based active business test.

Recommendation

That the submission be declined.

Issue: Inclusion of gains on financial instruments in accounting-based test

Submission
(35 – PricewaterhouseCoopers)

Proposed section EX 21E(7)(f) should be removed from the draft legislation.

Comment

Section EX 21E(7)(f) includes in passive income, for the purposes of the accounting-based active business test, gains from a non-derivative financial asset.

The submission argues that these gains should not be included because they are notional accounting entries rather than actual income and should not cause taxpayers to fail the active business test.

Officials disagree. Many of the gains on financial assets taken into account under financial accounting standards are also taken into account in the financial arrangement rules in the Income Tax Act, and under the tax-based active business test. Indeed, the default treatment under the financial arrangement rules is based on IFRS (financial accounting) treatment.

The rule only applies to financial assets such as loans to other parties, and most active businesses are unlikely to hold large quantities of such assets, particularly once the optional exclusions in section EX 21E(9) (which allows certain related-party transactions to be removed) are taken into account. Gains on financial liabilities, such as foreign exchange gains on loans taken out by firms to finance their active businesses, are not included. Gains on share investments are also not included, unless the shares are held on revenue-account.

The tax-based active business test may be used as an alternative if it provides a more favourable outcome for a particular taxpayer.

Recommendation

That the submission be declined.

Issue: Gains on derivatives in the measure of total income in the test

Submission
(67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

When calculating the denominator in the formula, income from derivatives should generally be included.

Comment

Officials agree with the submission. Derivative gains or losses should be included in total income (the denominator) when the derivative is hedging other components of total income,[7] is not entered into in the ordinary course of business or is held for a business of dealing.

[7] Total income incorporates passive income, so gains or losses on derivatives that hedge other components of passive income are also included here.

The recommended treatment would still exclude some gains or losses on derivatives that are entered into in the ordinary course of business. For example, a floating-for-fixed interest rate swap on interest payable would be excluded, since no account is taken of borrowing by the CFC, or derivatives hedging that borrowing, for the purposes of the active business test. This is appropriate. Bringing in such gains or losses would effectively be importing expenses (or financial liability movements) into the test. Expenses (and financial liabilities) are not included in the test measures of income because they are not good indicators of the character of a business; even active businesses must pay "passive" expenses such as rent, royalties and interest to carry on their trade.

It should normally be straightforward to separate hedges of income and financial assets from hedges of expenses and financial liabilities, since the risks applying to the first category will normally be opposite to those in the second category.

Officials have made separate submissions on the treatment of derivatives that hedge items in different classes, and on the treatment of the ineffective portion of a hedge.

Recommendation

That the submission be accepted, and that it be noted that officials have made related submissions.

Issue: Hedges of both passive income and other income in the active business test

Submission
(Matter raised by officials)

Where a derivative is in a hedging relationship with passive (or total) income and other items, gains or losses on the derivative should be apportioned on a fair and reasonable basis.

Comment

The active business test brings in, as passive income, gains on any derivative that is in a hedging relationship with passive income. This could bring in a gain on a derivative that hedges both active and passive income. For example, a business might hedge all foreign-currency receipts – whether sales, rent, royalty or interest receipts – against exchange rate movements using a single derivative. The rule could also bring in a derivative that hedges passive income and something that is neither passive nor total income (such as an exempt dividend).

Officials recommend that in this situation, the portion of the gain or loss attributable to a hedging relationship with something that is not passive income, be removed. The calculation of the portion should be done on a fair and reasonable basis, as shown in the example below.

A similar issue applies to a derivative in a hedging relationship with total income, because the derivative could simultaneously be in a hedging relationship with something that is not total income (such as an exempt dividend). Officials recommend that the portion of the gain or loss attributable to a hedging relationship with something that is not total income, be removed.

The adjustments increase the complexity of the test, but for at least some CFCs, not having the adjustment would incorrectly cause them to fail the accounting-based test when they have "active" derivative gains. In some cases, it could also allow CFCs to shelter passive income when they have "active" derivative losses.

The adjustment is not optional, since an optional adjustment would be a "one-way bet" – taxpayers would only use it to take out an "active" gain which artificially increases passive income, and would not use it to remove an "active" loss which artificially lowers passive income.

Officials do not expect the situation to arise often in practice, or for the amounts involved to be crucial to passing the test for a CFC carrying on an active business. This is simply because a CFC carrying on an active business will not usually have much passive income to hedge. An active CFC will not normally be receiving significant amounts of interest income or holding many non-derivative financial assets. An active CFC is more likely to receive royalty or rental income, but there are significant carve-outs from passive income for these items if they are received in the course of an active business.

The adjustment would not apply when the derivative is entered into outside the ordinary course of business or held for dealing, since the entire gain or loss should be passive income. For example, if a person takes out a foreign exchange contract to exchange NZD for US$10 million but only expects to have USD income of $1 million, there is a strong case for arguing that the derivative is not entered into in the ordinary course of business or is held for dealing.

Example

A CFC expects to have active sales income of US$10 million, passive royalty income of $1 million and USD-denominated expenses of US$6 million in a period. It takes out a forward exchange rate contract to hedge net exposure of US$5 million to exchange rate changes over the period. The forward exchange rate is USD0.50/NZD1.00.

The CFC actually receives US$9 million of sales income and US$2 million of royalty income, and has US$6 million of USD-denominated expenses during the period. The spot exchange rate throughout the period and on maturity of the contract is USD0.60/NZD1.00. There is a hedge gain of NZ$1.67 million.

The derivative is effectively in a hedging relationship with the portion of income that is not naturally hedged by expenses. The income is made up of active income (nine-elevenths) and passive income (two-elevenths). A reasonable apportionment would therefore attribute NZ$1.36 million (9 ÷ 11 × 1.67 million) of the gain on the derivative to a hedging relationship with something that is not passive income. NZ$1.36 million would be removed from passive income.
Other reasonable apportionments may exist

Recommendation

That the submission be accepted.

Issue: Treatment, in the test, of hedges that are not fully effective

Submission
(Matter raised by officials)

This submission explains the treatment of the ineffective portion of hedges because the rules in this area may not have been clearly understood. This submission does not result in any recommendation to change the rules.

Comment

Gains on a derivative that is in a hedging relationship with passive (or total) income are themselves passive (or total) income.

When a derivative is in a hedging relationship with passive (or total) income, it may not be fully effective. For example, a forward exchange rate contract might be taken out by a US CFC to exchange AUD for USD, and this might be used to hedge sales denominated in both AUD and NZD. It could be highly effective, given the normally close relationship between the AUD and NZD, but would not be fully effective if the AUD/NZD exchange rate did not remain constant.

Some submissions have requested an explanation of the treatment of the ineffective portion of hedges in the active business test.

The current wording of provisions in the bill brings in, as passive or total income (as applicable), the ineffective portion of gains or losses on derivatives that are in a hedging relationship, as well as the effective portion. Another provision removes the ineffective portion from total income, but if officials' other submissions are accepted, that provision will be removed.

Example

A CFC hedges forecast passive royalty income of US$100 million against USD/NZD exchange rate movements, using a forward exchange contract. The forward exchange rate is 0.50. The spot exchange rate when the royalty payment is received, and on maturity of the contract, is 0.80. The forecast turns out to have been incorrect, and actual royalties are only US$90 million, which is NZ$112.5 million on conversion into New Zealand dollars at the spot rate. There is a gain on the derivative of NZD$75 million, of which $67.5 million is attributable to the hedging relationship with the royalty and $7.5 million is attributable to the ineffective portion of the hedge. The entire gain on the derivative, being NZ$75 million, is included in passive income.

The ineffective portion of gains or losses on derivatives that are in a hedging relationship will often but not always appear, in financial statements, in a different line item from the effective portion. This is a function of accounting policy choices as well as applicable standards. The examples below assume typical accounting policy choices.

Examples

1. A CFC hedges passive royalty income against exchange rate movements using a derivative. The hedge qualifies for hedge accounting under IFRS and hedge accounting is used. The effective portion of the gain or loss on the derivative is combined with royalty income in a "royalties" line in the financial statements. The ineffective portion of the gain or loss, if any, appears in a "net gains and losses on derivative instruments" line.

2. A CFC hedges passive royalty income against exchange rate movements using a derivative. Hedge accounting is not used, perhaps because the CFC does not wish to incur the costs of complying with documentation requirements for hedge accounting. The total gain or loss on the derivative appears in a "net gains and losses on derivative instruments" line.

When the ineffective portion of the hedge is not in a separate line item from the effective portion, the provisions in the bill impose no cost.

When the ineffective portion of the hedge is in a separate line item, there is a potential cost of having to pick this out. However, in most cases, hedges taken out by an active business are likely to be highly or even 100 percent effective. In such cases, the ineffective portion will be small relative to other amounts and will only be of importance if the test statistic (passive income divided by total income) is close to the 5 percent threshold. This will reduce the number of situations in which additional costs are incurred in making the calculation.

At a certain point of ineffectiveness, the derivative would cease to be in a hedging relationship at all. Gains on the derivative could still be passive income, however, because the derivative could be held for speculative purposes (not entered into in the ordinary course of business) or for dealing. For example, taking out exchange rate cover well in excess of expected foreign exchange receipts would be a speculative transaction.

Recommendation

That the submission be noted.

Issue: Passive income received from other CFCs should be part of total income

Submission

(53 – Ernst & Young)

Proposed section EX 21D(5)(c)(ii) should be deleted.

Comment

Section EX 21D(5)(c)(ii) removes certain interest, rent or royalties that are received from a CFC in the same jurisdiction and therefore are not attributable income.

The submission is correct that these items should remain in the measure of total income in the active business test. Officials recommend that the provision be deleted, but note that these items will in some cases be brought in anyway by section EX 21D(5)(c)(iii), which is required to prevent manipulation of the test.

Recommendation

That the recommendation be accepted.

Issue: Elimination of inter-company transactions in the test

Submission
(32 – KPMG, 35 – PricewaterhouseCoopers)

There are provisions to eliminate transactions that are made for the purpose of increasing the denominator (measure of total income) in the test. These should be clarified.

Comment

Section EX 21D(5)(c)(iv) removes certain amounts from total income (the denominator) in the tax-based active business test, if they arose from a supply that was made for the purposes of increasing the denominator. In general the rule applies to cross-border transactions; a separate rule deals with most transactions between entities in the same jurisdiction. Section EX 21E(12)(j) is the equivalent of section EX 21D(5)(c)(iv) in the accounting-based active business test.

These are anti-avoidance rules, to prevent CFCs from artificially boosting total income to pass the test, by repeatedly selling goods or services to each other.

Most supplies between CFCs in different jurisdictions will boost measured income of the supplier. However, the intent is that the rule should apply only if the sale took place in order help the CFC pass the active business test. The wording in the bill limits application of the anti-avoidance provision to situations in which the supply was made for the purposes of increasing the denominator in the test statistic. If the supply was not made for that purpose, then even though an ancillary outcome of the supply is that the denominator rises, the supply is not caught by the rule.

PricewaterhouseCoopers also argues that the use of the term "supply" could be confusing because it has a specific meaning in the GST Act. The term is used because – in its ordinary meaning – it captures a wide range of income-generating activities.

Recommendation

That the submission be declined.

Issue: Income from the disposal of revenue account property

Submission
(Matter raised by officials)

In the active business test, only the gain on disposal of property, rather than the gross proceeds, should be included in passive income.

Comment

The gross proceeds from the sale of certain revenue account property are passive income under section EX 20B(3)(j). They are therefore also passive income under the tax-based and accounting-based active business tests (see section EX 21E(8)(c) for the latter).

If a taxpayer has to attribute CFC income (if they do not pass the active business tests) a deduction will typically be available under section EX 20D for the cost of the property, and this will be deducted from the gross proceeds in determining the amount to attribute. However, the active business tests themselves currently do not take account of the deduction.

The use of gross rather than net proceeds in the test is consistent with the general approach, which is to use gross amounts for the tests. Expenses are not inherently active or passive and so do not provide a good indication of the character of a business.

However, the property referred to in section EX 20B(3)(j) is often likely to be high-value property. This means that a normally active business that happens, in a particular year, to sell such property could easily fail the active business test even though its (net) economic gain from the sale is small.

To avoid this situation, we recommend that – at the option of the taxpayer – the income recognised in the active business test (via section EX 20B(3)(j)) may be reduced by a deduction for the cost of the property that would be available under section EX 20D. The income would not be able to be reduced below zero (no losses on sale would be included).

Recommendation

That the submission be accepted.

Issue: Personal services income earned through CFCs

Submission
(Matter raised by officials)

Businesses should not be eligible to use the active business test if they have certain personal services income.

Comment

Certain income from personal services is passive income under section EX 20B(3)(h). The provision applies when more than 80 percent of the CFC's income is from personal services income performed by a person who is associated with the CFC, the CFC has few fixed assets, and the services are not essential support for a product supplied by the CFC. In substance, the section applies only when the CFC is a vehicle for a person's personal services income and has no other substantial business.

In the bill as it stands, the active business test can still be used for a CFC that has this type of income. This is inappropriate, because the active business test and the active income exemption are not intended to benefit entities that are set up to shelter personal services income earned by New Zealand residents from New Zealand taxation.

Officials recommend that an entity with such income not be eligible to be an active business.

In any case, a CFC with such income would be unlikely to pass the active business test, even if it were eligible to use it.

Recommendation

That the submission be accepted.

Issue: Use-of-money interest if tax underpaid or overpaid on passive income

Submission
(32 – KPMG)

That passive income should be excluded from the use-of-money interest rules imposed on under or overpayments of provisional tax.

Comment

It is a fundamental feature of the income tax framework in New Zealand that use-of-money interest is charged by Inland Revenue on underpayments of tax and paid by Inland Revenue on overpayments of tax.

Businesses sometimes have to forecast their tax liability to avoid this interest – for example, when they pay provisional tax – and this involves some uncertainty. However, without the imposition of interest in the event of under-forecasting, there would be little incentive for a business to forecast correctly, and there would be less tax collected (in a present-value sense).

Recommendation

That the submission be declined.

Issue: Alignment of passive income and attributed CFC amount

Submission
(67 – New Zealand Institute of Chartered Accountants)

The rules for determining passive income for both the CFC attributable amount and the threshold tests should be aligned.

Comment

Taxpayers can choose between two threshold tests, one that uses tax rules to calculate income, and one that uses financial accounts and financial reporting concepts. The attributable CFC amount, being an amount of income that is subject to tax, is only calculated if the CFC fails the threshold test. If the CFC passes the test, there is no taxable amount.

If the taxpayer uses the test based on financial accounts and the taxpayer fails the test, the taxpayer must calculate the attributable CFC amount using tax rules. It would be inappropriate for an accounting measure of passive income to be used once tax is determined to be chargeable.

The threshold test that uses tax rules has two components, being passive income and gross income. Passive income for the test is calculated in the same way as the attributable CFC amount, with two differences.

The first difference is that the test measure must be calculated using the functional currency of the CFC, whereas the attributable CFC amount is calculated using existing tax principles. These existing tax principles allow the use of either New Zealand dollars for all calculations, or the currency of the CFC's financial accounts for all calculations except some involving high-value financial arrangements. If the currency of the CFC's financial accounts is used, the end result of the calculations is translated into New Zealand dollars using an average exchange rate.

Officials have identified a problem with the use of the CFC's functional currency in the threshold test. This relates to financial arrangements denominated in a currency other than the functional currency. The problem would be resolved in the tax-based test by the use of the existing tax principles. Therefore, officials recommend that the same currency rules – using existing tax principles – be used for both the tax-based

threshold test and the calculation of the attributable CFC amount. This recommendation, if accepted, would lead to a result that is consistent with the submission.

The second difference between the test and the attributable CFC amount calculations relates to consolidation. In some circumstances, there is an option to consolidate CFCs for the purposes of the test. However, CFCs are never consolidated for the purposes of calculating an attributable CFC amount. Rules are provided to ensure that optional consolidation for the test is undertaken using consistent accounting policies.

Recommendation

That the submission be accepted in part. The calculation of passive income under the tax-based threshold test should be more closely aligned with the calculation of the attributable CFC amount, by removing the special currency rules used in the test and allowing existing tax principles to apply.

Issue: Treatment of income from agency relationships

Submission
(32 – KPMG)

The treatment, in the active business test, of income from agency relationships should be clarified.

Comment

A business may act as an agent for certain payments. For example, a business might receive, and pay on to a property investor, rental income. KPMG recommends that income from such agency relationships be "netted off" against related expenses to avoid inflating the measure of passive income.

As noted in the submission on "netting off" of derivative and non-derivative financial asset gains and losses, the active business test is primarily a test based on gross amounts.

Where an entity is receiving significant amounts of passive income, "clipping the ticket", and passing the income on, it appears to fall into the category of businesses that should be classified as passive – those generating income that is not tied to any particular jurisdiction and could be easily relocated to a low-tax country. The fact that the entity then has deductions will mean profit is lower than income, but does not change the nature of the income.

Recommendation

That the submission be declined.

Issue: Resident CFCs

Submission
(30 – Staples Rodway)

The active income exemption should apply to a CFC that is resident in New Zealand by virtue of having its centre of management here.

Comment

By definition, a company cannot be a CFC if it is resident in New Zealand. Resident companies will continue to be subject to New Zealand tax on their worldwide income, in line with international norms. A company's place of management is an appropriate and internationally accepted criterion for determining its resident status.

Recommendation

That the submission be declined.

Issue: Non-attributing Australian CFCs – hybrid entities

Submission
(53 – Ernst & Young)

The definitions of "company", "CFC", "controlled foreign company" and "resident in Australia" should be reviewed to see if they require amendment along similar lines to the amended definition of "grey list company" introduced by clause 409(59).

Comment

Clause 409(59), which introduces a new definition of "grey list company", is a remedial amendment. It picks up a change made to the Income Tax Act 2004 as part of the rules for foreign hybrids introduced by the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006. Specifically, section EX 24(1) of the Income Tax Act 2004 was amended by the 2006 Act to allow foreign hybrid CFCs to qualify as being "resident" in a grey list country, despite not being liable to tax there. This change was incorrectly omitted from the Income Tax Act 2007.

We understand that the primary concern behind this submission is that a similar provision catering for foreign hybrid CFCs has not been included in new section EX 22 (Non-attributing Australian CFCs). Thus, an entity such as an Australian unit trust, which is a company (and therefore potentially a CFC) under New Zealand law but fiscally transparent in Australia, could not qualify as a non-attributing Australian CFC.

The reasons for the repeal of the grey list are well discussed elsewhere in this report. In particular, the government is concerned that passive income may not always be comparably taxed in grey list jurisdictions. This concern arises, in particular, when hybrid entities and/or financial instruments are involved.

The purpose of the new exemption under section EX 22 for Australian CFCs is to limit the compliance costs for small to medium-sized active businesses expanding into Australia, which would otherwise be associated with repeal of the grey list. In the event that a business moves into Australia using a hybrid structure, we consider it appropriate to apply the active business test in the usual way.

Recommendation

That the submission be declined.

Issue: Section EX 21E – drafting

Submission
(67 – New Zealand Institute of Chartered Accountants)

The amendment to section EX 21E(13) is unnecessary.

Comment

Clause 122(8) purports to replace section EX 21E(13)(a) of the Income Tax Act 2007 with an identical paragraph.

Recommendation

That the submission be accepted, and clause 122(8) be omitted from the bill.

Issue: Miscellaneous drafting issues

Submissions
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

The rule in section EX 21D(5)(c)(iv) should be moved to subpart GB, because it is an anti-avoidance rule.

Section EX 21C(2) could be better worded to simply state NZ GAAP. This term (NZGAAP) includes compliance with IFRS.

The term "test group" should be defined in the legislation for the purposes of proposed section EX 21C.

In proposed section EX 21C(6), in the opening sentence the words "apply with" should be changed to either "comply with" or, alternatively, the word "with" should be deleted.

Section EX 21C(6)(b) should be reworded as it contains a double negative which makes it difficult to understand.

The reference to "test group" before sections EX 21D(3) and EX 21E(4) should be removed because those sections apply to individual CFCs as well as test groups.

We submit that the terms "operating lease" and "finance lease" should be removed from the list of defined terms in proposed section EX 21E.

Comment

A general review of the drafting of the bill is being undertaken and these submissions will be considered as part of that review. It is not considered that they raise issues of policy.

Recommendation

That the submissions be noted, and considered as part of the review of the drafting of the bill.

Issue: CFCs resident in Australia – Australian exemption and consolidated groups

Submission
(35 – PricewaterhouseCoopers)

For a CFC to qualify for the Australian exemption it must be subject to tax on its income in Australia.

This creates an issue for CFCs which are part of an Australian consolidated group as technically only the head member of that group is subject to tax. The "subject to tax" requirement needs to be amended to accommodate CFCs which are part of a consolidated group.

Comment

Australia's consolidated group rules treat a subsidiary company as part of the head company of the group. This may create an issue as a CFC has to be subject to tax on its income. The requirement should be redrafted to ensure that CFCs that are part of consolidated groups can ordinarily qualify for the Australian exemption.

Recommendation

That the submission be accepted, and the subject to tax requirement be redrafted.

Issue: Australian exemption and offshore branches

Submissions

(35 – PricewaterhouseCoopers)

Section EX 22(1)(b)(i) denies the Australian exemption to CFCs which have benefited from a tax concession for income derived from business activities carried on outside Australia. This would deny the exemption in cases where the Australian CFC has foreign branch operations, holds an interest in a foreign hybrid vehicle, or receives non-portfolio dividends from overseas.

For these reasons the exclusion should be omitted.

If the exclusion is kept it should be modified so that it applies only to a CFC's overseas operations. This would save compliance costs as it would mean that the Australian CFC will only need to take into account its offshore business income (that is, it could disregard Australian-sourced income) when performing the active business test.

Alternatively, it should be modified so that "outside Australia" is replaced with "outside Australia and New Zealand". This would mean that Australian CFCs which only had branches in New Zealand would still be able to access the Australian exemption. This is appropriate as New Zealand taxes the income of a New Zealand branch.

Comment

This exclusion to the Australian exemption duplicates the conditions that must be met for the existing grey-list exemption to apply. The existing conditions have not been a reported source of difficulty for companies.

The changes proposed by PricewaterhouseCoopers would allow income from activities carried out by an Australian business through a branch operation or hybrid vehicle (such as a limited liability company in the United States) that is located outside Australia to qualify for the exemption. This would effectively extend the Australian exemption to apply to income earned in other countries. It is only appropriate to exempt this income if it is active. Otherwise it would be possible for businesses to structure all of their passive income through branches of an Australian CFC to avoid attribution of this income.

Australian CFCs with active offshore branches will be able to access the active income exemption and active business test and so there is no good case for granting them the Australian exemption.

The existing grey list exemption applies to Australian CFCs which receive exempt foreign non-portfolio dividends. On this basis, CFCs which receive foreign non-portfolio dividends still should be able to qualify for the Australian exemption.

Recommendation

That the submissions be declined.

Issue: Australian exemption drafting issue

Submission
(24A – New Zealand Law Society, 26 – Fonterra, 35 – PricewaterhouseCoopers, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

Section EX 22(1)(a)(iii) needs redrafting as it is not in plain language style.

It should be reworded as:

> not treated as being resident in a country other than Australia under an agreement between the government of Australia and the government of another country or territory that would be a double tax agreement if between the government of New Zealand and the government of the other country or territory; and

Comment

The reason for the current drafting ("treated… under no agreement") was to ensure that CFCs with a link to a third country were still eligible for the exemption in situations where Australia did not have a double tax agreement with that third country. Nevertheless, officials agree that the suggested change is easier to read and should provide much the same outcome.

Recommendation

That the submission be accepted.

Issue: Scope of Commissioner's determination for active insurance CFCs

Submissions
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants, 73 – Seniors Money International)

Insurance CFCs can apply for a Commissioner's determination process that, if satisfied, would deem them to be a non-attributing (active) CFC.

The determination process should be extended to cover financial institutions other than insurers, as like insurers, these companies cannot access the active income exemption as their core business income is passive.

One requirement for the determination to be granted is that the insurance CFC had to exist before 1 October 2008. This requirement should be deleted as it would discourage insurance companies from expanding offshore by setting up a new CFC. The requirement is arbitrary in that it would disadvantage companies that establish new CFCs relative to companies which already own or that acquire an existing insurance CFC. If the requirement is retained, a grey-list exemption should be maintained for financial service CFCs.

Comment

Financial CFCs are a special case because the types of income they generate from their core business activities (interest, premiums and investment income) are the same sorts of income that can be used to shift profits out of the New Zealand tax base (passive income).

As a result of consultation, several offshore insurance businesses were identified that would face an adverse tax result if the conduit exemption were removed before an active income exemption was introduced for financial CFCs. It was not considered feasible to retain the grey list and conduit for just these entities. Similarly it would not be prudent to try to design special rules that modify the active income exemption rules to accommodate financial CFCs until after the rules were finalised for ordinary CFCs. The Commissioner's determination is intended to provide limited, transitional relief to these existing insurance CFCs.

Extending the Commissioner's determination to other financial institutions would provide little additional benefit (given the lack of existing financial CFCs) but would require much more analysis and consultation. For example, we would need to develop a definition of a financial institution, which could be complex and would require consultation as part of an issues paper. In many respects it would duplicate the work required to develop a more robust exemption, namely adapting the definition of "passive income" for financial CFCs.

The requirement that the insurance business must exist before 1 October 2008 is an additional safeguard to prevent taxpayers from structuring the exemption as a way to reduce their New Zealand tax liabilities. This safeguard is appropriate given that the measure would allow a CFC to have unlimited passive income. The purpose of the measure is only to provide transitional relief for existing insurance CFCs which would otherwise be required to attribute all of their income due to the repeal of the conduit and grey-list exemptions. It is not intended to facilitate offshore expansion by other financial businesses.

Recommendation

That the submissions be declined.

Issue: Clarification of how the Commissioner's determination will work in practice

Submission

(35 – PricewaterhouseCoopers)

Further guidance should be provided on how the Commissioner will exercise his discretion in determining if a CFC qualifies for the active income exemption. This guidance could be provided through a *Tax Information Bulletin*.

Comment

Officials plan to prepare and release a *Tax Information Bulletin* clarifying how the Commissioner will apply the determination process for insurers.

Recommendation

That the submission be noted.

Issue: Allowing the Commissioner's determination for active insurance CFCs to be applied on a country-consolidated basis

Submission
(Deloitte – raised in correspondence with officials)

As currently drafted, if an insurance company has more than one CFC in a jurisdiction, each of these CFCs must individually satisfy the Commissioner's determination for insurance CFCs. Insurance companies should be able to apply for the determination on a country-consolidated basis.

Comment

This would be consistent with allowing taxpayers to consolidate their CFCs within the same country for the purposes of the active business test.

Recommendation

That the submission be accepted.

Issue: Excluding reinsurance from the Commissioner's determination for active insurance CFCs

Submission
(Matter raised by officials)

Reinsurance income should not count towards the requirement that the CFC generates all or nearly all of its income from premiums covering risks in its country of residence and from investment assets used to back the insurance.

Comment

Reinsurance is a contractual agreement that enables an insurer to offload its business risk. Reinsurance can be used to transfer risk and to alter the incidence of tax between jurisdictions or within jurisdictions, particularly where a captive insurer (related party) is involved.

Recommendation

That the submission be accepted.

ATTRIBUTABLE INCOME

Clauses 119 and 408

Overview

The definition of "passive income" (referred to in the legislation as the "attributable CFC amount") is central to the new CFC rules. The definition is applicable, in the first instance, in the active business test to decide whether a CFC is active or passive. If a CFC fails the active business test, then its passive income must be attributed to the New Zealand shareholders.

The broad categories of passive income are as follows:

- dividends;
- interests;
- royalties;
- rents;
- other passive income (income from offshore insurance businesses, life insurance policies, personal services and the disposal of revenue account property);
- certain income related to telecommunications services; and
- base company services income.

Within these categories, however, exceptions apply when the income is associated with an active business and there is limited risk to the New Zealand tax base.

Submissions were received on each of the categories of passive income.

Issue: Passive dividends and treating a CFC as though it were a New Zealand resident

Submissions
(67 – New Zealand Institute of Chartered Accountants, 53 – Ernst & Young)

The interaction between section EX 21(2) – which treats a CFC as though it were a New Zealand resident for the purposes of the Act – and sections EX 20B(3)(a) and (b) – which treat certain dividends as a component of passive CFC income – should be clarified.

Specifically, section EX 20B(3)(a) appears unnecessary as these dividends will already be taxed under section CW 9 (which makes certain dividends received by a New Zealand company subject to income tax).

Section EX 20B(3)(b) – which treats as passive income any unimputed dividends paid by a company resident in New Zealand – should be amended so as to exclude dividends paid by CFCs.

Comment

Section EX 21(2) applies the Act as if a CFC were a New Zealand resident for the purposes specified in subsection (2). This does not mean that a CFC is actually a company resident in New Zealand, or that a CFC's attributable income is the same as the income of a New Zealand company. Section EX 20B(3)(a) is necessary as dividends have to be a component of the attributable CFC amount in order to be attributed. Section EX 20B(3)(b) does not need to be amended as a CFC is by definition a company that is not resident in New Zealand.

Recommendation

That the submissions be declined.

Issue: New Zealand dividends paid to a wholly owned CFC

Submission
(68 – Corporate Taxpayers Group)

Dividends paid by a New Zealand company to a CFC should be exempt if the CFC and the New Zealand company belong to the same wholly owned group (even if the dividend is unimputed). This would be consistent with the exemption for dividends paid within a wholly owned group of companies that are resident in New Zealand.

Comment

Dividends paid within a wholly owned group of New Zealand companies are currently exempt (even if unimputed). Otherwise two commonly owned companies would have to merge to make the payment free from tax.

It is not appropriate to extend this treatment to wholly owned New Zealand CFCs as this would allow for structures whereby untaxed company profits could be distributed as unimputed dividends offshore (or routed back to New Zealand) with no tax impost.

Recommendation

That the submission be declined.

Issue: Defining “attributable CFC amount” (section EX 20B)

Submission

(62 – Minter Ellison Rudd Watts)

The definition of passive income (“attributable CFC amount”) set out in section EX 20B should not rely on the definition of “financial arrangement”.

Comment

The submission notes that the financial arrangement rules are designed to spread income and expenditure over the lifetime of an arrangement, rather than to distinguish between income of an active or passive nature. It further notes that certain passive assets (such as equity derivates) will not be treated as giving rise to passive income, whereas certain active assets are financial arrangements and therefore require specific exclusion.

Interest income is one of the most common forms of passive income. The financial arrangement rules govern the taxation of income from debt (or equivalent) instruments. Accordingly, it is helpful to refer to those rules when defining “attributable CFC amount” in section EX 20B. We consider this approach, with specific exclusions, is as transparent and as easily understood as the alternative of relying on newly introduced concepts.

The scope of the financial arrangement rules is broad and would generally encompass derivative instruments. Consequently, we have taken these rules as the starting point and then excluded certain arrangements when there is a policy rationale for doing so. The definition of “attributable CFC amount” is something that officials intend to monitor as the new rules are implemented. Modifications may be made over time.

Recommendation

That the submission be declined.

Issue: Heading before section EX 20B(4)

Submissions

(67 – New Zealand Institute of Chartered Accountants, 68A – Corporate Taxpayers Group)

The heading before section EX 20B(4) should be amended – from “arrangement income” to “financial arrangement income” or “passive interest income”.

Comment

Consideration will be give to whether there is any scope for simplifying or amending terminology used as part of a general review of the drafting of the international tax provisions in this bill.

Recommendation

That the submission be noted.

Issue: Treatment of short-term sale and purchase agreements

Submission
(67 – New Zealand Institute of Chartered Accountants)

A short-term sale and purchase agreement which the CFC has elected to treat as a financial arrangement under section EW 8 should not be dealt with along with other non-derivative financial arrangements under section EX 20B(4)(a) for the purposes of defining the attributed CFC amount.

Comment

The submission argues that short-term sale and purchase agreements should not be treated as passive income because such arrangements are closely linked to the trading activities of the business. While we can see that this argument has some merit, on balance, officials are inclined in the short term to stick with the current approach of treating such arrangements consistently with other financial arrangements. However, the definition of "arrangement income" is something that officials intend to monitor as the new rules are implemented, and modifications are likely over time.

Recommendation

That the submission be declined.

Issue: Derivatives entered into in ordinary course of business

Submission
(68/68A – Corporate Taxpayers Group)

It is unclear what derivates are entered into in the ordinary course of business (section EX 20B(3)(b)(ii)).

Comment

Income from derivates entered into in the ordinary course of business is not subject to attribution. The term "ordinary course of business" is not defined. However, its meaning has been discussed in an earlier commentary concerning the adoption of International Financial Reporting Standards for taxation purposes, *Tax Information Bulletin* (Vol. 20, No. 3, April 2008). This provides some useful guidance.

As that commentary noted:

> Facts and circumstances of a taxpayer's business would determine whether a financial arrangement has been entered into in the ordinary course of the taxpayer's business. For example, a taxpayer who borrows in a foreign currency, say in US dollars, to fund its subsidiaries in the US would most likely be considered to have entered into the loan as part of its ordinary course of business. A taxpayer who enters into a derivative contract to hedge a particular business risk would also be considered as having entered into the derivative contract in the ordinary course of its business. For example, an energy company may enter into contracts for differences to fix the price of electricity.

Recommendation

That the submission be declined.

Issue: Derivatives hedging passive income

Submission
(35 – PricewaterhouseCoopers)

The drafting of section EX 20B(3)(b)(iii) should be reconsidered.

Comment

Section EX 20B(3)(b)(iii) provides that income under a financial arrangement that is a derivative instrument forms part of the attributable CFC amount if it hedges "passive" income (that is, income that would form part of the attributable CFC amount under subsection (3) or subsection (4)(a)). The concern raised in the submission is that it is not clear what transactions this provision is intended to cover.

Section EX 20B(3)(b)(iii) refers to the relevant accounting standard, *New Zealand Equivalent to International Accounting Standard 39: Financial Instruments: Recognition and Measurement*. (Note that the reference needs to be amended from IFRS 39 to IAS 39.) The accounting standard notes that hedging relationships are of three types:

- fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss;

- cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss; and
- hedge of a net investment in a foreign operation as defined in NZ IAS 21.

A hedging relationship may exist under this standard even if hedge accounting does not apply.

Recommendation

That the submission be declined, but that section EX 20B (3)(b)(iii) be amended to refer to IAS 39 (rather than IFRS 39).

Issue: Exception for non-derivative arrangement income from an associated non-attributing active CFC

Submission
(30 – Staples Rodway)

The exception (from the attributable CFC amount) for non-derivative financial arrangement income between associated active CFCs should be extended to all associated active CFCs, regardless of whether they are resident in the same jurisdiction.

Comment

The bill ensures that the attribution rules do not interfere with holding company structures within a jurisdiction. Interest, royalty and rental income paid by associated non-attributing active CFCs resident in the same jurisdictions as the CFC receiving the payment is not attributable. This rule recognises that firms may prefer to concentrate ownership of intellectual property or capital in a holding company. Extending the exemption to transactions between CFCs in different jurisdictions would provide opportunities for firms to trap profits in low-tax jurisdictions, with risk to the domestic tax base.

We note that firms may use intra-group financing arrangements, and that these may involve CFCs in different jurisdictions. Elsewhere in this report we have recommended that the rules about the treatment of interest expenditure in the calculation of net attributable CFC income or loss be amended, to allow adjustments for on-lending to associated CFCs, including CFCs in different jurisdictions. This will ensure that, to the extent funds are on-lent by a CFC to an associated CFC, the on-lending CFC will not face any restriction of its own interest deductions.

Recommendation

That the submission be declined.

Issue: Cash basis person's rules

Submission

(67 – New Zealand Institute of Chartered Accountants)

The rules in section EX 20B should take into account clauses 109 to 114 of the bill, which introduce companies and trusts to the cash basis person's rules in the financial arrangement rules.

Comment

The financial arrangement rules generally require that a party to an arrangement must recognise income and expenditure over its term using one of several spreading methods prescribed in the legislation. In this way, the rules prevent deferral of income or advancement of expenditure. On maturity or disposal of an arrangement, a base price adjustment is required. This identifies any income or expenditure that has not already been accounted for on accrual.

A cash basis person is not required to apply a spreading method to their financial arrangements. They are still required to undertake a base price adjustment. To qualify for cash basis treatment, either a person must have income and expenditure under all financial arrangements of not more than $100,000, or the value of their financial arrangements must not exceed $1 million. In addition, the difference between accrual and cash treatment for the person must not exceed $40,000.

Previously, only natural persons could normally qualify for the cash basis. Section 9 of the Taxation (Business Tax Measures) Act 2009, which replaces section 109 of the bill, amended section EW 54 so that trusts and companies could also qualify. A number of consequential amendments were also made.

As a result of these changes, it is possible that a CFC could now qualify for cash basis treatment. This does not require any change to the provision made in section EX 20B about arrangement income to be included in the attributable CFC amount. The cash basis is intended to reduce compliance costs for taxpayers with limited financial arrangements by exempting them from the requirement to spread income and expenditure. It is not intended to remove income under financial arrangements from the tax base altogether. The Act clearly states, at section EX 55(2), that a cash basis person is not excused from the requirement to calculate a base price adjustment.

Recommendation

That the submission be declined.

Issue: Royalties from property owned by a New Zealand resident

Submissions
(22 – Les Mills International, 32 – KPMG, 65 – The Whyte Group)

Royalties derived by an upper tier CFC from a lower tier CFC should qualify as "removed passive income" if the lower tier CFC derived the royalty income from an unrelated third party.

Comment

We agree that a royalty payment received by an upper tier CFC from a lower tier CFC should be treated as active income, as long as the royalty payment was derived from a non-related third party. There may be valid commercial reasons for one CFC to be the main CFC that returns the third party royalty payments back to the New Zealand resident company.

The same treatment should also be extended to licence fee payments that do not fall within the definition of "royalty".

Recommendation

That the submission be accepted.

Submission
(67 – Zealand Institute of Chartered Accountants)

In section EX 20B(5)(d)(i), it is unclear what is meant by the expression "owned by a New Zealand resident who is not treated as a non-resident under a double tax agreement". The residence rules in a treaty should exist solely for the purposes of applying the terms of the treaty.

Comment

There are situations in which a taxpayer may be a resident of New Zealand under domestic tax law but treated as a non-resident under a double tax agreement. In those situations, New Zealand relinquishes to the other country its residence taxing right on royalty income derived by the taxpayer. The rationale behind the exclusion for certain royalties provided by section EX 20B(5)(d) is that the income is eventually being taxed in New Zealand. This would not be the case when a person qualified for relief as a non-resident under a double tax agreement.

Recommendation

That the submission be declined.

Issue: Widening the scope of the exemption by extending it to any member of the group in a jurisdiction

Submission

(32 – KPMG)

The exclusions for royalties derived by CFCs should be relaxed so that the exemption from attribution extends to any members of the group (referred to as the "test group" for the 5 percent test) in the jurisdiction that earns royalties from intellectual property if any one of the CFCs in the group created, developed or added substantial value to intellectual property.

Comment

The concern with intellectual property is that it is inherently mobile and profits are easily shifted from a home jurisdiction or from a high-tax jurisdiction to a low-tax jurisdiction through the payment of deductible royalties. In New Zealand, this base maintenance concern is magnified by the absence of a general capital gains tax which would apply to gains on sale of intellectual property out of New Zealand.

The international norm is to treat royalties from related and unrelated parties as passive income. The main exception is where there are genuine commercial reasons for the CFC to own the intellectual property, such as when the CFC has created, developed, or substantially enhanced the property. The United States also requires the CFC to have a pattern of activity with regard to the creation or enhancement of intellectual property.

The proposals in the bill generally follow this international norm. In fact the bill goes further by exempting all royalties where the CFC created or substantially enhanced the property, regardless of whether the royalty comes from a related party in another jurisdiction. (The United States and Australia both limit their exception to royalties from unrelated parties.)

Accordingly, the substance of the approach in the bill is that, provided the development of the intellectual property has a real connection with the jurisdiction through the CFC and has no prior connection to New Zealand, the royalty will not be attributable income.

The submission seeks further relaxation of the test that requires proof of a connection with the jurisdiction by permitting the exemption to apply to any member of the group in the jurisdiction provided one member of the group created the intellectual property. Our concern is that, as a practical matter, if intellectual property is allowed to be detached from the originating CFC and shifted to other members of the group, the test will become unenforceable over time. We are also mindful of the fact that both Australia and the United States require the intellectual property to be owned by the CFC that produced, developed or enhanced the property before the exemption applies. We would not rule out recommending further relaxation of the rules once taxpayers and officials alike gain more experience with how the rules operate. However, we consider a cautious approach is appropriate at this stage.

Recommendation

That the submission be declined.

Issue: Pattern of activity and substantial value requirements for the exemption of royalties from attribution

Submissions

(65 – The Whyte Group, 67 – Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

The requirement of a "pattern of activity" may penalise some CFCs that may not have the resources to undertake a "pattern of activity involving creating, developing or adding value to property that produces royalties".

Comment

The bill follows the United States' approach of requiring the CFC that creates/enhances intellectual property to demonstrate a pattern of activity in this regard. We recognise that the requirement to have a "pattern of activity" imposes an additional requirement that must be satisfied. The purpose of having this additional requirement is to ensure there is a genuine commercial rationale for the intellectual property having been developed by a CFC in that particular jurisdiction. This will buttress the requirement that the CFC must have created or enhanced the intellectual property in order to claim the exemption for the royalty.

One submission suggested that we should take the Australian approach. The Australian rule does not have a "pattern of activity" requirement although it does require that the royalties are derived in the course of a business carried on by the CFC. On balance, we considered the United States approach was more certain in terms of the base protection policy objective we sought to achieve. That is, given the mobility of intellectual property, the "pattern of activity" requirement will ensure the intellectual property is located in the jurisdiction for legitimate commercial reasons.

Recommendation

That the submissions be declined.

Submission

(34 – PricewaterhouseCoopers, 68 – Corporate Taxpayers Group)

Further clarity should be provided as to the meaning of the terms "pattern of activity" and "substantial value" in proposed EX 20B(5).

Comment

The terms "pattern of activity" and "substantial value" are not defined in the bill. It is intended that these terms should take their ordinary meaning. This requirement is designed to ensure there is a genuine connection between the intellectual property and its location.

Recommendation

That the submission be declined.

Submission
(67 – New Zealand Institute of Chartered Accountants)

There is a mismatch between what the commentary to the bill states and what is actually in the draft legislation in regards to the criteria of "regularly engaged" and "pattern of activity" for some of the royalty exclusions under proposed section EX 20B(5).

Comment

The policy intent behind the draft legislation is to allow the exclusions under proposed section EX 20B(5) only if those CFCs that have a pattern of creating, developing or adding substantial value to property. The explanatory note in the bill used the term "regularly engaged" as a means of describing what was intended by the rule. The central idea is that the CFC should have a history of creating, developing or adding substantial value to property.

Recommendation

That the submission be declined.

Submission
(67 – New Zealand Institute of Chartered Accountants)

It is unclear what is meant by the terms "created or developed" in the context of proposed sections EX 20B(5)(a), EX 20B(5)(a)(iii), EX 20B(5)(b) and EX 20B(5)(b)(iii). In particular, it is unclear whether the words are used in ejusdem generis or are they intended to import different things. If in the words are to be used in ejusdem generic then one expression is appropriate to convey the meaning.

Comment

These terms may overlap is some cases, but the terms "created" and "developed" do not have the same coverage, and to eliminate one or the other may narrow the scope of the section.

Recommendation

That the submission be declined.

Issue: Intellectual property linked to New Zealand

Submission
(65 – The Whyte Group)

The submission is concerned about the requirement that royalties will be exempted from attribution only if the intellectual property producing the income has no prior link to New Zealand. Specifically, there are concerns as to the practicality of the definitional approach regarding property "linked to New Zealand", especially with enforcing compliance. Furthermore, there is concern as to the indefinite link that is established between the property and New Zealand by the current draft definition. One submission suggested that there should be a time limit on the length of time intellectual property can be linked to New Zealand.

Comment

As a general comment, the new CFC rules are primarily concerned with protecting the New Zealand tax base. As in other countries, there is an emphasis in the rules on the requirement that the CFC have a role in creating, developing and enhancing the intellectual property. However, our rules go one step further in requiring that the intellectual property have no prior link to New Zealand. This requirement is needed because, unlike other jurisdictions, New Zealand has no general capital gains tax which would apply to transfers of intellectual property from New Zealand to a CFC. Our concern is that intellectual property could be created in New Zealand and then moved offshore once royalties are being generated.

The bill takes a definitional approach in the "linked to New Zealand" concept in order to provide some guidance as to what it intended to be covered by this requirement. The definition is deliberately comprehensive, to cover any connection including when the property has been owned by a New Zealand resident or a New Zealand business, created or enhanced in New Zealand, or gave rise to a deduction against the New Zealand tax base in the acquisition or creation of the property.

The submission is concerned that determining the existence of a link will be practically difficult, especially if intellectual property is subsequently used for the creation of other intellectual property in the CFC. Determining whether any of the criteria in the definition are met is largely a factual inquiry. Accordingly, determining whether the criteria have been triggered in a given situation will depend very much on the facts and circumstances of the situation.

We do not agree with introducing a time limit for the linkage to New Zealand, after which the linkage would cease. Obviously, some intellectual property can have an enduring life. Furthermore, it would be hard to determine a period of time that would be suitable for all types of intellectual property. The submission suggests a "nil tax value" approach, but we do not think this is appropriate in a context of protecting the New Zealand tax base.

With time, as taxpayers and officials gain experience in applying the test, it will be possible to develop a greater appreciation of any compliance or administrative difficulties. The government will then be in a better position to address shortcomings in the rules with the benefit of this experience.

Recommendation

That the submission be declined.

Submission
(65 – The Whyte Group)

Taxpayers should have the option to elect to pay tax at the time of the transfer of property based on the property's deemed market value – as an alternative to on-going attribution of royalties. In other words, if the taxpayer elected to pay the exit tax on the transfer of this property, the royalty from the property would no longer be attributable income of the CFC.

Comment

As mentioned in the submission, the officials' issues paper, released in October 2007, addressed the question of a compulsory exit tax on transfers of intellectual property out of New Zealand. The option was rejected, primarily because it was thought undesirable to introduce a capital gains tax on an ad hoc basis for an isolated case as a result of the international tax reforms. Moreover, there were concerns about the substantial difficulties with valuation and determining the cost basis for intellectual property. These concerns hold – even for an elective regime. Indeed, we would be concerned about taxpayers self-selecting into the rule that gives the best tax result.

Finally, we note that, implementing an elective exit tax option would require further policy analysis and design work and would not be possible in the timeframe of this bill.

Recommendation

That the submission be declined.

Submission
(67 – New Zealand Institute of Chartered Accountants)

In proposed section EX 20B(5) there should be an exclusion from the "property not linked to New Zealand" criteria for patents transferred to a CFC from New Zealand since these are taxed at the time of the transfer CFC.

Comment

The submission makes the comment that the sale of a patent is taxed in certain situations and that once it has been taxed, the intellectual property should be able to leave the New Zealand tax base. Examples of this are when the patent is held as revenue account property and is subsequently sold or the sale of a patent if the patent application with a complete specification is made after 21 June 2005. Officials agree that, on the face of it, there should be fewer policy concerns for intellectual property moving out of New Zealand if tax has been paid on its disposal. However, we consider this issue requires further consideration as part of phase 2 of the international tax reform.

Recommendation

That the submission be declined, and the issue considered as part of phase 2 of the international tax review.

Submission
(67 – New Zealand Institute of Chartered Accountants)

Proposed section EX 20B(9) defines property linked to New Zealand. However, the commentary is clear that the policy is intellectual property that had a prior link to New Zealand. If the tense is the past tense then that should be reflected in the principal sections in which the term is relevant.

Comment

In policy terms, the premise for taxing the royalty is because of a link to New Zealand in the creation of the underlying intellectual property. For the purposes of these proposed rules, the royalty continues to have a link to New Zealand. Officials do not think there is a need to change the proposed legislation.

Recommendation

That the submission be declined.

Submission
(65 – The Whyte Group)

Royalties derived by CFCs from related parties located in the same jurisdiction should be exempt from attribution – even when the property is linked to New Zealand. The same exclusion should apply to royalties derived by CFCs from related parties located in another jurisdiction.

Comment

As mentioned above, the bill already goes further than the legislation of comparable jurisdictions in extending the active income exemption to royalties received by a CFC from a related party. However, for the reasons previously mentioned, we consider the requirement that the property has no connection to New Zealand is necessary to protect the New Zealand tax base. The same concerns arise regardless of whether the CFC receives the royalty from a related party (inside or outside the jurisdiction of a CFC) or a third party. While there may be good commercial reasons for some companies to move their intellectual property offshore, the risk to the New Zealand tax base is too great to remove the "property linked to New Zealand" requirement from the related parties active royalty exclusion.

Recommendation

That the submission be declined.

Submission
(67 – New Zealand Institute of Chartered Accountants)

The exclusion from the passive treatment of royalties in proposed section EX 20B(5) should reflect the fact that some types of intellectual property are location-specific. Patents for example, derive their legal existence from the jurisdiction in which the patent is registered.

Comment

Royalty income derived from intellectual property over which a patent is registered can already be excluded from passive income treatment under one of the four royalty exclusions in proposed section EX 20B(5). Officials do not think there should be a separate exclusion for the situation where the CFC has registered its patent over the intellectual property in its home jurisdiction.

Recommendation

That the submission be declined.

Issue: Definition of "royalty"

Submission
(67 – New Zealand Institute of Chartered Accountants)

The definition of "royalties" for the purposes of the passive income rules in proposed sections EX 20B(3)(d) and EX 20B(5) should exclude "assistance" given in circumstances when such "assistance" would constitute a royalty under section CC 9(2)(h) and the "royalty" to which it relates is itself excluded under proposed section EX 20B(5).

Comment

It is agreed that the current definition of "royalty" under section CC 9(2)(h) will capture payments for "assistance". However, officials do not agree that payments for these types of service should be carved out from the general definition of "royalty". In particular, it would be very difficult to determine which portion of the royalty income is for "assistance". If the rest of the royalty income is passive, then taxpayers would have a natural incentive to over-allocate the receipt to the assistance portion of the payment. (Assistance is generally included in the meaning of "royalties" in double tax agreements specifically to address this concern.)

Recommendation

That the submission be declined.

Issue: Miscellaneous royalties drafting issues

Submission
(34 – PricewaterhouseCoopers)

The words "if such royalties were attributable CFC amounts" is confusing and should be removed from the proposed section EX 20B(5)(b)(i). In particular, the phrase is unnecessary as the CFC paying the royalty will not be attributing the amount but rather it will be an expense for that CFC.

Comment

There is an issue around the circularity of the active business test. For example, there can be situations where the status of the associated CFC cannot be determined as it needs to apply the same exclusions. Provisions were placed into each of the exclusions (royalties, rent and interest) so that when a CFC is trying to determine the status of an associated CFC in the same jurisdiction, it would do so without applying any of the exclusions to the associated CFC – that is, it will regard any royalties, rents or interest the associated CFC receives as passive income.

It is agreed that the phrase is confusing and unnecessary as such royalty payments will never be attributable amounts for the CFC that is paying the royalty under section EX 20B(5)(b)(i). Unless the wording relates to the CFC that is receiving the royalty payment, the requirement of "if such royalties were attributable CFC amounts" is irrelevant and more importantly, it does not make sense. Furthermore, the issue of circularity does not arise with this particular exclusion, the reason being that a CFC is able to exclude royalty payments it receives from a related CFC, regardless of whether the related CFC is active or passive. This is not the same for the other related party exclusions – rent, royalty and interest payments. A CFC's ability to exclude one of those payments is dependent on the payor CFC being active.

On that basis, it would appear that the words "if such royalties were attributable amounts" are unnecessary. Officials agree that the words "if such royalties were attributable CFC amounts" should be removed from the proposed section EX 20B(5)(b)(i).

Recommendation

That the submission be accepted.

Submission
(65 – The Whyte Group)

The drafting of the royalty exclusions in section EX 20B(5) can be tightened to provide for the same exemptions in fewer subsections. The combined effect of subsections (a), (b) and (c) is effectively to exclude all royalty income derived by a CFC from property not linked to New Zealand where the CFC has added substantial value.

Comment

Different criteria apply to the different exemptions provided by subsections (a), (b) and (c) as set out in the proposed legislation. For example, there is an additional requirement of an arm's length approach in subsection (b) which provides for an exemption for related party active royalties. To simplify the drafting of the exclusions as suggested in the submission would extend the exclusions beyond the policy intent.

Recommendation

That the submission be declined.

Submission
(67 – New Zealand Institute of Chartered Accountants)

The commentary states that there are four types of royalty exceptions, one of which is the same jurisdiction active royalty exclusion. However, it is difficult to determine which subsection relates to the same jurisdiction active royalty exception. In particular, it does not appear that any of the four exceptions in proposed section EX 20B(5) contain a reference to royalties needing to be being paid within the same jurisdiction. Furthermore, even if the drafting of the section is accurate, it is not intuitive.

Comment

The same jurisdiction active royalty exclusion is contained in proposed section EX 20B(5)(c) of the draft legislation. The requirement for the royalty to be paid by a related party within the same jurisdiction is set out by the requirement of the royalty being paid "by a person who would be an associated non-attributing active CFC". An associated non-attributing active CFC is defined in proposed section YA 1 to be a related CFC that is subject to the laws of the same country or territory as the other CFC.

Recommendation

That the submission be declined.

Issue: Rent

Submission
(67 – New Zealand Institute of Chartered Accountants)

Proposed section EX 20B(6)(a) excludes rents from passive income when the rent is sourced in the country in which the CFC is subject to tax by reason of being resident in the country, or through domicile or incorporation, for example. It also includes circumstances when the owners of the CFC are liable to pay tax on the income derived by the CFC so long as 80 percent of the CFC's income is derived within that jurisdiction. However, the bill commentary states that "rent from third parties will be treated as active income if it is derived from a lease of real or personal property in the same jurisdiction as the CFC". The "liable to tax" test is not the same test as "derived from the same jurisdiction" test.

Comment

The intention is that this exclusion should apply to rent from property that is located in the jurisdiction of which the CFC is a resident. The core test for the residence of the CFC operates by reference to liability to tax (paragraph (i) of subsection (6)(a)). The "liable to tax" and "same jurisdiction" tests are therefore complementary.

Paragraph (ii) of subsection (6)(a) was intended to deal with hybrid entities that are fiscally transparent (and therefore not liable to tax) in the foreign jurisdiction. As discussed elsewhere in this report, officials no longer consider that the rules should try to cater for hybrid entity CFCs and it is therefore recommended that this paragraph be removed from the bill.

Recommendation

That the submission be declined. The removal of paragraph (ii), along with similar provisions, is covered by a separate recommendation.

Submission

(67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

In terms of the proposed section EX 20B(6) rents will not be passive income if they arise from property that is not land if the rent relates to property used in the same jurisdiction as the CFC. One submission suggests that cross-border rental income (excluding land and buildings) should not be included as passive income. There is a concern with the level of compliance cost for CFCs that are in one operating group having to keep track of the rental payments made within the operating group. Another submission questions how this exclusion will apply to personal property such as ships and aircraft and related property.

Comment

The exclusion under the proposed section EX 20B(6) applies only to the extent that the personal property is used in the same jurisdiction as the CFC. The policy intent behind the exclusion is that there should be a nexus between the jurisdiction in which the CFC is located and the source of income. The aim is to limit opportunities to shift rental income from New Zealand with consequential base maintenance risks.

In the case of aircraft and ships, there simply is no nexus between the property and the jurisdiction in which the CFC is located. Accordingly, the exclusion from passive income will not apply.

Recommendation

That the submission be declined.

Submission
(67 – New Zealand Institute of Chartered Accountants)

Proposed section EX 20B(6)(f) excludes rents from attributable CFC income when the rent is a royalty. There is a question is to application and effectiveness of the exclusion.

Comment

The definition of "rent" is wider than that of "royalty" and can cover the same things. The policy intent is that if an item of income falls within the definition of both rent and royalty, the royalty provisions, not the rent provisions, should apply to determine whether the income is attributable. It is for this reason that a royalty has been excluded from the rent provisions.

Recommendation

That the submission be declined.

Submission
(67 – New Zealand Institute of Chartered Accountants)

The reference to "licences" and "bailment" in proposed section EX 20B(3)(e) should be removed.

Comment

The reason for the inclusion of licences and bailment in the definition of rent is to mirror the definition of "lease" under section YA 1. However, it is not advisable to rely solely on the definition of lease as the current drafting is clearer in what constitutes a rent for the purposes of the proposed CFC rules.

Recommendation

That the submission be declined.

Issue: Licence fees

Submissions
(30 – Staples Rodway, 65 – The Whyte Group, 67 – New Zealand Institute of Chartered Accountants)

Licence fees received from intangible property should not be treated as a "rent" under proposed section EX 20B(3)(e), but rather such payments should receive the same treatment as royalty income and, as such, licence fee payment should fall within the scope of the royalty provisions.

Comment

The proposed definition of "rent" in the bill mirrors the current definition of "lease" in other parts of the Income Tax Act. This is to ensure that there is consistency across the Income Tax Act. However, the policy intent was to carve out licence fees received from intangible property from the "rent" provisions and have the "royalty" provisions apply to such payments.

To ensure the policy intent of the proposed legislation is carried out, the proposed legislation should be amended to clarify the treatment of licence fees received from intangible property by explicitly treating such payments in the same way as royalty payments.

Recommendation

That the submissions be accepted.

Submission
(65 – The Whyte Group)

Third party licence fee income derived by a CFC should be deemed active and exempt from attribution, regardless of whether it is derived in the same jurisdiction as the CFC or another jurisdiction.

Comment

As noted above, it is agreed that licence fees received from intangible property and royalty income should receive the same treatment. As such, the same exclusions applicable to royalty payments should be extended to licence fees also. While we agree that third party licence fee income derived by a CFC should be deemed active and exempt from attribution, it is important to stress that the same criteria applicable to the proposed royalty exemptions should also be applied to licence fee payments that are not royalties.

Recommendation

That the submission be accepted, and that certain licence fee payments be treated as active and exempt from attribution provided those payments satisfy all the requirements set out in the royalty exclusions.

Issue: Insurance income – change in revenue account property

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section EX 20B(3)(f)(ii) – regarding income from a change in value of revenue account property used in an insurance business – should be removed. This is because a change in the value of revenue account property would not be income under any other part of New Zealand tax law and that in any case, income from the sale of property that is likely to generate passive income is covered elsewhere in sections EX 20B(3)(i) and (j).

Comment

Officials agree that section EX 20(3)(f)(ii) is not necessary as the income which it is intended to capture would be covered elsewhere in the passive income definition.

Recommendation

That the submission be accepted.

Issue: Income from a life insurance policy that is not FIF income

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section EX 20B(3)(g) – income from a life insurance policy which is not included in the calculation of FIF income or loss – appears unnecessary as any life insurance policy taken out by a CFC should already be taxed under the FIF rules.

Comment

Section EX 20B(3)(g) would apply if the CFC took out life insurance with a New Zealand company. Payouts on these policies are treated as passive income as otherwise they could be used to make New Zealand income free from tax.

Recommendation

That the submission be declined.

Issue: Key person insurance

Submission
(Matter raised by officials)

While income under a life insurance policy should be included in the passive income of a CFC, there should be an exception for "key person" insurance.

Comment

Income under a life insurance policy is included in passive income of a CFC because it can be used as a substitute for interest. For instance, income from insurance bonds is income under a life insurance policy even though the bonds may have only a very small insurance component.

However, CFCs may have "key person" insurance, which insures the CFC against the death or incapacity of key personnel, typically senior managers. Taking out such policies would be a normal part of an active business. Where this insurance is term life insurance over personnel of the CFC, income under the policy should not be counted as passive income.

Recommendation

That the submission be accepted.

Issue: Income from personal service

Submission
(67 – New Zealand Institute of Chartered Accountants)

The "working person" in the proposed section EX 20B(3)(h) should not include a person who is not resident in New Zealand in the income year.

Comment

The policy intent behind the personal services rule is to eliminate the situation where a New Zealand resident uses a CFC to avoid tax on income from personal effort. As such, it would be sensible for the rule to apply to a "working person" who is resident in New Zealand in at any time in the income year. New Zealand does not tax a non-resident's foreign-sourced income.

Recommendation

That the submission be accepted.

Issue: Revenue account property

Submission

(68 – Corporate Taxpayers Group)

There is confusion as to whether the amount of gain is based on the cost of the property converted at the foreign exchange rates at the date of acquisition or whether it is the gain in the foreign currency converted into New Zealand currency at the date of sale. The submission considers that taxpayers should be given the option to calculate gain in foreign currency and convert it into New Zealand dollars in accordance with the current rules that apply in section EX 21.

Comment

Officials agree that taxpayers should be given the option to calculate the gain in the foreign currency and convert it into New Zealand dollars in accordance with the current rules that apply in section EX 21. The bill provides that section EX 21 applies for various purposes, including determining an attributable CFC amount. The rules about currency conversion at section EX 21(4) would therefore already apply for most purposes.

The bill currently provides that, for calculations under section EX 21D (the tax-based active business test), the CFC's functional currency must be used (section EX 21(3B)(b) and (8B)). Officials consider that this requirement can be dropped and that the usual rules in section EX 21(4) can also apply for the purposes of section EX 21D.

Recommendation

That the submission be accepted.

Submission

(67 – New Zealand Institute of Chartered Accountants)

Proposed section EX 20B(3)(j) should reflect the policy as set out in the commentary to the bill.

Comment

The policy intent of section EX 20B(3)(j) is to treat income derived from the disposal of revenue account property held by a CFC that is not used in an offshore active business as passive income. The submission states that the current drafting of the section does not deliver this policy intent; in particular, as currently drafted, the section will apply to all disposal of revenue account property, even if the property is used in an offshore active business.

Section EX 20B(3)(j) currently refers to revenue account property that is "capable of giving rise to income of the CFC referred to in another paragraph of this section". Officials agree that this could potentially be given a very wide interpretation. The submission suggests that the provision be amended so that it only applies to property that is actually employed in deriving passive income. This seems sensible.

Recommendation

That section EX 20B(3)(j) be amended to refer to revenue account property employed in, or for the purpose of, deriving income of the CFC referred to in a another paragraph of the subsection.

Submission
(35 – PricewaterhouseCoopers)

The word "alienation" in proposed sections EX 20B(3)(j) and EX 20B(7) should be replaced with "disposal".

Comment

Officials agree that New Zealand domestic law prefers the term "disposal" over "alienation".

Recommendation

That the submission be accepted.

Submission
(Matter raised by officials)

Income from the disposal of share options held on revenue account should be included within the attributable CFC amount.

Comment

Share options (along with shares) are excepted financial arrangements (sections EW 4(3) and EW 5(13)) specifically excluded under subpart EW. This means that they do not give rise to an attributed CFC amount under section EX 20B(4). Income from the disposal of shares held on revenue account will be subject to attribution by virtue of section EX 20B(3)(i), but there is currently no equivalent provision for share options. Trading in intangibles is inherently mobile and, as such, is an activity that ought to be treated as giving rise to attributable income. In view of this, we consider that income from trading in share options should be treated as an attributable CFC amount.

Recommendation

That section EX 20B(3) be amended so that income from the disposal of share options held on revenue account is treated as an attributable CFC amount.

Issue: Certain income related to telecommunications services

Submission

(66 – Telecom)

All income from a telecommunications service relating to the use of international submarine cables should be treated as active if the income interest in the CFC is not greater than 50 percent.

Comment

As a general principle, the active income exemption aims to put CFCs on the same tax footing as competitors in their own jurisdiction, if the CFC is carrying on an active business there. For example, a CFC in an overseas country that operates retail outlets in that country will face the same liability for tax as its competitors.

There are limits to this principle, however. Certain types of income – referred to collectively in the new rules as passive income – are not tied to a particular jurisdiction and can be moved to a low-tax jurisdiction to minimise tax. If this income is not taxed, there is a real danger that New Zealand-sourced income will be shifted overseas and that the tax base will be undermined. Income from international submarine cables used in telecommunications is one such type of income.

Because large parts of these cables are not included in any jurisdiction and, in the absence of specific tax rules, income from their use will be taxable only in the country in which the assets are owned. This can be chosen to be a low-tax or nil-tax jurisdiction.

The submission states that even if income from a telecommunications cable is passive income, it should not be passive income unless the income interest of the New Zealand taxpayer in the CFC exceeds 50 percent. Unless the interest exceeds 50 percent, according to the submission, the New Zealand taxpayer has no control over the location of the CFC.

For the purposes of the definition of controlled foreign company (CFC) in the Income Tax Act 2007, it is sufficient for a New Zealand resident to hold a control interest of 40 percent or more in the foreign company, as long as no non-resident also holds an interest of 40 percent or more. Officials do not see any justification for departing from this long-standing rule.

Recommendation

That the submission be declined.

Submission
(68A – Corporate Taxpayers Group)

Section EX 20B(3)(m) is unnecessary and, if retained, subparagraphs (i), (iii) and (iv) should be removed.

Comment

Section EX 20B(3)(m) includes, as passive income, income from a telecommunications service that is physically performed in New Zealand, except when the service is between the CFC's jurisdiction and New Zealand and is not performed by staff or equipment of the CFC located in New Zealand.

Telecommunications services are not passive income under the normal "base company income" rule in section EX 20B(3)(k), which catches income from services physically performed in New Zealand. Telecommunications was specifically removed from that rule because of the technical difficulty of determining where a telecommunications service is performed. Section EX 20B(3)(m) clarifies that income from the provision of telecommunications services between the jurisdiction of the CFC and New Zealand is active income of the CFC.

However, section EX 20B(3)(m) contains limitations to ensure that the rule is not used to shift domestically sourced income abroad. (See the submission on "mobile roamers" below for an example of what might happen.) The submission correctly makes the point that income that the limitations seek to catch will often be caught anyway because there will be a substantial place of business in New Zealand. This will not always be the case. If the income is caught, there will be a tax credit, to be used against attributed passive income, to prevent double taxation.

Recommendation

That the submission be declined.

Submission
(66 – Telecom)

CFC income from telecommunications services provided between two sites in New Zealand (such as where a "mobile roamer" of a CFC travels to New Zealand and makes a call to a person in New Zealand) should not be passive income.

Comment

CFC income from telecommunications between the jurisdiction of the CFC and New Zealand is not passive income if certain requirements are met. This exemption does not extend to telecommunications entirely within New Zealand.

A CFC is not often expected to encounter the situation of telecommunications entirely within New Zealand. However, the submission provides the specific example of "global roamers". For example, a CFC in Australia might provide a global roaming service to its Australian customers. If those customers then travel to New Zealand and use that global roaming service to makes calls here, the calls will generate CFC passive income.

The primary reason for carving some telecommunications services out of the definition of passive income is that it is difficult to identify where a telecommunications service is performed (it is always performed in at least two countries if there is cross-border communication). In the case of calls carried out entirely within New Zealand, there is no such difficulty.

Furthermore, if the exemption were extended to telecommunications within New Zealand, there would be a danger that existing New Zealand telecommunications providers would incorporate CFCs in low-tax jurisdictions and provide – for example – mobile phone services to New Zealanders through those CFCs. It is not the aim of the reforms to allow income to be shifted in this way.

Recommendation

That the submission be declined.

Submission
(66 – Telecom)

CFC income from telecommunications between the jurisdiction of a CFC and New Zealand should not be passive if the CFC is an associate of a network operator.

Comment

CFC income from telecommunications between the jurisdiction of the CFC and New Zealand is not passive income if certain requirements are met. One of those requirements is that the CFC, or a person who has an income interest in the CFC of 50 percent or more, is a network operator under the Telecommunications (Interception Capability) Act 2004.

In Telecom's case, the network operator in the corporate group is not a CFC and does not own any CFCs. However, CFCs within the group and the network operator have a common parent. Telecom's submission is that the rules should be widened to bring in such a structure, so that CFC income will not be passive. Telecom's submission is that it should be sufficient for the CFC and the network operator to be associated persons.

The purpose of the network operator requirement is to increase the likelihood that the business activity that is being relieved from tax is genuine telecommunications. Officials agree that sister companies within a group should be able to satisfy the requirement if a parent and subsidiary can. Officials therefore recommend that the requirement be altered so that the exemption applies where the CFC is a network operator, or where a company has a 50 percent or greater income interest in both the network operator and the CFC.

Officials do not recommend altering the rule to include any “associate” or “associated person” because this would potentially bring in entities outside a corporate group.

Recommendation

That the submission be accepted in part, and that the requirement for the CFC to be a network operator or to be majority-owned by a network operator be altered so that the network operator and the CFC merely need a common controlling parent.

Submission
(66 – Telecom)

CFC income from telecommunications between the jurisdiction of a CFC and New Zealand should not be passive merely because the service is performed using equipment or staff of the CFC based in New Zealand.

Comment

CFC income from telecommunications between the jurisdiction of the CFC and New Zealand is not passive income if certain requirements are met. One of those requirements is that the service is not performed using equipment that is physically located in New Zealand and in the possession of the CFC or another CFC. Another of the requirements is that the service is not performed using staff located in New Zealand and employed or contracted by the CFC or another CFC.

Telecom submits that income from such a service would probably be taxable in New Zealand under normal principles if the CFC had substantial equipment or staff here, and should not be taxed under the CFC rules.

If tax is imposed under the CFC rules, the CFC receives a credit for any tax paid on the same income in New Zealand. (See section LK 1 of the Income Tax Act 2007.) Telecom recognises this in its submission. This prevents double taxation. It is not an uncommon occurrence for CFCs to pay some tax in New Zealand and to receive a credit for that tax when calculating attributable CFC income.

The reason for the rule is that there may be situations in which a CFC’s income from equipment and staff based in New Zealand is not taxable in New Zealand under a double tax agreement. It then must be taxed under the CFC rules if double non-taxation is to be prevented.

Recommendation

That the submission be declined.

Issue: Base company rules – services partly performed in New Zealand

Submissions
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

When a service is partly performed in New Zealand, tax should be imposed under section EX 20B(3)(k) only on the income that relates to that part of the service. *(PricewaterhouseCoopers, Corporate Taxpayers Group)*

Section EX 20B(3)(k) should be amended to ensure that a service must be physically performed in New Zealand, or that incidental services are not captured. *(New Zealand Institute of Chartered Accountants)*

Comment

Section EX 20B(3)(k) provides that income derived by a CFC from a service performed wholly or partly in New Zealand (other than a telecommunications service) is included in the attributable CFC amount. This rule protects the domestic tax base from inappropriate off-shoring of New Zealand-sourced income by routing a service through a CFC.

The reference in this provision to a service being partly performed in New Zealand ensures that the provision applies to all services performed here, even if they are also partly performed somewhere else. We agree that, when a service is only partly performed in New Zealand, it would be appropriate to allow the income derived to be apportioned on a reasonable basis for the purposes of determining the attributable CFC amount. This should also help to address concerns around incidental services.

Section EX 20B(3)(k) is already expressly limited to services physically performed in New Zealand.

Recommendation

That section EX 20B(3)(k) be amended to make clear that apportionment is permitted.

Issue: Base company rules – income with a New Zealand source

Submission
(35 – PricewaterhouseCoopers, 68 – Corporate Taxpayers Group)

Section EX 20B(3)(k) should be restricted to circumstances in which income has not been subject to New Zealand tax – recognising that, except when relief is available under a double tax agreement, income from services performed in New Zealand will normally be taxed here anyway on a source basis.

Comment

The possibility that income derived by a CFC will be taxed directly, as well as under the CFC rules, arises for any New Zealand-sourced income. Rents, royalties and other payments sourced and taxed in New Zealand may also be within the scope of section EX 20B. In each case, double taxation is relieved through the provision of credits under subpart LK. When a CFC pays New Zealand tax on an amount of income, a credit is available to offset the shareholder's tax liability. If the shareholder's liability exceeds the tax paid by the CFC – as may be the case for non-corporate shareholders with a marginal rate higher than the company rate – it is appropriate that the shareholder remains liable for the balance.

Recommendation

That the submission be declined.

Issue: Base company rules – interaction with the active business test

Submission
(32 – KPMG)

Section EX 21E(8) should be reconsidered as it disadvantages global companies that utilise the services of their CFCs to fill skill gaps in New Zealand.

Comment

Section EX 21E(8) tests whether a CFC is a non-attributing active CFC. Paragraph (d) states that the income from services performed in New Zealand should be treated as "added passive" income for these purposes. Such income is included in the attributed CFC amount under section EX 20B(3)(k). It is therefore appropriate that it should also be taken into account under section EX 21E. There is already a minimum threshold under section EX 21E because any CFC with less than 5 percent passive income will be exempt from attribution on all their income.

Recommendation

That the submission be declined.

Issue: Holding company exemptions and liability to tax in the foreign country

Submission

(Matter raised by officials)

The "holding company" exemptions should be available only to CFCs that are liable to tax in the same jurisdiction.

Comment

An active CFC can pay royalties, interest and rent to an associated CFC such as a holding company, without the associated CFC having to recognise any passive income, as long as the CFC and the associated CFC are in the same jurisdiction (see sections EX 20B(5)(c), (6)(c) and (8)(a)). The CFC and the associated CFC are considered to be in the same jurisdiction if the associated CFC is:

> "Subject with the CFC to the laws of the same country or territory under which, for each company,—
>
> (i) the company is liable to income tax on its income because of its domicile, residence, place of incorporation, or centre of management [and/or]
>
> (ii) persons holding income interests in the company are liable for the income tax on its income and the country or territory is the source of 80% or more of that income" (see definition of "associated non-attributing active CFC" in section YA 1).

We consider that the second limb of the residence test in the definition ("persons holding income interests…") should be removed. If it remains, income of an active business may not be taxed in any jurisdiction, which provides strong incentives for New Zealand taxpayers to move investments and business activities abroad. This is not the intent of the international tax reform; there is an expectation that CFCs will face the normal tax rate in their jurisdiction.

Example

CFC A and CFC B are both residents of Country A. Country A considers CFC A to be a company and CFC B to be a non-entity for tax purposes. Country A considers that any payments to CFC B are in fact made directly to CFC B's shareholders in New Zealand.

CFC A is an active business and earns income of $100 million. CFC A pays deductible interest and royalties of $100 million to CFC B, reducing A's taxable income under the rules in Country A to nil. CFC B is not liable to tax in Country A (Country A may attempt to impose non-resident withholding taxes on payments to CFC B, but usually at a substantially lower rate than the company tax rate).

Rules as printed in the bill:

Under New Zealand tax rules, CFC A is considered to have no passive income because it is an active business. CFC B has no passive income because of the "holding company" exemptions.

There is little or no tax in Country A or in New Zealand on the income of the CFCs.

Proposed rules:

As with the current rules, there will be little or no tax imposed by Country A, and CFC A will be treated in New Zealand as having no passive income. However, CFC B will be treated as having $100 million of passive income. Tax will be imposed on this amount, unless CFC B has sufficient active income (approximately $2 billion in this case) to qualify as an active business.

Similar changes are recommended to the rules relating to the active business test, to prevent consolidation of CFCs that are not liable to tax in the same country (in the same way as with the "holding company" exemptions, consolidation leads to inter-CFC payments not being included as passive income of the recipient).

The second limb of the residence test in the definition comes from the test for residence of CFCs that was introduced in 2006 (this test was unintentionally omitted from the 2007 Income Tax Act). The test was introduced to extend the "grey list" exemption from ordinary companies to so-called hybrid entities – entities that New Zealand sees as companies but which are not liable to tax in the foreign jurisdiction because that jurisdiction sees them as "flow-through" for tax purposes. For example, an Australian unit trust is not liable to tax in Australia as long as it distributes all its income to unit-holders, but New Zealand sees the unit trust as a company.

The 2006 extension was an appropriate measure for hybrid CFCs that earned business income (other than interest, rent, dividends and royalties) through a fixed place of business, because the foreign jurisdiction would impose tax on New Zealand shareholders of the CFC at the normal foreign tax rate. In the context of grey list countries, this meant tax paid abroad would be broadly comparable to tax paid in New Zealand. The extension was not so logical for CFC earning passive income, because the foreign jurisdiction had only limited rights to tax the New Zealand shareholders on the income, usually by imposing a non-resident withholding tax at a lower rate than the corporate tax rate. However it was not appropriate to draw a distinction between the two sorts of income in that context.

Recommendation

That the submission be accepted.

Issue: Rent exemption and liability to tax in the foreign country

Submission
(Matter raised by officials)

That the exemption for rent from property in the CFC's jurisdiction be available only to CFCs that are liable to tax in the same jurisdiction.

Comment

Section EX 20B(6)(a) and (b) remove, from passive income, rent received by a CFC from land or property in a country under the laws of which:

(i) the company is liable to income tax on its income because of its domicile, residence, place of incorporation, or centre of management [and/or]

(ii) persons holding income interests in the company are liable for the income tax on its income and the country or territory is the source of 80% or more of that income".

We consider that the second limb of the residence test in the definition ("persons holding income interests…") should be removed. The previous submission on the "holding company" exemptions provides more explanation.

Recommendation

That the submission be accepted.

NET ATTRIBUTABLE CFC INCOME OR LOSS

Clauses 119, 121 and 122

Overview

The rules for calculating net attributable CFC income or loss are set out in new sections EX 20C and EX 20D, and section EX 21:

- Section EX 20C provides that net attributable CFC income or loss is to be calculated using a prescribed formula and lays down the main rules concerning the deductibility of expenditure.
- Section EX 20D makes special provision regarding the deductibility of interest expenditure for excessively debt-funded CFCs.
- Section EX 21 applies the Act (subject to certain modifications) for certain specified purposes, which include the calculation of net attributable CFC income or loss, as though a CFC were a New Zealand resident.

Non-interest expenditure will be deductible in calculating net attributable CFC income or loss to the extent it is incurred for the purposes of deriving an attributable CFC amount and not incurred for the purposes of deriving a non-attributable amount. This is consistent with the nexus test that applies to non-interest expenditure in the domestic context.

For most resident companies, there is no nexus test for interest expenditure. Allowing a CFC to deduct all interest would mean debt could be used to shelter attributable income. Deductions for interest expenditure incurred by a CFC will therefore be based on the proportion of a CFC's assets that are used to derive an attributable CFC amount.

To prevent offshore debt being concentrated in CFCs with mainly attributable assets, thereby sheltering attributable income, special rules apply to CFCs that are excessively debt funded. A CFC will be treated as excessively debt funded if its debt-to-asset ratio is more than 75 percent and its relative debt-to-asset ratio is more than 110 percent. In this case, the CFC's interest deductions will be based on the overall asset mix of all the interest holder's CFCs.

Issue: Mechanics of the calculation provision

Submission
(67 – New Zealand Institute of Chartered Accountants)

Paragraphs (a)(ii) and (b)(ii) of section EX 20C(1) could give anomalous results. The section should be redrafted to exclude these provisions.

Comment

Section EX 20C(1) makes provision for the amount of a CFC's net attributable CFC income or loss. Paragraph (a)(ii) provides that the amount of net attributable CFC income is zero if paragraph (a)(i) does not apply. (Paragraph (a)(i) applies if the amount calculated under subsection (2) and section EX 21 is more than zero.) Similarly, paragraph (b)(ii) provides that the amount of net attributable CFC loss is zero if paragraph (b)(i) does not apply. (Paragraph (b)(i) applies if the amount calculated under subsection (2) and section EX 21 is less than zero.)

The concern raised in the submission is that a CFC with net income could nevertheless argue that its net attributable CFC income was zero under section EX 20C(1) by virtue of paragraph (b)(ii) because paragraph (b)(i) did not apply. Consideration will be given to whether there is scope for simplifying the drafting of section EX 20C, along with other provisions of the bill. As a technical matter, however, the concern raised in the submission is unfounded. Paragraphs (a) and (b) deal with income and losses separately. For a CFC with net income, paragraph (b)(ii) would indeed apply, but its effect would simply be to set the amount of the CFC's net loss at zero. The amount of the CFC's net income would still be determined in accordance with paragraph (a).

Recommendation

That the submission be declined.

Issue: Cross-references in the calculation provision

Submission
(67 –New Zealand Institute of Chartered Accountants)

The calculation rule in section EX 20C(1) should refer to "attributable CFC amount", or to section EX 20B, rather than to section EX 21.

Comment

Section EX 20C(1) refers to the formula in subsection (2) as well as to section EX 21. The formula in subsection (2) refers back to the attributable CFC amount determined under section EX 20B. The submission notes that section EX 20B itself refers to the rules in section EX 21 and questions whether it is necessary also to refer to those rules in section EX 20C(1).

The provisions of the Act that are applied by virtue of section EX 21 for the purposes of section EX 20B may be different from those that are relevant for the purposes of section EX 20C. For example, rules about deductibility are not generally relevant for the purposes of section EX 20B but are relevant to section EX 20C(7).

Recommendation

That the submission be declined.

Issue: Interaction between sections EX 20C and EX 21

Submission
(67 – New Zealand Institute of Chartered Accountants)

Deductions may be available both under section EX 20C and section EX 21 and the two sets of rules should therefore be rationalised.

Comment

Section EX 21(1) makes it clear that the section only applies for the specific purposes of calculating a CFC's attributable CFC amount (section EX 20B) and net attributable CFC income or loss (section EX 20C). Section EX 20C in turn provides that net attributable CFC income or loss is to be calculated using the formula in subsection (2). The rules in section EX 21 are relevant for the purposes of applying that formula. The formula, together with the other provisions of sections EX 20C and EX 20D, sets out when and to what extent deductions are available. A deduction that is not authorised by section EX 20C cannot independently be brought into the calculation of net attributable CFC income or loss by section EX 21.

Recommendation

That the submission be declined.

Issue: Non-interest expenditure

Submission
(32 – KPMG, 68/68A – Corporate Taxpayers Group)

Section EX 20C(7)(a) should simply require that expenditure is deductible to the extent it is incurred for the purposes of deriving an attributable CFC amount (without the additional requirement that it not be incurred for the purposes of deriving a non-attributable amount).

Comment

Section EX 20C(7)(a) provides that expenditure not relating to a financial arrangement is deductible to the extent it is:

(i) incurred for the purposes of deriving an attributable CFC amount; and

(ii) not incurred for the purposes of deriving an amount that is not an attributable CFC amount; and

(iii) a deduction of the CFC.

The submission concerns paragraphs (i) and (ii). Those paragraphs follow the model laid down in existing law for deductions generally. Specifically, section DA 1(1) provides that a person is allowed a deduction for expenditure incurred in deriving assessable or excluded income. At the same time, section DA 2(3) provides that a person is denied a deduction for expenditure incurred in deriving exempt income. If an item of expenditure relates to both assessable/excluded income and exempt income, the effect of subpart DA is to require apportionment of that expenditure. Likewise, when expenditure incurred by a CFC relates to both attributable and non-attributable amounts, the effect of paragraphs (i) and (ii) of section EX 20C(7)(a) together is to require apportionment.

Recommendation

That the submission be declined.

Issue: Interest expenditure – general approach

Submission
(68/68A – Corporate Taxpayers Group)

The rules about interest expenditure incurred by CFCs should allow taxpayers to trace borrowed funds to determine deductibility.

Comment

Under the bill, the extent to which interest expenditure incurred by a CFC is to be taken into account in determining net attributable CFC income or loss depends on the proportion of the CFC's total assets that are used to derive an attributable CFC amount. Limiting deductions in this way is intended to prevent debt being used to shelter attributable income. Effective taxation of this income is fundamental to protecting the tax base.

Allowing taxpayers to trace borrowed funds to determine interest deductibility would expose the tax base to an unacceptable level of risk. Tracing would involve identifying how debt had been applied and allowing a deduction for interest if the funds were used to derive attributable income. Although superficially attractive, tracing ignores the fact that money is fungible, and equity and debt readily substitutable. It therefore has little economic significance and can produce arbitrary results. Tracing would provide significant planning opportunities for firms, which would be able to match debt (and deductible interest payments) to attributable income streams, sheltering such income.

Recommendation

That the submission be declined.

Issue: Interest expenditure – basis of apportionment

Submission
(68/68A – Corporate Taxpayers Group)

The rules about interest expenditure incurred by CFCs should base apportionment on income rather than underlying asset values.

Comment

Using asset values, rather than income, as the basis for apportionment is preferred because it reduces the bias of varying rates of return from different asset classes. In short, it better reflects how capital is actually employed in the business. Asset-based apportionment should generally benefit the taxpayer, compared with an income-based approach, because returns on passive assets tend to be lower than those on active business assets.

Recommendation

That the submission be declined.

Issue: Interest expenditure – on-lending

Submission
(68/68A – Corporate Taxpayers Group)

The rules about interest expenditure incurred by CFCs should include an on-lending concession.

Comment

The submission argues that the rules about interest expenditure incurred by CFCs will create an additional tax liability when a CFC borrows to finance on-lending. Depending on the circumstances, interest earned by the CFC from the onward loan may be fully attributable, whereas only part of the interest it pays on the funds borrowed to finance the loan may be deductible.

If the CFC is on-lending to a third party, the bill achieves the desired result. Borrowing to fund debt investment and thereby derive attributable income is no different in principle from borrowing to fund any other passive investment. In any event, because money is fungible, matching particular debts to particular assets (including onward loans) is arbitrary and may not reflect the underlying economic reality.

There is a better case for modifying the rules as they apply to intra-group financing arrangements. New Zealand multi-nationals may operate financing subsidiaries which obtain debt finance on behalf of the group and then on-lend to operating subsidiaries. The rules in the bill potentially interfere with these arrangements by creating a tax liability that is essentially artificial if the counter-factual is direct borrowing by the operating subsidiary. This could be resolved by allowing a full deduction for interest paid by a CFC when funds are on-lent to associated CFCs. This would not involve tracing of borrowed funds. Rather, there would be an arithmetical adjustment based on the value of qualifying loans made by a CFC as a proportion of its own borrowing.

Recommendation

That the submission be accepted in relation to on-lending to associated CFCs.

Issue: Interest expenditure – excessively debt funded CFCs

Submissions
(24A – New Zealand Law Society, 35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants, 68/68A – Corporate Taxpayers Group, 73 – Deloitte for Seniors Money International)

The rules about interest expenditure incurred by CFCs should not make special provision for CFCs that are excessively debt funded. *(Corporate Taxpayers Group)*

The provision for excessively debt funded CFCs is structurally flawed because it does not reduce interest deductions by reference to the amount of excess debt. *(New Zealand Law Society, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

The provision for excessively debt funded CFCs should include an on-lending concession. *(Corporate Taxpayers Group, Deloitte for Seniors Money International)*

Comment

The provision made for excessively debt funded CFCs is an integrity measure which supports the standard rules about interest expenditure incurred by CFCs. In the absence of this provision and subject to commercial constraints, offshore group debt could be concentrated in CFCs with a high proportion of attributable assets. Equity funding could be concentrated in active CFCs with mainly non-attributable assets. Such structures could prevent the effective taxation of attributable income.

The existing bill provision is flawed and needs to be corrected. The policy intention is that, when a CFC is excessively debt funded, its interest deductions should be capped at the amount that would be allowed if apportionment was done by reference to the assets of all CFCs of the interest holder. Thus, if a CFC with mainly attributable assets is excessively debt funded, interest deductions will be limited by reference to the offshore asset mix of the group as a whole. This is different from the approach taken under the thin capitalisation rules, where adjustments reflect the amount by which debt exceeds the relevant threshold. The thin capitalisation approach is not appropriate for the purposes of section EX 20D. If an excessively debt funded CFC held more non-attributable assets than the group average, there would be no loss of revenue to New Zealand and it would be inappropriate to further restrict interest deductions.

When a CFC is performing group treasury functions, it may have a debt-asset ratio and a relative debt-asset ratio that routinely exceeds the prescribed thresholds. If the group as a whole is carrying on an active business, its offshore assets may be predominantly attributable assets. In that case, the application of a cap under section EX 20D would significantly restrict interest deductions for the CFC. In view of this, it seems appropriate to allow an adjustment for on-lending by a CFC when calculating its debt-asset ratio and relative debt-asset ratio. The adjustment should be limited to on-lending to associated CFCs, to limit firms' ability to use debt to shelter attributable income.

Recommendation

That the submissions be accepted in part, so that the provision for excessively debt funded CFCs be retained, but amended in line with the policy intention and tempered by an on-lending concession.

Issue: Interest expenditure – active financing entities

Submission
(73 – Deloitte, for Seniors Money International)

The rules about interest expenditure incurred by CFCs should not apply to active financing entities.

Comment

The case for extending the active income exemption to financial institutions (among others) will be considered as part of the second stage of the international tax reforms. Interest allocation and interest apportionment rules for financial institutions will be considered as part of that work. Officials do not recommend exempting offshore financial institutions from the interest expenditure rules in the meantime. Dealing appropriately with financial institutions raises difficult policy and technical issues. There are potentially significant implications for the tax base if the rules are not properly designed.

Although finance companies will tend to have debt-to-asset ratios in excess of the threshold (75 percent) prescribed in section EX 20D(2)(a), two safeguards should help to mitigate the impact of the rules in the short-term. First, a CFC will only be treated as excessively debt funded if it also has a relative debt-to-asset ratio of more than 110 percent. This means that a CFC will only be treated as excessively debt funded if it geared out of line with the group as a whole. Secondly, even if a CFC is treated as excessively debt funded, its interest deductions will only be capped if it has a proportion of attributable assets that is higher than the group average.

Recommendation

That the submission be declined, but the matter considered as part of the second stage of the international tax reforms.

Issue: Interest expenditure – testing dates

Submission
(68A – Corporate Taxpayers Group)

The rules about interest expenditure should include flexible testing dates and allow taxpayers to undertake calculations at different times, consistent with the thin capitalisation rules.

Comment

As the submission points out, clarification is needed about when and how asset valuation under section EX 20C is to be carried out. The thin capitalisation rules, which allow daily, monthly or annual measurement of group debt and group assets provide a useful model. An equivalent outcome is already substantially achieved under section EX 20D through the application of sections FE 8 to FE 11, although some minor technical corrections are required.

Recommendation

That the submission be accepted.

Issue: Interest expenditure – accounting standards

Submission
(67 – New Zealand Institute of Chartered Accountants)

It is not appropriate to require the use of generally accepted accounting practices for measuring assets and debts of CFCs for the purposes of section EX 20D.

Comment

CFCs are already effectively subject to New Zealand tax law as if they were resident companies by virtue of section EX 21. This includes certain requirements to comply with generally accepted accounting practices. It is appropriate that, when measuring assets and debts for the purposes of calculating net attributable CFC income or loss, New Zealand accounting standards should apply. A similar approach is taken in section EX 20C.

Recommendation

That the submission be declined.

Issue: Interest expenditure – fixed-rate foreign equity and deductible foreign equity

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants, 68/68A – Corporate Taxpayers Group)

Dividends on fixed-rate shares and dividends that are deductible in a foreign jurisdiction should not be subject to the rules about interest expenditure incurred by CFCs, but should rather be treated as fully deductible for the purposes of calculating net attributable CFC income or loss.

Comment

While foreign dividends will generally be exempt under the new rules, dividends on fixed-rate shares and deductible dividends will remain taxable when paid by a CFC to a New Zealand-resident company or another CFC. In the absence of the branch equivalent tax account rules (which will be repealed after a transitional period), taxing these dividends gives rise to the possibility of economic double taxation: foreign income derived through a CFC may be taxed on accrual as it is earned, and then taxed again if paid out as a taxable dividend.

This double taxation will be relieved by allowing deductions for the payment of such taxable dividends when calculating net attributable CFC income or loss. The potential for double taxation only arises to the extent that a dividend paid by a CFC represents a distribution of attributable income (which is taxed on accrual) rather than non-attributable income (which is not). It is therefore appropriate to limit deductions for such dividends in the same way as for interest.

Elsewhere in this report, it is recommended that the bill be amended so that dividends on fixed-rate shares and deductible dividends are no longer treated as interest. Rather, they will be treated as taxable dividends in the hands of New Zealand-resident shareholders or CFCs. As part of that change, express provision will be made to ensure that deductions for these dividends remain subject to the same limits as deductions for interest.

Recommendation

That the submission be declined.

Issue: Interest expenditure – cross-reference to subpart FE

Submission
(62 – Minter Ellison Rudd Watts)

In section EX 20D(8), the reference to section FE 31 should instead be a reference to section FE 31B.

Comment

The cross-references to subpart FE in section EX 20D(8) need to be updated to take account of changes introduced by clauses 172 to 174 of the bill. They key provision to refer to is new section FE 31B, which makes provision for the worldwide group for an excess debt outbound company. Sections FE 31C and FE 32 are also relevant. Section FE 31 as amended deals with worldwide groups for corporate excess debt entities that are not excess debt outbound companies and is therefore no longer relevant for these purposes.

Recommendation

That the submission be accepted.

Issue: Interest expenditure – miscellaneous drafting issues

Submissions
(67 – New Zealand Institute of Chartered Accountants)

Section EX 20D(1) would make more sense if it applied for the purposes of section EX 20C(6). The existing cross-reference to section EX 20C(3) does not read intuitively and means that people have to refer to two separate subsections.

The heading to and first line of section EX 20D(15) should refer to "excessively debt funded" entities.

The reference to section EX 20C(6) in section EX 20D(15) should be a reference to section EX 20C(6)(b).

Comment

Section EX 20D needs to be generally amended to give effect to the policy intent. In making those changes, consideration will also be given to these detailed drafting suggestions.

Recommendation

That the submissions be noted.

Issue: Section EX 21 – income from another CFC

Submission
(67 – New Zealand Institute of Chartered Accountants)

An amount of passive income as defined in section EX 20B should not be attributable if the income is also attributable income of another CFC.

Comment

Under existing law (section EX 21(16) and (17)), dividends between CFCs are not taken into account in determining branch equivalent income. This submission argues that the same principle should apply to items of attributable income derived by one CFC from another CFC if a person has an income interest of 10 percent or greater in both CFCs.

Under the bill, dividends will only form part of a CFC's attributable CFC amount in certain limited circumstances. Other types of income derived by a CFC from another CFC may form part of the attributable CFC amount. This is necessary, in particular, to prevent profits being shifted to exploit low tax regimes. It also reflects the fact that payments such as interest and royalties will generally be deductible to the CFC making the payment.

Recommendation

That the submission be declined.

Issue: Section EX 21 – treatment of subvention payments

Submission
(67 – New Zealand Institute of Chartered Accountants)

The provisions of section EX 21 should be examined to make sure that the approach in section EX 20C(1)(a)(i) and (b)(i) is valid.

Comment

Section EX 20C(1) provides that net attributable CFC income or loss is calculated using the formula in subsection (2) and the rules in section EX 21. The submission notes that the rules in section EX 21 may not always be mere calculation rules, and suggests that they be re-examined to ensure their application continues to be appropriate once the active income exemption takes effect. The submission questions, in particular, the treatment of subvention payments under section EX 21(24).

Section EX 21(24) modifies the application of the Act in relation to subvention payments for the purposes of calculating branch equivalent income. The provision is aimed at subvention payments made under foreign law. The issue raised in the submission is that, under the new CFC rules, a subvention payment could be made from a profit-making CFC subject to attribution in return for losses from a loss-making active CFC. In that case, attributable income would be offset by deductions under section EX 21(24), but there would be no corresponding increase in the attributable income of the active CFC (because it is not subject to attribution). This could give rise to tax planning opportunities, with losses from an active business transferred by way of a subvention payment to shelter the attributable income of an associated CFC.

We are not aware of other provisions of section EX 21 requiring further amendment.

Recommendation

That the submission be noted, and that section EX 21(24)(b) be amended so that a deduction is not available to a CFC making a subvention payment to a non-attributing active CFC.

INTEREST ALLOCATION RULES

Overview

The interest allocation rules are a key part of the international tax reform package. They are designed to counter a major potential risk to the tax base following the introduction of the new active exemption. The exemption could create an incentive for firms to fund their CFCs from New Zealand to maximise their interest deductions against New Zealand income. This would potentially erode the New Zealand tax base.

The interest allocation rules will address this risk. They have been designed with a view to the commercial realities faced by companies, particularly small and medium-sized companies. The rules do not eliminate the risk to the New Zealand tax base from over-allocation of interest costs to New Zealand, but they do guard against the possibility of extreme abuse.

Other countries, including Australia, that have an active income exemption, have similar interest allocation rules.

Issue: Outbound interest allocation rules should not be introduced

Submissions

(21 – NZ Oil and Gas, 32 – KPMG, 35 – PricewaterhouseCoopers, 59 – Fletcher Building, 62 – Minter Ellison Rudd Watts, 67 – New Zealand Institute of Chartered Accountants)

Applying interest allocation rules to New Zealand firms with interests in CFCs will significantly reduce the benefit of the new international tax rules. Companies that currently have significant CFC investments covered by the grey list exemption will be particularly affected. The rules will also impose significant compliance costs.

Interest allocation rules are not required because there is currently no evidence to indicate that New Zealand companies are allocating excessive amounts of debt to their New Zealand operations, and any potential mischief would be addressed by New Zealand‘s transfer pricing rules.

From a practical point of view, the proposed rules will inhibit expansion abroad. When businesses start up in foreign jurisdictions, the initial funding will often come in the form of equity from the New Zealand parent – either because the host jurisdiction has minimum equity requirements or because the subsidiary cannot obtain funds from banks in the host jurisdiction. The New Zealand parent may well have to borrow in New Zealand to fund its equity investment and the interest allocation rules may prevent this borrowing from being deductible.

Comment

The introduction of an active income exemption for CFCs is a radical change to New Zealand's tax rules. It fundamentally changes the incentives governing the location of CFC interest expenses. Under an active income exemption, CFC income may be taxed at much lower tax rates in the CFC's jurisdiction. Deducting interest expenses incurred in generating income that is subject to a low rate of foreign tax against New Zealand's higher taxed income effectively subsidises offshore investment. This could create an incentive for some New Zealand companies with outbound investment to over-allocate their global interest costs against their New Zealand-sourced income, in effect eroding the New Zealand tax base.

The outbound interest allocation rules proposed in the bill are simply intended to provide a minimum defence against the erosion of the New Zealand tax base in the context of an active income exemption. Generous safe harbours and minimum thresholds contained in the bill mean that these rules should apply infrequently. Under the proposed rules interest deductions would only be denied when the New Zealand company's debt-to-asset ratio exceeded 75 percent – which would represent a very high level of gearing for most businesses – or 110 percent of the worldwide group's debt-to-asset ratio. Even then, only debt in excess of these thresholds would be subject to interest denial. Moreover, firms with more than 90 percent of their assets in New Zealand would be exempt from applying the rules. Officials are also recommending raising the threshold for interest deductions below which the rules do not apply from $250,000 to $1 million. This will further limit the application of the rules. More details on this relaxation are provided later in this report.

Recommendation

That the submissions be declined.

Issue: Outbound interest allocation rules should not apply to New Zealand companies that are owned and controlled by New Zealand residents

Submissions
(21 – NZ Oil and Gas, 32 – KPMG, 40 – Fisher & Paykel Healthcare, 59 – Fletcher Building, 66 – Telecom, 68 – Corporate Taxpayers Group, 73 – Seniors Money International, 78 – Seaworks)

The proposed interest allocation provisions do not take into account that the imputation rules provide an incentive for New Zealand-owned companies to pay tax in New Zealand. The imputation rules mean that New Zealand-owned firms have no incentive to allocate excessive debt to New Zealand. If interest allocation rules for outbound investment are to be introduced, they should only apply to those entities that currently are within the scope of the thin capitalisation rules – that is, non-residents and New Zealand companies owned by non-residents.

Comment

It is important that the interest allocation rules apply to New Zealand-owned companies as well as to foreign-owned firms. Imputation does provide some limited protection for the New Zealand tax base. However, exempt active income will only be taxed to New Zealand shareholders if and when it is repatriated to the New Zealand parent and if and when the parent company subsequently distributes the income to the shareholder. New Zealand will suffer a tax loss if the repatriation of the income and its distribution to New Zealand shareholders is delayed. The New Zealand shareholder may also never be taxed on CFC income if, for instance, the sale of the shares in the CFC takes place before repatriation.

Recommendation

That the submission be declined.

Issue: Application of interest allocation rules to smaller entities

Submission
(67 – New Zealand Institute of Chartered Accountants)

The outbound interest allocation rules should not apply to entities that meet two of the following criteria:

- turnover of less than $10m;
- assets of less than $20m;
- fewer than 50 staff.

Submission
(38 – New Zealand Council of Trade Unions)

Although the interest allocation rules might place a disproportionate compliance burden on SMEs, the rules should not contain any distinction between firms based on their size.

Comment

There is no reason in principle to completely exclude SMEs from the interest allocation rules. If the rules did not apply to SMEs, it would be possible for smaller enterprises to load excessive amounts of debt into their New Zealand operations. Although the loss to the tax base in each individual case might be limited, the cumulative effect could well be significant.

However, it is true that smaller firms can sometimes find it more difficult than larger firms to borrow in overseas jurisdictions and can encounter greater difficulties in pushing debt down into their CFCs. The compliance requirements of the interest allocation rules could also in some cases be more burdensome for smaller firms than for larger groups. The interest allocation provisions currently in the bill contain certain features that are intended to mitigate any potential impact on SMEs, particularly the minimum threshold of $250,000 for interest deductions below which the rules do not apply.

Officials have considered whether any further provision should be made for SMEs in the rules. After consultation with firms and professional advisers, officials recommend that the minimum threshold of $250,000 should be increased to $1 million. Officials also recommend that the impact of the interest allocation rules should be mitigated for firms that breach the 75 percent debt percentage safe harbour and have interest deductions of between $1 million and $2 million. The formula by which this would be achieved would ensure that the amount of relief available was gradually reduced, so that a firm with just over $1 million of interest deduction that breached the 75 percent safe harbour would get almost full relief, while a firm with nearly $2 million worth of deductions would get virtually no relief. Where a firm had deductions of more than $2 million, this recommended concession would have no effect. Gradually withdrawing the concession for firms with deductions of more than $1 million avoids the possible cliff-edge effect of a pure “de minimis” threshold.

This concession is based on interest deductions rather than company size, so at first sight it might appear not to be focused on SMEs. However, the concession will only be of practical benefit to SMEs. Any large company with interest deductions of under $2 million would be well within the 75 percent debt percentage safe harbour, so this concession would not provide any additional benefit for such companies.

It should be emphasised that there is no significant evidence that the interest allocation rules as currently drafted would have a major impact on SMEs at the moment. So the recommended extensions of the concessions do not address immediate concerns. They are instead designed to mitigate any potential impact on SMEs as they expand overseas in future years.

Recommendation

That the submissions be declined, but that the current minimum threshold below which the interest allocation rules do not apply be raised from $250,000 to $1 million, and some relief be available for firms with interest deductions of between $1 million and $2 million.

Issue: Interest allocation rules should not apply to individuals resident in New Zealand

Submission
(68B – Corporate Taxpayers Group)

The interest allocation rules should not apply to individuals.

Comment

There is no reason to differentiate between individuals and companies that own CFCs. Specifically, there is no reason to allow individuals with interests in CFCs to deduct excessive amounts of debt against income from their New Zealand operations. In practice, the rules will usually apply to companies with interests in CFCs because, as a commercial reality, multi-national operations are usually organised through corporate structures. But the rules should apply to New Zealand-resident individuals and trustees of trusts settled by New Zealand residents. Otherwise arrangements could be put in place to circumvent the rules by adjusting the ownership structure of companies.

Recommendation

That the submission be declined.

Issue: There should be a transitional period during which the new rules do not apply to existing financing arrangements

Submission
(35 – PricewaterhouseCoopers, 66 – Telecom)

There should be a grandparenting period to allow taxpayers to undertake a review of their current financing arrangements. Reviewing current financing arrangements and, if necessary, seeking alternative sources of finance can be time-consuming. The grandparenting could therefore take the form of an additional safe harbour equal to the debt existing on 1 December 2007 and apply for five years from that date.

Comment

Transitional arrangements of this sort tend to be complex from a legislative perspective. The effect of the interest allocation rules on financing arrangements that are already in place is not expected to be widespread. This is because safe harbours are relatively generous. Officials have also recommended further changes to minimum thresholds which should mitigate any potential impact on the existing financial arrangements of small and medium-sized firms. On balance, there appears no practical need for grandparenting arrangements.

Recommendation

That the submission be declined.

Issue: The proposed expansion of a natural person's New Zealand group for the purposes of the inbound interest allocation rules should not proceed

Submission

(67 – New Zealand Institute of Chartered Accountants)

New section FE 3 (inbound) expands the non-resident natural person's New Zealand group to include all associated persons who are resident in New Zealand, or who are not resident but are trading through a permanent establishment, or who derive other income from New Zealand. It is not clear why the existing rules for inbound thin capitalisation have been changed. This extension is not appropriate as the debt of the associated person of a natural person should not be brought into account for the purposes of the interest allocation rules.

Comment

Under the current rules a non-resident natural person's New Zealand group comprises only that person. This can produce anomalous results when compared with the current treatment of non-resident companies. Currently, for interest allocation purposes, where a non-resident company owns a New Zealand company the New Zealand group consists of the non-resident company, the New Zealand company and any foreign subsidiaries owned by the New Zealand company. However, under the current rules, if a non-resident individual owns a New Zealand company which in turns owns foreign subsidiaries, the New Zealand company and its subsidiaries do not form part of the individual's group. This is anomalous and could open up opportunities for arbitrage.

Recommendation

That the submission be declined.

Issue: The 75 percent safe harbour should be raised to 80 percent or 85 percent for companies that are mainly New Zealand-owned

Submission

(32 – KPMG)

The 75 percent safe harbour should be increased to reflect the difficulties faced by New Zealand-owned companies in obtaining overseas financing for expansion abroad.

Comment

The 75 percent safe harbour is already generous. It represents a level of gearing significantly higher than would be found in most firms. In the early phase of the international tax review the possibility of a lower threshold was raised. However, the government decided not to pursue a lower threshold because of the commercial

difficulties firms might face in borrowing offshore. But increasing the level of the safe harbour would defeat the purpose of the interest allocation rules by allowing firms to allocate excessive amounts of debt against the New Zealand tax base.

Recommendation

That the submission be declined.

Issue: The 75 percent safe harbour should be increased for financial institutions

Submission
(73 – Deloitte, for Seniors Money International)

The 75 percent safe harbour is not appropriate for financial institutions as these will often have very high levels of gearing.

Comment

The on-lending concession in the interest allocation rules should help financial institutions. The concession recognises that it can often be cheaper or more practical for New Zealand multi-nationals to raise debt in New Zealand to fund their offshore operations. New Zealand companies can then shift the debt costs offshore through intra-group loans.

Under the on-lending concession, where loans are provided by a New Zealand company to its CFCs on arm's-length terms, the total debt and total assets in the group debt percentage ratio are both reduced by the on-lent amount. This adjustment removes the on-lent amount from the safe harbour calculation. The concession should be of particular benefit to financial institutions given their high levels of gearing and their potential need to provide funding to offshore subsidiaries.

Another feature of the rules that mitigates any potential effect on financial institutions is the second safe harbour that complements the 75 percent debt percentage threshold. This second safe harbour ensures that the interest allocation rules do not apply provided the debt percentage of the New Zealand group does not exceed 110 percent of the worldwide group's debt percentage. Provided the business model (including gearing) used by the New Zealand part of a business is in line with the world-wide group, the interest allocation rules should not have an impact.

Given these features, there is no justification for increasing the safe harbour for these entities.

Recommendation

That the submission be declined.

Issue: The safe harbour for SMEs should be based on the formula used for the interest allocation rules in the conduit rules, rather than fixed at 75 percent

Submission
(67 – New Zealand Institute of Chartered Accountants)

The interest allocation rules as they apply to SMEs should be based on the interest allocation rules in the conduit provisions. Under these rules there is no interest allocation restriction provided that the overall level of funding of the New Zealand assets does not exceed that of the consolidated group (including non-grey list CFC debts and assets). Alternatively, the 75 percent should be an initial safe harbour, with taxpayers being allowed to undertake a full consolidation with CFCs if that gives a higher base percentage than 75 percent.

Comment

These suggestions would effectively relax the interest allocation rules in some cases by allowing CFC assets to count in the measurement of a base percentage threshold. The 75 percent safe harbour is already very generous, and relaxing the rules in this way would undermine the basic purpose of the rules.

Recommendation

That the submission be declined.

Issue: The exclusion of interests in CFC from the calculation of total group assets should not apply when that CFC income is passive

Submission
(26 – Fonterra, 35 – PricewaterhouseCoopers, 53 – Ernst & Young, 66 – Telecom, 67 – New Zealand Institute of Chartered Accountants)

New section FE 16(1B) excludes CFC investments from the calculation of total group assets. However, CFCs that fail the active business test will continue to attribute their passive income to their New Zealand shareholders and those shareholders will pay tax on that income. Since the income will be taxable, New Zealand firms should not be denied an interest deduction for money borrowed to fund the passive CFC. Only active CFC interests should be excluded from the definition of assets. Passive CFC investments should be included, perhaps with an adjustment to reflect any attribution of passive income which has foreign tax credits that would reduce New Zealand tax payable.

Comment

In practice, many CFCs will produce both exempt active and passive income. Establishing apportionment rules to differentiate between interest costs that related to active CFC income and those that related to passive CFC income would introduce significant complexity. The rules would also need to account for foreign tax credits that would be provided to offset the New Zealand tax liabilities on passive income, the calculation of which should, in theory, include an appropriate share of the interest costs. Given that the interest allocation rules are simply intended as a minimum backstop to protect the New Zealand tax base, designing complex rules to address the issues in this area is not appropriate. It is worth noting that Australia does not provide special rules for entities with outbound passive investments. Interest costs incurred by Australian entities with CFCs with passive investments are subject to their interest allocation rules, while the passive income is also taxed on accrual.

Recommendation

That the submission be declined.

Issue: Internally generated goodwill should be included in total group assets under section FE 16(1)

Submission
(35 – PricewaterhouseCoopers)

Internally generated goodwill is a genuine business asset. Companies can borrow against this goodwill but, since the goodwill is not recognised in their asset base for interest allocation purposes, they may be denied a deduction for interest on the funds borrowed.

Comment

The rules for measuring a group's asset base need to be robust and take account of generally accepted accounting practice. Following the adoption of International Financial Reporting Standards, internally generated goodwill is no longer recognised for accounting purposes. This reduces total reported assets. There is no reason for the interest allocation asset measurement rules to depart from generally accepted accounting practice. It is very difficult to establish an independent value for internally generated goodwill. Including it in the group's assets could artificially inflate the New Zealand asset base, thus undermining the interest allocation rules.

Recommendation

That the submission be declined.

Issue: It should be possible to use the market value for all assets, rather than the value in financial statements, when measuring assets

Submission
(68A – Corporate Taxpayers Group)

As the provisions are currently drafted, a group would only be able to value trading stock at market value. All other assets would have to be valued on other bases – for example, according to the financial statements, or at net current value. The impact of the interest allocation rules could be mitigated, especially for SMEs, by allowing groups to use market valuations for all assets

Comment

It is important to have robust rules for the measurement of a group's asset base. Without these, the interest allocation rules will not work effectively. The market value of trading stock is relatively easy to establish. However, the market value of other assets is far less easy to establish, and robust rules based on generally accepted accounting practice are required. Otherwise there would be a risk that closely held companies could attribute an artificially high value to some of their assets. This would inflate the value of their New Zealand asset base and thus defeat the purpose of the interest allocation rules.

However, the rules do contain a number of design features that should mitigate any potential impact on SMEs.

Recommendation

That the submission be declined.

Issue: Fixed-rate shares should be excluded from the scope of the interest allocation rules

Submission
(24A – New Zealand Law Society, 35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

Payments for fixed-rate shares should not be added to interest deductions and fixed-rate shares should not be counted as part of group debt for the purpose of the interest allocation rules. By treating fixed-rate shares as debt, the proposed rules potentially penalise taxpayers by treating as notional income an amount of supposed interest (that is, the dividend on a fixed-rate share) for which no deduction can be claimed. Fixed-rate shares should be treated as equity, and payments in relation to the shares should be treated as dividends, for all tax purposes. The arbitrary reclassification of fixed-rate shares as debt for the purposes of the interest allocation rules is inequitable and unjustifiable.

Comment

Fixed-rate shares issued to New Zealand taxpayers should be treated as debt for the purposes of the interest allocation rules. The after-tax financing costs of these shares are the same as debt financing (since imputation credits can be attached to these shares) and they have commercial characteristics that are substitutable with debt. If fixed-rate shares were not treated as debt, taxpayers could circumvent the proposed interest allocation rules by issuing fixed-rate shares instead of commercial debt to New Zealand taxpayers. This would undermine the protection for the tax base provided by the 75 percent debt-to-asset ratio. There are various examples in New Zealand and overseas of taxpayers using fixed-rate shares as debt substitutes to gain after-tax financing advantages. Since the interest allocation rules are designed as a basic backstop to protect the tax base, the effect of including fixed-rate shares within the scope of the rules should be minimal for companies financing themselves on normal commercial terms.

Recommendation

That the submission be declined.

Issue: Grandparenting rules should be introduced for financing arrangements involving fixed-rate shares and redeemable preference shares

Submission
(24A – New Zealand Law Society, 35 – PricewaterhouseCoopers)

Grandparenting rules should be included for taxpayers that currently have financing structures involving the issue of fixed-rate shares or redeemable preference shares. Taxpayers with these structures in place may be adversely affected by the interest allocation rules. It may be possible for these taxpayers to re-finance in order to remain below the safe-harbour thresholds, but this process will take time. A grandparenting period of say, five years for these financing arrangements would be appropriate and would be in line with the policy adopted for the purposes of the banking thin capitalisation rules when they were enacted.

Comment

Grandparenting arrangements can sometimes be justified when changes in tax law have a significant effect on commercial arrangements that taxpayers have previously put in place. However, the interest allocation rules are simply a basic backstop to protect the New Zealand tax base in the future. They are not intended to be a complex set of rules catering for every situation, because the majority of taxpayers should not be affected by the rules. In this context, complicated grandparenting arrangements for fixed-rate and preference shares are not appropriate.

Recommendation

That the submission be declined.

Issue: The interest allocation rules need to address the treatment of foreign exchange losses

Submission
(68A – Corporate Taxpayers Group)

The interest allocation rules need to take account of foreign exchange losses where foreign exchange gains may also arise with respect to a debt instrument in a different income year. Foreign exchange losses are treated as an interest expense, and where a firm breaches the 75 percent safe harbour, the deductibility of interest expenses will be restricted. However, foreign exchange gains will always be taxable on debt instruments. This lack of symmetry should be addressed, especially as it will generally be the New Zealand headquarters that bears a group's foreign currency risk.

Comment

The interest allocation rules for outbound investment are intended to provide basic protection for the New Zealand tax base in the future. They are not intended to be a sophisticated set of detailed rules catering for every eventuality and, wherever possible, they build on the existing apportionment rules for thin capitalisation. Thus, in their treatment of foreign exchange gains and losses, they reflect the current treatment in the thin capitalisation rules.

In practice, the outbound interest allocation rules would only affect the deductibility of foreign exchange losses when companies were already highly geared. However, it would be normal for companies with significant amounts of debt denominated in foreign currency to have hedging arrangements in place which should largely offset any exchange loss. In this context, when it is unlikely that there will be major problems for firms engaged in normal commercial transactions, the development of special rules to cater for the treatment of foreign currency gains and losses would add unnecessary complexity to the interest allocation rules.

Recommendation

That the submission be declined.

Issue: The treatment of deductible foreign equity under section FE 16(1b) is anomalous

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

Under the legislation as currently drafted, fixed-rate foreign equity held by a New Zealand group in its CFCs that is eligible for the on-lending concession can be included in the measurement of the New Zealand group's assets. However, deductible foreign equity will not be eligible for the on-lending concession and will

therefore not be eligible for inclusion as part of the New Zealand group's assets. This is an anomalous and inequitable outcome, as dividends from a CFC's fixed-rate shares and a CFC's deductible foreign dividends will both be subject to New Zealand tax when received by the New Zealand group.

Comment

The bill classifies fixed-rate foreign equity as a financial arrangement and deductible foreign equity distributions as interest. In response to submissions opposing these classifications, officials recommend that both fixed-rate foreign dividends and deductible foreign dividends be treated as non-exempt (that is, taxable) dividends. This treatment will mean that fixed-rate foreign equity is not a financial arrangement and therefore it will not be eligible for the on-lending concession. This is appropriate, as without the financial arrangement spreading rule, a fixed-rate dividend could be used to defer tax. This means that fixed-rate foreign equity and deductible foreign equity will be treated consistently.

Recommendation

That the submission be noted.

Issue: Calculation of debt percentages

Submission
(Matter raised by officials)

Officials have discussed the matter of calculating debt percentages with professional advisers. It is clear from these discussions that there is a strong case for catering for the situation where a New Zealand group puts more equity into its CFCs than exists in the New Zealand group.

Comment

Where a New Zealand group puts more equity into its CFCs than exists in the New Zealand group, the New Zealand group assets may be reduced to zero (because of the effect of new section FE 16(1B)). The debt percentage of the New Zealand group would then be impossible to calculate, as the debt percentage is found by dividing the amount of total group debt by the amount of total group assets. Although in practice it would be very unlikely that a New Zealand group would fund its CFCs with more equity than the group itself possesses, the draft legislation should be amended to ensure that the interest allocation rules do work effectively in these situations.

Recommendation

That the submission be accepted.

Issue: Associated persons and interest allocation rules

Submission
(67 – New Zealand Institute of Chartered Accountants)

It is not clear how an associated person's debts and assets should be measured in working out the consolidated debts and assets of a natural person or trustee for the purposes of new section FE 14(2) and (3). This should be clarified.

Comment

The general aim of the associated persons provisions is to counter non-arm's length transactions that could undermine the intent of the tax legislation. For the purposes of the interest allocation rules as they apply to natural persons or trustees, it is necessary to include associated persons in the definition of the New Zealand group in section FE 3. If the group simply consisted of a natural person or a trustee, then individuals or trustees could get around the interest allocation rules by using close associates to take on excessive amounts of debt in New Zealand, while CFC income was exempt.

In many cases a natural person or trustee should have little or no difficulty in measuring the debts and assets of an associated person such as a company they wholly own. However officials will monitor this area and, if practical problems do arise, we will consider providing guidance.

Recommendation

That the submission be noted.

Issue: References in sections FE 6(3)(ab) and FE 15(1)(b) to fixed-rate foreign equity should be replaced with a reference to fixed-rate shares

Submission
(24A – New Zealand Law Society, 35 – PricewaterhouseCoopers, 62 – Minter Ellison Rudd Watts, 67 – New Zealand Institute of Chartered Accountants)

References in these sections to fixed-rate foreign equity are not effective. This is because a New Zealand company is by definition not a foreign company, so cannot issue fixed-rate foreign equity as defined in the bill. The sections should instead refer to fixed-rate shares.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Drafting of new subparagraph FE 1(1)(a)(i)

Submission
(53 – Ernst & Young)

The words "(an outbound entity)" in proposed new subparagraph FE 1(1) (a) (i) should be placed after "CFC" so that it qualifies the whole of the phrase "a New Zealand resident with an income interest in a CFC" rather than just "a New Zealand resident". The present wording could suggest that the thin capitalisation rules apply to any New Zealand resident controlling any other New Zealand resident.

Comment

In context, the words "(an outbound entity)" do not seem misleading. The suggested alternative, of placing the words "(an outbound entity)" immediately after "CFC", could itself lead readers of the legislation to construe the CFC as the "outbound entity". On balance, it seems preferable to retain the existing word order.

Recommendation

That the submission be declined.

Issue: Paragraphs FE 3(1)(c) and (2)(c) should be relocated to section FE 5

Submission
(67 – New Zealand Institute of Chartered Accountants)

Paragraphs FE 3(1)(c) and (2)(c) provide that, in the calculation of the total assets of a natural person, the person's private and domestic assets should be ignored. This subsection would be better placed in the amended section FE 5(1). This is because the person's total assets are not referred to in section FE 3 but are referred to in section FE 5.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: The outbound interest allocation rules should apply only when the income interest in a CFC is greater than 10 percent

Submission
(67 – New Zealand Institute of Chartered Accountants)

The proposed rules on interest allocation should apply only when a New Zealand resident has an income interest of 10 percent or greater in a CFC. This is not achieved by the current draft provisions.

Comment

Officials consider this outcome is achieved by clause 408(65) which makes the necessary changes to the definition of "income interest" in section YA 1.

Recommendation

That the submission be noted.

Issue: Clarity of drafting in new section FE 4

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

The terms "excess debt outbound entity" and "excess debt entity" are confusing and may lead to confusion in applying the rules. These terms imply that the relevant companies have too much debt, rather than that they are companies that are required to comply with the interest allocation rules.

Even if the terms are retained, the drafting of section FE 4 could be made more consistent. The amendment made by clause 157 for outbound companies refers to the specific relevant paragraphs of section FE 2, while the FE 4 references covering inbound entities refer generally to FE 2 rather than to the specific relevant paragraphs. Section FE 4 should be amended to refer the definitions of the existing terms, such as excess debt entity, to the specific paragraphs of section FE 2 as the new outbound rules do.

Comment

"Excess debt entity" is the term used in the current legislation for interest apportionment on thin capitalisation and has not caused confusion amongst companies or advisers to date. The term "excess debt outbound entity" builds on the existing definition of "excess debt entity" and should be readily understood in context by those who need to apply the new rules.

It is necessary to specify the relevant paragraphs of section FE 4 in defining an "excess debt outbound company" because the definition rests on whether certain specific paragraphs do or do not apply. The definition of "excess debt entity" does not require this distinction.

Recommendation

That the submission be declined.

Issue: Reference to "value" in new section FE 16 (1B)

Submission
(68A – Corporate Taxpayers Group)

Section FE 16(1B) provides that the value of any CFC investment should be excluded in calculating total group assets. It should be made clear that the reference to value is a reference to the value of these assets as determined under section FE 16(1).

Comment

Section FE 16(1B) follows immediately after section FE 16(1) and qualifies the application of that section. Given this context, it seems superfluous to emphasise the bases on which the value of the CFC investment should be arrived at.

Recommendation

That the submission be declined.

Issue: Apportionment under paragraph FE 16(1B)(b)

Submission
(68A – Corporate Taxpayers Group)

It is not clear how the apportionment of equity value in paragraph FE 16(lB)(b) is intended to work. Further detail is required.

Comment

Officials do not see any major difficulty with this apportionment. Taxpayers with interests in CFCs should be able to work out the extent to which a CFC derives income covered by paragraph FE 16(1B)(b), and then apply the relevant proportion to their CFC investments.

Recommendation

That the submission be declined.

Issue: Omission of “group” in new wording of section FE 18(4)

Submission
(35 – PricewaterhouseCoopers)

The word “group” should be inserted after “worldwide” in the proposed rewording of section FE 18(4).

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Identification of New Zealand parent

Submission
(67 – New Zealand Institute of Chartered Accountants)

The provision in new section FE 26(2)(c) that identifies the New Zealand parent as the excess debt outbound company where no New Zealand-resident company has a 50 percent or greater interest in the company should be moved elsewhere. It does not sit sensibly in section FE 26. In addition, the interaction of sections FE 26(2)(c) and FE 26(4B) is confusing.

Comment

Section FE 26(2) sets out the circumstances in which an excess debt entity should be treated as the New Zealand parent. Section FE 26(2)(c) refers to circumstances in which no single company resident in New Zealand has an ownership interest in the entity of 50 percent or more. There does not seem to be any obvious confusion in this structure.

The proposed wording of sections FE 26(2) and FE 26 (4) seems to work in a sensible fashion. Section FE 26(2)(c) refers to the situation in which no single company resident in New Zealand has an ownership interest in the entity of 50 percent or more; section FE 26(4B) refers to a situation where a New Zealand-resident company has an ownership interest of 50 percent or more in the entity. The demarcation here seems clear.

Recommendation

That the submission be declined.

Issue: Identification of members of the New Zealand group

Submission
(67 – New Zealand Institute of Chartered Accountants)

In the list of definitions at the end of section FE 28, a definition of “control” is included in the list but this is repealed in clause 408. This should be removed. This will also eliminate the need for paragraph 2.

Comment

Officials agree that “control” should be omitted from the list of defined terms at the end of section FE 28. However paragraphs (2) and (3) of that section are required to set out the rules that should apply to excess debt entities that are not identified under section FE 27 as being under the control of the New Zealand parent.

Recommendation

That the submission be accepted in part.

Issue: Definition of “worldwide group”

Submission
(67 – New Zealand Institute of Chartered Accountants)

In section FE 31B(2), a worldwide GAAP group is defined as “all non-residents who are required to be included with the company in the consolidated financial statement under GAAP”. Under NZ IAS 27 it is conceivable that a company may not have to consolidate its financial statements even when it has an attributing income interest in a CFC – for example, if the parent is itself a wholly owned or partially owned subsidiary or if the parent’s debt and equity instruments are not traded in a public market.

Comment

The conditions set out in IAS 27 under which consolidation is not required are fairly stringent. It is therefore difficult to envisage a situation when the ultimate New Zealand parent or another member of the company’s New Zealand group would not be required to produce consolidated financial statements that would include any subsidiaries that owned CFCs and those CFC interests themselves.

Recommendation

That the submission be declined.

Issue: Drafting of section FE 31B(2)

Submission
(67 – New Zealand Institute of Chartered Accountants)

In section FE 31B(2), “statement” should read “statements”.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

FOREIGN DIVIDEND EXEMPTION

Clauses 5, 6, 13, 16, 32, 53, 54, 55, 98, 122, 126, 184, 189, 190, 192, 199, 200, 254, 277, 286–288, 290–295, 299–304, 306, 330, 332, 340, 342–348, 352, 353, 370, 373–376, 391, 392, 396, 398, 408, 409, 433, 434, 452, 468, 469, 483, 486, 487, 489, 496, 497, 500, 501, 505–507, 512, 514 and 515

Issue: Taxation of fixed-rate foreign equity and deductible foreign equity

Submissions

(24A – New Zealand Law Society, 35 – PricewaterhouseCoopers, 67– New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

The taxation of dividends paid in respect of fixed-rate foreign equity and deductible foreign equity should be reconsidered.

These dividends should be exempt (as per ordinary foreign dividends) as it is not clear that they pose a risk to the tax base and taxing these distributions could disadvantage New Zealand firms relative to investors based in other countries who are not taxed on such distributions.

Alternatively, if the above submission is not accepted, fixed-rate dividends should only be taxed when they are deductible in the foreign jurisdiction.

Comment

The bill exempts foreign dividends received by a company or CFC except for dividends that are deductible in the foreign jurisdiction and dividends from fixed-rate shares. These two exceptions are consistent with the approach in the existing international tax rules where these dividends do not qualify for underlying foreign tax credits.

An exemption for deductible dividends would pose significant risks to the domestic tax base. This is because a deductible dividend would reduce or eliminate tax imposed in the offshore jurisdiction, resulting in an effective exemption there and in New Zealand. This could create an incentive to shift New Zealand activity offshore.

For example, consider a situation where a New Zealand company can earn $100 of active income in New Zealand, or in a CFC which faces foreign tax of 30% (the same as in New Zealand), but which is allowed a deduction for its dividends. The company would earn $70 after tax from performing the activities in New Zealand. However, by moving the activities into the CFC and paying a deductible dividend back to the New Zealand company, the company could earn an after-tax return of $100, (depending on the rate of foreign withholding taxes) if New Zealand did not tax the dividend.

It is also appropriate to tax fixed-rate dividends, even if there is no deduction for the dividend payer. Otherwise, in certain circumstances, a fixed-rate share could be used in place of a loan in order to gain a tax advantage. Again, this is a form of tax arbitrage which gives rise to base maintenance concerns. This arbitrage opportunity would most likely arise when the tax rate in the foreign jurisdiction is lower than the New Zealand tax rate.

Recommendation

That the submissions be declined.

Issue: Taxation of fixed-rate foreign equity

Submission
(24A – New Zealand Law Society)

Fixed-rate foreign dividends should be exempt if the holder of foreign fixed-rate equity holds a voting interest of at least 10 percent. The rationale for this is that a holder of at least 10 percent of the voting rights in a CFC is an equity investor, and so is not acting as an "in substance" lender.

Comment

The risks associated with exempting fixed-rate foreign dividends are no lower if a company has a 10 percent interest in the foreign company. If anything, there is more risk from a closely held CFC using a fixed-rate share in place of debt in order to gain a tax advantage.

Recommendation

That the submission be declined.

Issue: Reclassification of fixed-rate foreign equity as a financial arrangement

Submissions
(24A – New Zealand Law Society, 32 – KPMG, 35 – PricewaterhouseCoopers, 60 – ASB, 62 – Minter Ellison Rudd Watts, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

Fixed-rate foreign equity should not be reclassified as a financial arrangement debt. A change to the debt/equity boundary is outside the scope of the international tax review and should be considered as part of a broader review. The financial arrangement rules could be difficult to apply to fixed-rate shares as companies would have to spread future income and take into account foreign exchange fluctuations.

If fixed-rate foreign equity is treated as a financial arrangement, then:

- the measure should not apply to existing instruments;
- the measure should not apply to imputed dividends paid by an Australian CFC; and
- foreign exchange gains and losses should be disregarded.

To prevent the possibility of double taxation, deductible dividends and fixed-rate dividends should be exempt when a taxpayer is attributing income from both a payer CFC and payee CFC.

Comment

The bill reclassifies fixed-rate foreign equity as a financial arrangement and deductible foreign equity distributions as interest.

Officials received many submissions opposing this approach. Arguments against it included:

- The change is not minimal – it goes further than simply replacing the foreign dividend payment (FDP) and branch equivalent tax accounts (BETA) mechanisms. A change to the debt/equity boundary is outside the scope of the international tax review and should be considered as part of a broader review.
- The changes increase compliance costs and may jeopardise existing commercial arrangements.

These concerns, as well as the more specific issues raised in the above submissions, would be eliminated by treating fixed-rate foreign dividends and deductible foreign dividends as non-exempt dividends.

Recommendation

That the submissions be declined, but that fixed-rate foreign dividends and deductible foreign dividends be treated as non-exempt dividends. To mitigate any double taxation, a deduction should be allowed for a CFC paying these dividends in cases where they would be taxable (that is, paid to a New Zealand company or another CFC).

Issue: Reclassification of fixed-rate foreign equity – technical issues

Submissions

(35 – PricewaterhouseCoopers, 62 – Minter Ellison Rudd Watts, 67 – New Zealand Institute of Chartered Accountants)

Some drafting and technical issues need to be addressed if the bill goes ahead with reclassifying fixed-rate foreign equity financial arrangements and deductible foreign equity distributions as interest. Specifically:

- A provision is required to determine the opening value of fixed-rate foreign equity.
- Fixed-rate foreign equity is reclassified as a financial arrangement in section EW 5(13), while dividends paid on fixed-rate foreign equity are treated as interest in section CD 36(B). This could cause these dividends to be counted as passive income twice.
- In section CD 36B(1), the words "the company of a company resident in New Zealand" should be replaced with "the company held by a company resident in New Zealand".
- Section CD 36(B) should be reworded so that it includes distributions in respect of an interest held by a CFC.

Comment

Officials now recommend that fixed-rate and deductible foreign dividends be treated as a non-exempt dividend. This would negate the need for these technical changes.

Recommendation

That the submissions be accepted. Note that these issues will automatically be resolved if fixed-rate and deductible foreign dividends are treated as non-exempt dividends as in the above recommendation.

Issue: Definition of "deductible foreign equity"

Submission

(24A – New Zealand Law Society)

Paragraph (b) of the definition of "deductible foreign equity" is too broad and is likely to be unworkable in practice. This paragraph makes an otherwise exempt dividend taxable if it is sourced directly or indirectly from an amount that is paid to the foreign company by another company if the foreign company is not liable for income tax on the amount and the other company is able to claim a deduction for the amount.

The purpose of this "look-through" rule is to ensure that a second foreign company cannot be interposed into the middle of a transaction to convert a deductible dividend into an ordinary dividend.

There are some circumstances where the application of this rule would be inconsistent with the intent of the active income exemption. For example, the amount from which the dividend is paid could have been a fee for goods or services that the foreign company has provided. In this case, the ordinary dividend could be sourced out of active income (as opposed to a deductible dividend).

Paragraph (b) should be qualified by a requirement that the amount must be paid in respect of a financial arrangement or a share.

Comment

The definition for "deductible foreign equity" duplicates wording currently used in the underlying foreign tax credit rules, which are being replaced by the dividend exemption.

Other changes in the bill ensure that deductible dividends are taxed when received by a CFC – this reduces (but does not eliminate) the need for the "look-through" rule referred to above.

The submission identifies some examples where the current rule would lead to inappropriate results. Clarifying the definition in the way the submission suggests would carve out such transactions without creating significant additional risk to the New Zealand tax base.

Recommendation

That the submission be accepted, and that paragraph (b) of the definition of deductible foreign equity be qualified by a requirement that the amount must be paid in respect of a financial arrangement or a share.

Issue: Definition of "fixed-rate foreign equity"

Submission
(35 – PricewaterhouseCoopers)

Paragraph (d) of the definition of "fixed-rate foreign equity" is too broad/unclear.

Comment

It is necessary to tax dividends paid in respect of fixed-rate foreign equity otherwise these could be used in place of a loan to gain a tax advantage. Paragraph (d) is consistent with this rationale and ensures that fixed-rate foreign equity includes any dividends that are "equivalent to the payment of interest for money lent".

This definition must be broad because dividends are excluded from the financial arrangement rules. This means that a dividend that was a substitute for an interest payment would be exempt unless it was captured by the fixed-rate foreign equity definition.

The definition of "fixed-rate foreign equity" duplicates wording that is currently used in the underlying foreign tax credit rules, which are being replaced by the dividend exemption.

Recommendation

That the submission be declined.

Issue: Dividends from grey list FIFs

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section CW 9, which is modified to make dividends from non-attributing portfolio FIFs subject to income tax, should apply to interests of greater than 10 percent also.

Comment

It is appropriate that the dividend exemption apply to greater than 10 percent interests in FIFs as this is consistent with maintaining the grey list exemption for non-portfolio FIFs until the active income exemption is extended to them. At the moment a dividend that a company receives from a greater than 10 percent interest in a grey list FIF is covered by a deemed underlying foreign tax credit. This is equivalent to a dividend exemption.

Recommendation

That the submission be declined.

Issue: Drafting matters

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section CD 53(3) removes the reference to section CW 11. However, section CW 11 is not repealed.

Comment

The submission is correct; the reference to section CW 11 should not be removed.

Recommendation

That the submission be accepted.

Submission
(67 – New Zealand Institute of Chartered Accountants)

The reference to "FDP credit" in section CD 53(2) should be removed.

Comment

Under the proposed reform, no new FDP credits will be generated. However, companies will still be able to attach FDP credits to their dividends so the reference to "FDP credit" in section CD 53(2) should remain in place.

Recommendation

That the submission be declined.

TRANSITIONAL AND CONSEQUENTIAL MATTERS

Clauses 30, 60, 147, 176–178, 193, 195, 220, 251, 253, 269, 273, 308–322, 350, 354–367, 408 and 488

Overview

This chapter discusses submissions on transitional and consequential matters arising from exemptions for offshore active income and foreign dividends introduced by the bill. The submissions fall into three categories:

- **Those dealing with the transitional rules for attributed CFC net losses and foreign tax credits.** The effect of these rules is that 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).
- **Those dealing with the repeal of various memorandum accounts, namely conduit tax relief (CTR) accounts, branch equivalent tax accounts (BETAs), and foreign dividend payment (FDP) accounts.** The bill effectively suspends these accounts. CTR companies will be able to continue to attach CTR credits to any dividends they distribute to their non-resident shareholders for a period of two years. Existing BETA debit balances can also be carried forward and used for a two-year transitional period. Existing FDP credit balances can be carried forward and used for a five-year transitional period.
- Miscellaneous consequential matters.

Issue: Transitional loss carry-forward and tax credit rules – general approach

Submission

(67 – New Zealand Institute of Chartered Accountants)

Losses and foreign tax credits accrued under the existing rules should remain available without restriction under the new rules.

Comment

Allowing unrestricted relief for historical losses would be problematic. As a basic principle, there should be a nexus between expenditure and taxable 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 expenditure (and therefore net losses) incurred to derive this income. 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, which would simply erode the tax base and prevent the effective taxation of attributable income.

Similar concerns arise in relation to foreign tax credits. Allowing historical credits to be applied without restriction would be inconsistent with the general principle that credits under subpart LK are available for foreign tax paid on income that is also taxable in New Zealand, up to the amount of the New Zealand tax liability on that income. The purpose of these credits is to prevent double taxation, not to allow attributable income to be sheltered from New Zealand tax.

Recommendation

That the submission be declined.

Issue: Transitional loss carry-forward and tax credit rules

Submissions
(26 – Fonterra, 30 – Staples Rodway, 35 – PricewaterhouseCoopers, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants, 68/68A – Corporate Taxpayers Group)

The transitional rules for historical losses and credits should be redrafted and/or simplified. *(Staples Rodway, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants, Corporate Taxpayers Group)*

A simpler mechanism should be introduced to determine the availability of historical losses and/or credits. Approaches suggested are:

- allowing taxpayers to use figures from a one- or two-year period to fix the value of their historical losses/credits for later years;
- allowing taxpayers to use accounting results or local jurisdiction tax results as a proxy for branch equivalent income;
- allowing taxpayers to opt for a fixed conversion ratio, to be specified in the legislation;
- allowing taxpayers to convert historical losses/credits based on the attributable income percentage used for the purposes of the active business test.
  (Fonterra, PricewaterhouseCoopers, Ernst & Young, New Zealand Institute of Chartered Accountants)

To reduce compliance costs, taxpayers should be given the option of either cancelling their historical losses/credits or transferring them to a separate memorandum account for a limited period. *(New Zealand Institute of Chartered Accountants)*

The calculation should be made on a pro rata basis (in other words, the requirement to set historical losses/credits against non-attributable income first should be dropped). *(PricewaterhouseCoopers, Corporate Taxpayers Group)*

Section LK 5B(2)(a) is not very clear in subparagraphs (i) and (ii) regarding the description of non-attributed CFC liability. *(Corporate Taxpayers Group)*

Comment

Transitional rules restricting the value of historical losses and historical foreign tax credits are appropriate and necessary. Submissions on the bill generally accept the policy underpinning the proposed rules. However, a number of practical concerns have been raised. Among those who have made submissions on the rules, there is a degree of consensus that they are difficult to understand and will impose on-going compliance costs on the limited number of firms to which they apply.

As a result, officials propose a revised approach to historical losses and foreign tax credits. Some degree of complexity is unavoidable, but the modified approach should make the rules easier to apply, and significantly reduce on-going compliance costs. The new approach can be summarised as follows:

- Historical losses and credits will be available for carry-forward in the usual way, but kept separate from losses incurred and credits accrued under the new rules.
- Attributable income as a proportion of branch equivalent income for the year will be calculated for the wholly owned group of which the interest holder is a member. The calculation will be carried out separately for each relevant jurisdiction. The net income figure (exclusive of tax expenses) from financial accounts can be used as a proxy for branch equivalent income for these purposes.
- This fraction will be applied to determine the effective value of historical losses and credits as they are used. Put simply, if a person has attributable income of $100 and branch equivalent income of $150 in a year, historical losses and credits will be used up at the rate of $1.50 for every $1 of taxable income or tax offset for that year.
- To reduce complexity, there will be no special rule for the year in which historical losses or credits run out. In other words, there will be no requirement for historical losses and credits to be used first against non-attributable income or notional tax on such income. (This is concessionary.)
- To ensure that historical losses and credits do not remain indefinitely, there will be a requirement for a minimum amount of historical losses and/or credits for a jurisdiction to be "used" each year. (Otherwise, taxpayers with CFCs that generally satisfy the active business test and therefore have no attributable income might never "use up" their transitional losses/credits.)
- To reduce on-going compliance costs, taxpayers can elect to convert all historical losses and credits into new losses and credits using figures from the two preceding years. Elections will be made on a jurisdiction-by-jurisdiction basis and will apply to all New Zealand companies in the same wholly owned group. A single election will cover both losses and credits. Elections will be irrevocable.

- There are two important limitations on the right to make an election:
  - The earliest year for which an election can be made is two years after the rules for non-portfolio FIFs are reformed. This is because the measure of attributable income will change at the point the FIF rules are reformed, affecting the appropriate conversion rate.
  - An election will only be permitted for a jurisdiction if the taxpayer (or the wholly owned group of which the taxpayer is a member) actually has branch equivalent income from that jurisdiction in each of the two preceding years. This is because, if a taxpayer (or wholly owned group) does not have at least one CFC or branch equivalent FIF in the jurisdiction in each of those two years, or if the taxpayer's (or group's) overall position is a branch equivalent loss from the jurisdiction, the appropriate correct conversion rate will generally be unclear.
- At any time, a taxpayer can elect not to carry forward historical losses and credits from a particular jurisdiction. Again, elections will be made on a jurisdiction-by-jurisdiction basis and will be irrevocable. A single election will cover both losses and credits.

Recommendation

That the transitional rules for historical losses and historical credits be amended as described.

Issue: Transitional loss carry-forward and tax credit rules – technical and drafting matters

Submissions
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants, 68A – Corporate Taxpayers Group)

The heading to section IQ 2(1B) should read "attributed CFC net losses from 2009–10 or later income years". *(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

The transitional rules for losses in section IQ 2(1C)(a)(ii) should refer to branch equivalent income from a particular jurisdiction. *(Corporate Taxpayers Group)*

The transition rules for credits incorrectly focus on amounts for a particular CFC and should instead operate on a per-jurisdiction basis (as for losses). *(Corporate Taxpayers Group)*

The loss and credit transitional rules should make clear that the relevant figure is branch equivalent income adjusted by the taxpayer's income interest. *(Corporate Taxpayers Group)*

Comment

Officials agree that the heading to section IQ 2(1B) needs to be corrected. We also agree that the rules (losses and credits) should apply on a per-jurisdiction basis and that a person's branch equivalent income for the purposes of these rules should be determined by reference to their income interest in relevant CFCs.

Recommendation

That the submissions be accepted.

Issue: Transitional loss carry-forward and tax credit rules – interaction with existing law

Submission
(68A – Corporate Taxpayers Group)

The interaction of section IQ 2(1C)(b) with the existing CFC carry-forward rules is unclear as a result of the application of the ring-fencing rules in section IA 2(5) and (7). Clarification is required about how the residual loss to carry forward is determined.

Comment

The submission relates to an issue with the existing rules in the Income Tax Act 2007. Specifically, the concern is that there is no provision allowing attributed CFC net losses to be carried forward to a later year.

This issue has been raised previously with, and considered by, the Rewrite Advisory Panel. The Panel's view was that there had not been an unintended legislative change in respect of section IQ 1 and subpart IA on the introduction of the Income Tax Act 2007. Inland Revenue considers that the law as it stands allows attributed CFC net losses to be carried forward. However, as part of a general review of the loss provisions in Part I, officials may seek to improve the clarity of the rules. Any amendments would be a matter for a later bill.

Recommendation

That the submission be declined.

Issue: Memorandum accounts – CTR account balances

Submission
(66 – Telecom)

Credit balances in a conduit tax relief (CTR) account should not be cancelled for companies with a mix of resident and non-resident shareholders.

Comment

Submissions on the December 2007 issues paper demonstrated that cancellation of the CTR account balances could in some cases increase taxes paid by non-resident shareholders on dividends paid out of conduit relieved income. This was not the policy intent.

Accordingly, the bill maintains these CTR account balances. The government announced in July 2008 that it plans to legislate in a later bill to repeal any remaining CTR account balances at the beginning of the 2011–12 income year. For taxpayers who do not want to incur the compliance costs of maintaining their CTR account balances for another two years, there is an option for them to elect to stop being a CTR company.

Recommendation

That the submission be declined, and that it be noted that this submission is already accommodated by the bill.

Issue: Memorandum accounts – election to stop being a CTR company

Submission
(35 – PricewaterhouseCoopers, 66 – Telecom)

FDP credits should be able to be converted to imputation credits immediately after a company makes an election to stop being a CTR company.

Comment

At present, CTR companies cannot convert FDP credits into imputation credits as the conduit mechanism is designed to ensure that FDP credits are only distributed to residents, while CTR credits are only distributed to non-residents. These streaming rules are no longer required given the repeal of further conduit tax relief.

Current legislation allows a company to elect to stop being a CTR company, but the election does not take effect until the following tax year. If the election took effect from the following day, it would save compliance costs of maintaining CTR accounts until the end of the year, and would allow these companies to immediately convert FDP credits into imputation credits.

Recommendation

That the submission be accepted, and that section OD 4 be amended so that a company stops being a CTR company the day after an election is made (rather than the year after, as under existing legislation).

Issue: Memorandum accounts – transitional period for BETAs

Submission
(68/68A – Corporate Taxpayers Group)

The two-year transitional period for BETA debits should be increased to five years.

Comment

The two-year period that was announced for BETA debits is considered adequate as the purpose of BETA debits is to relieve double tax in situations where a dividend has been received in advance of the income being attributed. It would be highly unusual if there was more than a two-year gap between a dividend being paid and income being recognised. Debits remaining after two years would be more likely to be sheltering new attributable income than relieving double taxation.

Recommendation

That the submission be declined, and that it be noted that the final repeal of BETA debits will be legislated for in a later tax bill.

Issue: Memorandum accounts – transitional rules for BETAs

Submissions
(35D – PricewaterhouseCoopers, 66 – Telecom, 68/68A – Corporate Taxpayers Group)

There should be no special rule for BETA debits during the transitional period as this will increase compliance costs. Companies should be able to apply BETA debit balances under the existing rules. *(PricewaterhouseCoopers)*

There are various technical concerns with the transitional rule for BETA debits:

- The rules should provide that BETA debits do not need to be used against income from grey list countries.
- Transitional rules should continue to give priority to usage against attributable income.
- Group usage of BETA debits should not be made mandatory.

- The rules should make it clear that it is branch equivalent income adjusted by the income interest percentage.
- The rules should make it clear that foreign tax paid can be applied as a credit against CFC income.
  (*PricewaterhouseCoopers, Telecom, Corporate Taxpayers Group)*

Comment

BETA debits relieve tax on attributable income when a dividend has already been taxed. This prevents double taxation. The bill currently provides for an apportionment rule to allow pre-reform BETA debits to be carried forward and applied against total CFC income (as opposed to only attributable income). This rule is similar to the transitional rules for losses and credits.

On reflection, the existing BETA legislation appears to provide the right result without the need for a transitional rule. The use of BETA debits is already limited to the amount of attributed CFC income (less deductions and foreign tax credits) in a given year by section OE 7(3B). The government has also announced plans to legislate in two years time to clear remaining BETA debit balances.

Removing the transitional rule for BETA debits will resolve the detailed technical concerns raised in submissions.

Recommendation

That the transitional rules for BETA debits be removed from the bill.

Issue: Memorandum accounts – application of changes

Submission
(53 – Ernst & Young)

The CTR and BETA changes in clauses 308 to 322 should apply by reference to tax years rather than income years.

Comment

Officials agree that "tax years" is the correct concept as these memorandum accounts operate on a tax-year basis.

Recommendation

That the submission be accepted, and that references to "income years" in clauses 308 to 322 be replaced with references to "tax years".

Issue: Memorandum accounts – post-transitional rules

Submission
(68/68A – Corporate Taxpayers Group)

Rules governing the treatment of CTR credits, BETA debits, and FDP credits at the end of the relevant transitional period should be announced now to provide certainty.

Comment

The government announced in July 2008 that it plans to introduce legislation to repeal remaining CTR account and BETA debit balances at the beginning of the 2011–12 income year. At the same time, it also announced that any outstanding FDP credits would be converted into imputation credits at the beginning of the 2014–15 income year. The legislation was not included in this bill because of the complexity of having various modifications with different application dates applying to the same provisions.

Recommendation

That the submission be declined.

Issue: Miscellaneous – attributed repatriations rules

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

The attributed repatriation rules are no longer needed once the foreign dividend exemption is introduced, and should therefore be repealed.

Comment

The attributed repatriation rules are intended to ensure that taxpayers cannot avoid tax on CFC dividends by purchasing New Zealand property and giving this to shareholders instead of paying a dividend.

Officials agree that these complex rules are no longer needed as the incentive to use an attributed repatriation to repatriate CFC income is greatly diminished now that most foreign dividends received by companies will be exempt. Although tax is still imposed on some dividends (for example, dividends paid on fixed-rate shares and deductible dividends), it is unlikely that an attributed repatriation could be used as an effective substitute for these dividends.

Recommendation

That the submission be accepted.

Issue: Miscellaneous – requirements for being a qualifying company

Submission

(67 – New Zealand Institute of Chartered Accountants)

The rule in clause 195 should be added to the list of requirements for being a qualifying company in section HA 6(2).

Comment

Officials agree that it would be better to list all the requirements for being a qualifying company in one place. Clause 195 prevents qualifying companies from holding CFCs and non-portfolio FIFs. This is a necessary consequence of the foreign dividend exemption as otherwise qualifying companies could be used to repatriate CFC and FIF income to non-company shareholders free from New Zealand tax.

Recommendation

That the submission be accepted.

REPEAL OF THE GREY LIST EXEMPTION

Clauses 17, 25, 26, 66, 67, 80, 118, 122, 125, 138, 175, 255 and 408

Issue: The grey list exemption should be retained

Submissions
(30 – Staples Rodway, 32 – KPMG, 35 – PricewaterhouseCoopers, 40 – Fisher and Paykel Healthcare, 54 – Business New Zealand, 59 – Fletcher Building, 66 – Telecom, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

The grey list exemption should be retained.

The main reason cited in submissions for retaining the grey list was that it saves compliance costs as it means that CFCs located in one of eight countries would not have to apply the CFC rules or calculate their income for New Zealand tax purposes. Other reasons given include:

- The original rationale of grey list countries having comparable tax systems remains valid with an active/passive rule.
- If the grey list is removed it is unlikely that any New Zealand tax will be paid on investments in grey list countries (as a result of foreign tax credits).
- Most of New Zealand's major trading partners, including Australia, have an active income exemption and a listed country exemption.
- The grey list has existed since 1988 yet there has been no major tax base risk identified.
- Any perceived risks from the grey list are outweighed by the compliance cost savings. Risks could be dealt with by carve-outs which specifically target perceived risk.

The grey list should be expanded. *(Fletcher Building)*

Comment

Compared with the active business test which applies equally to all jurisdictions, a grey list is arbitrary and distortionary. It creates a preference to invest into traditional, high tax jurisdictions when market growth and investment opportunities are increasingly outside of the grey list. This distortion on investment decisions was one reason why the grey list was removed for portfolio investors when the fair dividend rules were introduced in 2007.

The grey list made sense as a pragmatic mechanism for reducing compliance costs on investments in eight countries when all income of CFCs was otherwise taxed on accrual. It does not make sense under the new rules where an active income exemption and low compliance cost active business test will apply to investments in all jurisdictions.

The grey list exemption is based on an assumption of comparable taxation in listed jurisdictions. Although this assumption generally holds for active business income, it cannot be relied upon for passive income.

Grey list countries have exemptions and concessionary rules for investment income to implement their domestic policy frameworks. This was the case with UK investment trusts and the Open Ended Investment Companies where gains were exempted from tax on the basis that the UK unit holders would be taxed on their investments. However, New Zealand unit holders also benefited from the entity-level exemption under the FIF grey list exemption. The removal of the grey list following the enactment of the FDR rules addressed this concern.

Technical differences between different countries' treatment of particular instruments create opportunities whereby passive income is not taxed in the other jurisdiction. For example, fixed-rate shares are sometimes classified as debt in some grey list countries such as the United States. This means that a CFC can get a deduction on the payment of a fixed-rate dividend and so would pay no foreign tax on the underlying income. Yet New Zealand would not give a deduction in equivalent circumstances.

Similarly, technical differences also occur in relation to different countries' treatment of entities. Sometimes income (particularly foreign income) flows through grey list entities without any entity-level taxation. This was the case with Australian unit trusts. It is also the case with US limited liability companies (LLCs). In the latter case, it was clarified that US LLCs would only qualify for grey list treatment if more than 80 percent of income was actually sourced in the US.

These examples illustrate the fact that entities in grey list countries do not necessarily face the full rate of tax in the jurisdiction. In these cases, a grey list exemption would allow taxpayers to allocate passive income to a grey list CFC in order to reduce their total tax liability. This creates a risk to the New Zealand tax base.

Some submissions have suggested that these risks could be managed through the use of carve-outs or anti-avoidance rules. However, this would require on-going maintenance of the tax systems of listed countries. Although it is possible to monitor tax rates and major reforms, it is much more difficult to identify the arbitrage opportunities that can arise from technical and systemic differences between how particular instruments or entities are treated across different countries. Even when arbitrage is identified, it can be difficult to target.

Recommendation

That the submissions be declined.

Issue: The grey list exemption should be retained for SMEs

Submission
(67 – New Zealand Institute of Chartered Accountants)

The grey list should be retained for entities which are under a certain size.

Comment

Restricting the grey list to SMEs would not address the fundamental risk that arises from exempting passive income that may not face the full rate of foreign tax in the grey list country.

We recognise that small or medium-sized entities are less likely to have the existing technical expertise to apply the CFC rules or the active business test. In view of this concern, the bill includes an exemption from attribution for CFCs in Australia. This would address much of the SME problem, because most SMEs expand first to Australia.

Recommendation

That the submission be declined.

Issue: The grey list exemption should continue to apply for a transitional period

Submission
(54 – Business New Zealand, 68 – Corporate Taxpayers Group)

If the grey list is abolished, there should be a transitional period of two or three years. This would provide businesses with time to adjust to the change.

Comment

The active business test should generally ensure that active businesses are not subject to attribution. Within this context, retaining the grey list for two or three years would primarily benefit CFCs with significant amounts of passive income. This would constitute a risk to the domestic tax base.

Recommendation

That the submission be declined.

Issue: Exemptions based on effective or headline tax rates

Submission
(32 – KPMG, 68 – Corporate Taxpayers Group)

If the grey list is abolished, consideration should be given to exemptions that are based on a foreign country's effective or headline tax rates on passive income.

Comment

An exemption based on headline rates would pose the same problems as the grey list. Technical differences between countries' treatment of particular instruments or entities can create opportunities whereby passive income does not face the full rate of tax in the foreign jurisdiction.

An exemption based on effective tax rates would presumably be no different from the existing practice of providing tax credits for foreign tax paid, as companies would still need to calculate what the effective foreign tax rate was on their passive income in that country.

Recommendation

That the submission be declined.

Issue: Repeal of grey list – drafting error

Submission
(35 – PricewaterhouseCoopers)

Clause 425 incorrectly amends schedule 24 to refer to section DZ 1. It should read "section DZ 11" as this would be consistent with schedule 24 of the Income Tax Act 2007.

Recommendation

That the submission be accepted.

REPEAL OF CONDUIT TAX RELIEF

Clauses 175 and 255

Issue: The conduit tax relief rules should be retained

Submissions

(32 – KPMG, 66 – Telecom, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

The conduit tax relief rules should be retained.

The policy rationale for conduit – that New Zealand should not tax non-residents on their foreign-sourced income – remains valid with the introduction of an active income exemption.

Removing the conduit rules will discourage foreign investment into/through New Zealand.

The introduction of interest allocation rules for banks and outbound investment reduces any risk to the tax base from providing conduit tax relief.

Comment

The conduit rules remove income tax on income that a New Zealand company receives from its CFCs when the New Zealand company is owned by non-residents. Conduit income is still subject to non-resident withholding tax when distributed by the New Zealand company to its non-resident shareholders.

A major reason for introducing conduit rules was to allow a New Zealand-based subsidiary to act as the regional headquarters for subsidiaries in other jurisdictions without adverse tax consequences. This provides economic benefits to New Zealand by creating and retaining management expertise and valuable head-office functions in New Zealand.

The conduit rules will become unnecessary for active income, since the conduit exemption is, in effect, being replaced by the active income and foreign dividend exemptions. This means that if conduit rules were maintained they would only apply to companies which earn passive CFC income. Compared with active CFCs, which are used to expand a company's core business, a conduit exemption for passive investments is unlikely to create the economic benefits associated with regional headquarters that are described above.

Retaining conduit rules for passive income would expose the tax base to significant risk. This is because New Zealand-sourced income can be converted into passive CFC income.

Finally, interest allocation rules simply impose an upper limit on the level of New Zealand debt that can be used to fund a CFC – they do not eliminate the risks to the tax base from relieving passive income.

Recommendation

That the submissions be declined.

Issue: Retaining the conduit rules and the grey list for finance CFCs

Submissions
(60 – ASB, 68 – Corporate Taxpayers Group)

The conduit rules and grey list should be retained for banking and finance businesses in preference to the development of an active exemption for them, or at least until an appropriate active exemption can be developed and implemented for banking and finance businesses.

Comment

The grey list exemption and conduit tax relief need to be repealed at the same time for all entities otherwise these exemptions could be used to shelter passive income.

As a result of consultation, several offshore insurance businesses were identified that would face adverse tax results if the conduit exemption were removed before an active income exemption was introduced for financial CFCs. A commissioner's determination process is being provided to allow these CFCs to qualify as non-attributing CFCs (that is, active businesses). This provides a limited relief measure until special rules are developed to extend the active income exemption to insurance and finance businesses.

Retaining the grey list or conduit exemptions for financial institutions would provide little additional benefit (given the lack of existing financial CFCs) but would impose a risk on the tax base. This is because New Zealand-sourced income can be converted into passive CFC income.

Recommendation

That the submissions be declined.

Issue: NRWT relief should be introduced for conduit investments

Submission
(32 – KPMG, 35 – PricewaterhouseCoopers, 59 – Fletcher Building, 60 – ASB, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

There should be no non-resident withholding tax (NRWT) on dividends paid to non-residents if the income is sourced from CFCs. In other words, conduit relief of NRWT should be introduced. This would ensure that New Zealand remains competitive with Australia, which operates such a scheme.

Comment

Officials are exploring the feasibility of this measure as part of the second phase of the international tax review. The policy merits of providing an exemption would need to be weighed against the fiscal cost and possible base maintenance concerns, including the level of protection provided by the new CFC rules and its accompanying interest allocation rules.

Recommendation

That the submission be noted.

Issue: Conduit anti-avoidance rule

Submissions
(35 – PricewaterhouseCoopers, 36 – Russell McVeagh, 60 – ASB, 67 – New Zealand Institute of Chartered Accountants, 68 – Corporate Taxpayers Group)

The conduit anti-avoidance rule in section GZ 2:

- should be redrafted as it appears to apply more broadly than the policy intention (which was described in the December 2007 issues paper);
- should only apply when there is a dominant purpose of obtaining a conduit tax relief benefit;
- should only apply to new conduit deals (after 4 December 2007), not to transactions under existing structures;
- should be limited to arrangements that produce a benefit from the repeal of the conduit rules (as opposed to arrangements that produce any benefit under a taxation law);
- should apply no earlier than 4 December 2007, as this was the date that the issues paper that announced the policy change was released;

- should only apply to arrangements (as opposed to transactions) that became legally binding after 1 January 2008. The reason for the deferral would be to ensure it does not capture taxpayers who were already committed to a transaction at the time of the policy announcement. The risk that an arrangement could be put in place in the 27 days between the announcement and the 1 January 2008 is minimal.

Comment

Proposed section GZ 2 provides a specific anti-avoidance rule to deny conduit tax relief and impose income tax when a conduit arrangement has a purpose of inappropriately providing a tax benefit to a New Zealand resident.

The purpose of conduit tax relief is to relieve tax on non-residents to the extent that they are earning CFC income through a New Zealand "conduit company". Under the existing rules, any undistributed conduit income is clawed back in situations where the conduit company becomes substantially New Zealand owned (a 34 percentage point or greater increase in resident shareholding) or migrates offshore. Otherwise New Zealand shareholders could receive tax benefits which they are not entitled to. The bill removes the claw-back rules.

The anti-avoidance rule is primarily intended to be a deterrent against the use of structures in the interim period which would exploit the removal of the claw-back rules. It is unlikely to be used in practice. As such, it is appropriate to have a reasonably broad rule which applies from the time the policy for repealing conduit was first announced in the December 2007 issues paper.

We are reviewing the drafting of the section in light of submissions to ensure it is appropriately targeted.

Recommendation

That the submissions be noted.

Submission
(24A – New Zealand Law Society)

In section GZ 2, it should be clarified that the reference to a "New Zealand resident" is a reference to a New Zealand resident as defined for the purposes of the CTR rules.

Comment

The definition of "New Zealand resident" used in the CTR rules is the same as the definition used elsewhere in the Act and so does not need to be clarified.

Recommendation

That the submission be declined.

MISCELLANEOUS SUBMISSIONS

Clauses 25, 119–124 and 147

Issue: Structure and drafting of the legislation

Submissions
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

Further consideration should be given to the structure of the new CFC rules. In addition, the legislation should include a section outlining the various rules and the structure of the provisions. *(PricewaterhouseCoopers)*

Terms such as "attributable CFC amount", "net attributable CFC income or loss", and "non-attributing active CFC" used in the bill should be replaced with plain English terms like "passive amount", "net passive income or loss", and "active CFC". (*New Zealand Institute of Chartered Accountants)*

Comment

The international tax provisions of the bill are being reviewed to see whether there is scope to reduce complexity and improve the clarity of the legislation.

Recommendation

That the submissions be noted.

Issue: Section CQ 2 – drafting

Submissions
(67 – New Zealand Institute of Chartered Accountants)

The word "and" should not follow section CQ 2(1)(g).

New paragraphs (fb) and (g) in section CQ 2(1) should be re-labelled as paragraphs (g) and (j) [sic] to avoid the use of two letters as a section or paragraph reference.

Comment

Officials agree that the word "and" is not needed as nothing follows paragraph (g).

We agree that there is some merit in changing the paragraph references, particularly given that new paragraph (g) is not an exact substitute for existing paragraph (g). Re-labelling the new provisions as paragraph (h) and paragraph (i) will make clear that existing paragraph (g) has been repealed.

Recommendation

That the submissions be accepted, and that the new paragraphs replacing existing paragraph (g) of section CQ 2(1) are renamed paragraph (h) and paragraph (i), and that the word "and" after what will then be paragraph (i) be omitted.

Issue: Repeal of section EZ 31

Submission
(68/68A – Corporate Taxpayers Group)

The exemption for certain listed CFCs in section EZ 31 should be retained and relaxed rather than repealed.

Comment

Section EZ 31 provides an exemption from the requirement to attribute income from CFCs or FIFs in other jurisdictions held by a grey list CFC if the CFC is a listed company and is constrained from providing the information necessary to calculate branch equivalent income or loss. The exemption was inserted to cater for an exceptional circumstance where a New Zealand-owned CFC and a grey list was a listed entity. That situation no longer exists. The exemption was set to expire in the 2011 income year.

Recommendation

That the submission be declined.

Issue: Ring-fencing of CFC losses by jurisdiction

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

Ring-fencing of CFC losses by jurisdiction should be abandoned on the move to an active income exemption.

Comment

The move to an active income exemption does not affect the case for the jurisdictional ring-fencing of CFC losses.

The ring-fencing of CFC losses was introduced on the recommendation of the Valabh Committee in 1988.[8] The Committee noted that the allowance of a credit for foreign tax paid by a CFC means that a CFC profit is not equivalent to a domestic profit in terms of its consequences for tax revenue. It follows that CFC losses should be treated differently from domestic losses, and their offset against domestic income restricted. It was also argued that unrestricted loss offset may give rise to base maintenance problems if New Zealand residents were able to acquire losses in foreign companies.

The fact that credits are allowed for foreign tax paid by CFCs argues for ring-fencing on a jurisdictional basis, since a difference in New Zealand revenue consequences may arise between CFC profits earned in different jurisdictions, depending on the local rate of tax. The Committee also noted that jurisdictional ring-fencing is needed to prevent the income of CFCs in tax havens, which could include income diverted from New Zealand, being sheltered by losses incurred elsewhere.

Recommendation

That the submission be declined.

Issue: Use of FIF losses against CFC income

Submission
(26 – Fonterra)

It should be clarified that jurisdictional ring-fencing of FIF net losses is by reference to branch equivalent FIF income and attributed CFC income.

Comment

Like CFC losses, losses from branch equivalent FIFs are ring-fenced on a jurisdictional basis. As a matter of policy, these losses should be ring-fenced by reference to branch equivalent FIF income and attributed CFC income from the jurisdiction in question. That was the position under the Income Tax Act 2004.

The submission notes that the Income Tax Act 2007 appears to have changed the treatment of branch equivalent FIF losses carried forward to a subsequent year. Such losses now appear to be ring-fenced by reference to all FIF income from a particular jurisdiction, but not by reference to attributed CFC income. This is an unintended change which needs to be corrected to restore the position under the Income Tax Act 2004. Officials note that the matter has not previously been referred to the Rewrite Advisory Panel for its consideration.

Recommendation

That the submission be accepted, and the problem corrected, with an application date from the beginning of the 2008–09 income year.

[8] International tax reform: Full imputation part 2: Report of the Consultative Committee (July 1988), chapter 4.6.

Issue: Tax credits on attributed CFC income

Submission
(30 – Staples Rodway)

Tax credits are currently provided for foreign tax paid on attributed CFC income. The position needs to be clarified now that only passive income will be attributed. An apportionment methodology should be provided for taxpayers to work out what proportion of their foreign tax relates to passive income.

Comment

Under the existing rules a person has a tax credit equal to the amount of foreign income tax paid in relation to attributed CFC income. With the introduction of an active income exemption only passive income will be attributed. This means that foreign tax paid on active income will not count towards foreign tax credits. Rather than prescribe a specific methodology for apportioning foreign tax paid, it is sensible to leave it to businesses to apply the existing rule appropriately. Businesses are already doing this for foreign taxes on items such as capital gains which are not taxed in New Zealand.

Recommendation

That the submission be declined.

Issue: Streaming of imputation credits

Submission
(59 – Fletcher Building, 68/68A – Corporate Taxpayers Group)

Limited streaming of imputation credits to New Zealand-resident shareholders should be allowed.

Comment

This issue is outside the scope of the bill and is being considered within the context of the imputation review. The discussion document, *Streaming and refundability of imputation credits*, was released in August 2008.

Recommendation

That the submission be declined.

Foreign investment fund remedial amendments

EFFECT OF PREVIOUS YEAR'S QUICK SALE GAINS ON OPENING VALUES

Submission
(20 – BDO Spicers)

The opening values in section EX 45B(10) of the Income Tax Act 2004 and section EX 56(9) of the Income Tax Act 2007 should not include the effect of the previous year's quick sale gains.

Comment

Officials agree. The references to "FIF income" in the opening value formulas in section EX 45B of the Income Tax Act 2004 and section EX 56 of the Income Tax Act 2007 should not include "quick sale gains".

Recommendation

That the submission be accepted.

AUSTRALIAN-RESIDENT LISTED COMPANY EXEMPTION

Submission
(29 – Russell McVeagh)

The exemption for Australian-resident companies listed on the Australian Stock Exchange should include companies that have had shares transferred under a court-approved reorganisation.

Comment

The bill amends the exemption for shares in Australian-resident companies listed on the Australian Stock Exchange which are the subject of court-approved reorganisations. The requirement that shares in the company be included in an approved Australian Stock Exchange index will be expanded to include situations where the shares are included in an approved index at the beginning of the final month of the preceding income year, if the shares are cancelled in the first month of an income year under a court-approved arrangement. Officials agree that this amendment should be extended to shares that have been transferred under a court-approved arrangement.

Recommendation

That the submission be accepted.

DEEMED DISPOSAL AND RE-ACQUISITION WHEN FIF BECOMES NEW ZEALAND-RESIDENT

Submission
(32 – KPMG)

There should be a deemed disposal and re-acquisition rule (at market value) to deal with situations where a foreign investment fund becomes New Zealand-resident.

Comment

Officials agree. There is currently a provision – section EX 66 – that deals with the situation when a New Zealand-resident entity becomes a non-resident, resulting in New Zealand investors in that entity holding an attributing interest in a FIF. This provision treats the investor as having disposed of and reacquired the interest at market value. A similar provision is necessary to deal with the situation when a non-resident entity (a FIF) becomes a New Zealand resident. New Zealand investors in that entity should be treated as having disposed of and reacquired their interest in that entity at market value.

Recommendation

That the submission be accepted.

APPLICATION OF QUICK SALE ADJUSTMENT TO FDR CALCULATIONS FOR UNIT VALUERS

Submission
(33 – Investment Savings and Insurance Association of NZ Inc)

Proposed section EX 53(8) should be amended to reinstate:

- the 1-day exclusion; and
- that the period that is used to determine whether quick sale adjustments are required is limited to the valuation period, not the income year.

Comment

Officials agree.

Recommendation

That the submission be accepted.

MANAGEMENT FEE REBATE RECEIVED FROM AN OFFSHORE FUND WHICH IS SUBJECT TO FAIR DIVIDEND RATE (FDR) METHOD

Submission
(33 – Investment Savings and Insurance Association of NZ Inc, 32 – KPMG)

Management fee rebates received from the offshore manager in relation to the FIF interest should not be taxable. Section EX 59(2) of the Act should be extended to include income derived from and in relation to the FIF interest held. *(Investment Savings and Insurance Association of NZ Inc)*

Management fee rebates received in relation to an interest that is an offshore unit trust should not be separately taxable. *(KPMG)*

Comment

Given that the management fee would be a deductible expense to the New Zealand managed fund investor, officials consider that any rebate of the fee should be included as income. Officials consider that section EX 59 should be amended to ensure that the provision does not remove from income any rebate of the fee when the FDR or cost FIF calculation methods are used.

Recommendation

That the submission be declined. Section EX 59 should be amended to ensure that the provision does not remove from income any rebate of the fee where the FDR or cost FIF calculation methods are used.

TAXPAYER SHOULD BE ALLOWED TO CHANGE METHOD IN FIRST YEAR

Submission
(35 – PricewaterhouseCoopers)

Taxpayers should be allowed a one-off opportunity to change to the new FDR or cost methods from the first income year beginning after 1 April 2007.

Comment

Officials consider that section EX 50(8) of the Income Tax Act 2004 allowed people who were using the comparative value method for their FIF interests before 1 April 2007 to switch to the FDR method for these interests from 1 April 2007. For people using other FIF calculation methods – such as the accounting profits method – before 1 April 2007, officials consider that it is appropriate for the general requirement of using one method consistently for an interest continues to apply. If it is not practicable to continue to use a particular FIF method the current rules provide sufficient flexibility to allow another method to be used.

Recommendation

That the submission be declined.

COMPARATIVE VALUE LOSS RESTRICTION

Submission

(Matter raised by officials)

The comparative value (CV) loss restriction rule in section EX 51(7) and (8) should apply to foreign superannuation and life interests.

Comment

Given the ability to use FDR for foreign superannuation and life interests, the loss restriction in the CV method should apply to such interests. Otherwise investors would be able to claim a loss under the CV method but limit any gain to 5 percent under FDR. This amendment should apply from the start of the 2009–10 income year.

Recommendation

That the submission be accepted.

APPLICATION DATE OF FDR DETERMINATIONS

Submission
(31 – NZ Funds)

Portfolio investment entities that return their income on a quarterly basis should be allowed to apply a determination retrospectively from the start of the quarter or the income year in which the determination is given.

Comment

Officials agree with the submission as it is consistent with the policy intent of the FIF rules.

Recommendation

That the submission be accepted.

CRITERIA FOR USING FDR METHOD – HEDGING REQUIREMENT

Submission
(Matter raised by officials)

The hedging requirement in section EX 46(10)(c) should be clarified so that it includes situations when the hedge is held by the New Zealand investor.

Comment

The FDR method cannot be used for certain types of investments that are broadly the same as New Zealand dollar-denominated debt investments. One of these exclusions is contained in section EX 46 (10)(c), which currently provides that the FDR method cannot be used for an interest in a non-resident entity that holds directly or indirectly assets of which 80 percent or more by value consist of financial arrangements that are denominated in New Zealand dollars or are hedged back to New Zealand currency with that hedging being at least 80 percent effective.

It should be clarified that the instrument which hedges the investment to New Zealand currency can be held by the New Zealand investor as well as a non-resident entity.

Recommendation

That the submission be accepted.

MINOR DRAFTING ISSUES

Submissions
(32 – KPMG)

A number of minor remedial amendments should be made to the FIF rules.

Comment

Officials recommend that the minor remedial amendments identified by the submission should be taken into account in amending the FIF rules as part of this bill.

Recommendation

That the submission be accepted.

International Financial Reporting Standards (IFRS) provisions

OVERVIEW

The bill contains remedial amendments to International Financial Reporting Standards (IFRS) financial arrangement legislation included in the Taxation (Business Taxation and Remedial Matters) Act 2007. The original legislation primarily affects the spreading of income and expenditure on financial arrangements and other minor matters. The remedial amendments in the current bill relate to financial arrangements and should help to clarify and remove uncertainty. It is not intended that these changes represent a fundamental shift in policy from the original legislation. However, a more formal review is intended, and will be conducted under the generic tax policy process.

All but two of the proposed amendments to the legislation in this report will commence and apply from the original commencement and application dates of the IFRS legislation.

The two exceptions will both be prospective.

Officials consider that it is necessary to make the changes retrospectively either to confirm acceptable interpretations where the existing provisions are unclear or to correct fundamental issues where the policy intention has always been clear. Officials consider that only a very small number of taxpayers will need to refile past returns. In these cases penalties and use-of-money interest will not be applied.

Officials consider that the retrospective nature of the relevant amendments will not result in different treatment of taxpayers in similar fact situations.

Issue: Reconsider the existing/proposed rules, ground-up rewrite

Submission
(32 and 32A – KPMG)

The existing and proposed rules do not work and a fresh regime is a matter of urgency. Officials should be directed to consult urgently on this matter.

Comment

The submission does not provide any rationale for the statement that the existing and proposed rules do not work and that a fresh regime is a matter of urgency. No other submission goes this far in respect of the rules.

Officials are aware that certain aspects of the rules as drafted do not work well and propose further amendments. These are dealt with below. As stated earlier, a more formal review is planned, and will be conducted under the generic tax policy process.

Recommendation

That the submission be noted.

Issue: IFRS operating leases which are finance leases/financial arrangements for tax

Submission

(32 – KPMG)

The proposed amendments do not address operating leases for IFRS and are not finance leases for tax purposes but are financial arrangements.

Comment

The submission is valid for at least one known lease. The problem can be remedied by changing the application of the proposed amendment to cover all operating leases for IFRS which are financial arrangements for tax purposes, which includes finance leases.

Recommendation

That the submission be accepted.

Issue: Finance leases and mandatory use of yield to maturity

Submission

(35 – PricewaterhouseCoopers)

All finance leases should be included in the mandatory use of the yield to maturity (YTM) provision (as amended to deal with foreign currency amounts).

Comment

The submission has some validity as the rules for calculating the loan values of finance leases for tax purposes are different from those applying for IFRS accounting. This is a compliance matter that will be considered in the wider review.

Another recommendation in this report ("(Pre-IFRS) taxpayer choice of spreading method (including YTM)") is that the YTM method is made available for New Zealand currency denominated non-derivative financial arrangements. This method could then be used for finance leases. The existing rules regarding the cost of the asset and the associated "loan" under the finance lease will continue to apply in the meantime, with YTM being applied to the cash flows based on the initial loan.

For non-New Zealand currency denominated finance leases Determination G9C will apply, giving a YTM result.

The use of YTM will be available from the 2009–10 income year.

Recommendation

That the submission be noted as being addressed by the recommendation mentioned above.

Issue: Interest-free loans and loans that are below market value/variations in financial arrangements such as finance company workouts

Submissions

(32 – KPMG, 35 – PricewaterhouseCoopers, 53 – Ernst & Young, 67 – New Zealand Institute of Chartered Accountants)

A yield to maturity or alternative method should be available for interest-free loans or loans that are below market value. In many cases the latter situation would include loans to finance companies in workout situations. *(KPMG)*

The legislation should provide yield to maturity as an option for IFRS taxpayers where there is a variation in terms of a financial arrangement. *(PricewaterhouseCoopers)*

The legislation should be amended to allow taxpayers who have adopted NZ IFRS for financial reporting purposes to elect to use the yield to maturity method or materially similar alternatives for income tax purposes for finance company workouts. *(Ernst & Young)*

The interaction of the IFRS accounting standards with the financial arrangement (tax) rules is causing some anomalous results. Accordingly, amending tax legislation may be required at short notice to address these concerns. The submission then refers to the restructuring of debt in distressed finance companies as an example. *(New Zealand Institute of Chartered Accountants)*

Comment

The issue regarding financial arrangements which are at lower than market value for various reasons and which result in a one-off present-value type adjustment in the IFRS accounting results has validity as often, the only tax option is to use the IFRS accounting result with often inappropriate results. In these situations, it is proposed that the yield to maturity approach be allowed for tax purposes from the 2009–10 income year (see recommendation under heading ("(Pre-IFRS) taxpayer choice of spreading method (including YTM)").

Officials note that nil/low interest loans in the nature of equity from related parties may be treated under IFRS accounting on a present-value basis in some circumstances and amounts dealt with in equity reserves. The proposed treatment above may need to be distinguished for any related-party low/nil interest loans which otherwise may come within its ambit.

This second matter will be included in the wider review mentioned earlier.

The problem of distressed finance company workouts and the like will be dealt with in a separate process announced by the Ministers of Finance and Revenue in their press release of 15 December 2008.

Recommendation

That the submissions be noted.

Issue: Anti-arbitrage provisions in the legislation

Submission
(32 – KPMG, 35 – PricewaterhouseCoopers, 68A – Corporate Taxpayers Group)

The proposed amendments to the anti-arbitrage provisions in the legislation do not achieve the intended effect.

Comment

All three submissions have highlighted that the proposed changes to the anti-arbitrage provisions do not achieve the intended effect. Officials were already aware of the issue.

The anti-arbitrage provisions should allow the use of the determination alternatives, expected value method or the modified fair value method for a financial arrangement if:

- the financial arrangement is not a hedge of, or is being hedged by, another financial arrangement under IFRS accounting; or
- a financial arrangement is a hedge of, or is being hedged by, another financial arrangement under IFRS accounting and the other financial arrangement has not been accounted for using the fair value method or a method that accounts for gains and losses related to the hedge.

It is considered that the proposed changes will achieve the intended policy intent.

Recommendation

The submission be accepted.

Issue: Transitional provisions and early adopters of the IFRS accounting methods

Submissions

(67 – New Zealand Institute of Chartered Accountants, 68A – Corporate Taxpayers Group)

The proposed transitional adjustments measures in the bill in respect of IFRS early adopters changing from the IFRS fair value method should be amended to allow taxpayers the option to choose another IFRS method, provided the other requirements of the proposed measures are met. The submission is based on a technical concern that provisions in the current rules will counteract the policy intention regarding the proposed changes in the bill. Where an early adopter qualifies under the proposed measures, they should be permitted to apply the spreading adjustment method included in the original legislation. *(New Zealand Institute of Chartered Accountants)*

The provisions do not necessarily put early adopters in the same position as late adopters. This is because the original IFRS financial arrangements legislation was finalised after early adopters had made their decisions and there is probably a cost of changing elections. *(Corporate Taxpayers Group)*

Comment

The first submission has merit and it should be made clear that taxpayers who adopted the IFRS fair value method in the 2005–06 income year and who otherwise meet the requirements to change from that method to another IFRS financial reporting method under the proposal in the bill will automatically qualify to do so. This overrides any technical argument that such a change may be prevented as it causes an advancement, deferral, or reduction of an income tax liability.

New Zealand Institute of Chartered Accountant's second submission is the same as the Corporate Taxpayers Group submission which is discussed in the next paragraph.

The Corporate Taxpayers Group submission is correct in its analysis of the position and the bill reflects the preferred policy position recognising that taxpayers are being given a choice to switch methods and that the resulting base price adjustment may go either way. However, it is understood that the situation has been satisfactorily dealt with under the existing legislation. Should this not be the case the matter can be further considered.

The proposed review will allow taxpayers to further consider their methods of returning income and expenditure from financial arrangements.

Recommendation

That the first submission on transitional matters be accepted.

That the submissions on early adopters of IFRS method be noted.

Issue: Change of spreading method transitional adjustments on entry to new tax rules

Submission
(53 – Ernst & Young)

The extent to which transitional adjustments must be brought into account for income tax purposes if taxpayers who have adopted NZ IFRS for financial reporting purposes remain required to adopt an IFRS financial reporting method should be restricted.

Comment

The submission does not say to what extent transitional adjustments should be restricted, but does suggest that capitalised interest is a problem. This is dealt with immediately below under the heading "Interest capitalised to the balance sheet by IFRS financial reporting".

The 2007 legislation included the requirement for a change of spreading method adjustment when a taxpayer transitions to the IFRS tax rules. The application of the 2007 legislation has not been modified by any of the proposals in the bill. The change of spreading method on entry to the new tax rules is more appropriate than deferring any adjustment until the base price adjustment is calculated on maturity/disposal. There has been no change to the original policy on this matter.

Recommendation

That the submission be declined.

Issue: Interest capitalised to the balance sheet by IFRS financial reporting

Submission
(33 – Investment Savings and Insurance Association of NZ Inc, 35 – PricewaterhouseCoopers, 53 – Ernst & Young)

The original 2007 legislation has cast doubt on the longstanding ability to deduct on an incurred basis, interest and other borrowing costs capitalised to the balance sheet under IFRS accounting. Instead, the legislation may mean it has to be deducted subsequently when it passes through the profit and loss account as depreciation, or as part of a base price adjustment.

Comment

The policy regarding capitalised interest and other borrowing costs has for some time been that it is deductible as incurred for tax purposes. However, enactment of the 2007 tax legislation for IFRS has created doubt on this matter. There was no intention to change the longstanding policy as a result of the enactment of the 2007 IFRS-

related legislation. It will be necessary to retain the original policy outcome on a retrospective basis.

Further work in this area is being considered in the context of the more formal review to consider whether further simplification is achievable.

Recommendation

That the submission be accepted.

Issue: Pre-IFRS GAAP financial reporting method

Submission
(53 – Ernst & Young)

Taxpayers' ability to use the pre-IFRS GAAP financial reporting method where they have not adopted NZ IFRS for financial reporting purposes should be reinstated.

Comment

The 2007 legislation repealed the section allowing the use of pre-IFRS GAAP financial reporting methods as a method available for tax. For taxpayers who have adopted IFRS financial reporting the repeal is understandable as the new IFRS tax rules specifically include methods based on IFRS financial reporting. However, the scope of the repeal was wider than intended.

While this is not a matter contained in the current bill, the problem should be addressed urgently and on a retrospective basis.

Recommendation

That the submission be accepted.

Issue: (Pre-IFRS) taxpayer choice of spreading method (including YTM)

Submission
(53 – Ernst & Young)

(The pre-IFRS) choice of spreading method should be reinstated, regardless of whether taxpayers have adopted NZ IFRS for tax purposes.

Comment

The submission infers that the previously legislated yield to maturity (YTM) method has been removed for IFRS taxpayers and should be reinstated as a choice available to taxpayers. The 2007 legislation removed YTM for IFRS taxpayers as it was considered that other methods provided in the new IFRS tax rules gave taxpayers appropriate choices for tax which were in some cases very similar to YTM.

Officials are considering via a wider review whether significant changes should be made to the IFRS-based spreading rules for financial arrangements in the long term. This could include widening the choices available to taxpayers as suggested in the submission.

However, officials are aware of certain limited situations involving New Zealand currency denominated non-derivative financial arrangements where the use of a YTM method would enable taxpayers to remove for tax purposes volatility created by IFRS financial reporting which may not otherwise be able to be mitigated. It is proposed that the use of Determination G3 (the yield to maturity determination) be permitted in these circumstances, pending the wider review. A choice will be provided to switch to the YTM method in the 2009–10 income year with a change of spreading method adjustment to apply.

Recommendation

That the submission be noted, and the use of the yield to maturity method by IFRS taxpayers be permitted for New Zealand currency non-derivative financial arrangements from the 2009–10 income year pending the wider review.

Issue: General submission – methods, choices and volatility

Submission
(35 – PricewaterhouseCoopers)

The financial arrangement rules should continue to allow taxpayers to follow accounting for tax purposes (with or without an adjustment for reserves). However, to address volatility, taxpayers should have two or three other choices, preferably including YTM, expected value and modified fair value.

The rules need to include a consistency provision to prevent taxpayers from "cherry picking" tax methods, but this should be one single, universal test.

Comment

The current legislation allows taxpayers to follow accounting for tax purposes as the default method. They can choose three alternative methods, provided the financial arrangement/s meet the criteria for those alternatives. There are some situations where the choice of alternative methods is clouded because of the required treatments of IFRS accounting. These difficulties were not anticipated at the time the original

legislation was drafted, and it is proposed to deal with those situations as part of the wider review.

Pending this review, officials consider the present scheme of the legislation should remain intact.

In respect of consistency, we consider that the present scheme of the legislation and tests are appropriate, but that they should also be further considered in the wider review.

Recommendation

That the submission be noted.

Issue: IFRS financial reporting method – wording clarification

Submissions
(35 – PricewaterhouseCoopers)

Section EW 15D(1) does not specify whether the allocation of an amount for tax must be the amount shown in a taxpayer's financial statements or whether an allocation can be done applying an accounting methodology available under IFRS but not used by the taxpayer.

Further, it does not refer to the profit and loss account or balance sheet in the financial statements. The amount allocated for tax purposes should be based on the amount in a taxpayer's profit and loss account in its financial statements.

Comment

The policy intent is that the taxpayer must have applied the allocation method in its financial statements to be able to use it for tax purposes. It is not intended that a taxpayer can use any allocation method which IFRS accounting may generally permit without actually using it for its own financial statements. It should be noted that the policy is based on considerations such as simplicity, ease of compliance and that the financial statements are audited.

The second submission point being made is understood by officials and will be addressed in the wider review of the legislation. Officials note that some amounts intended as able to be allocated for tax sit in some equity reserves and not within the profit and loss account. The present legislation allows for this.

Recommendation

That the first submission be accepted.

That the second submission be noted.

Issue: Impaired credit adjustments for financial arrangements accounted for under the (IFRS financial reporting) fair value method – dealers

Submission
(35 – PricewaterhouseCoopers)

Dealers in financial arrangements should be excluded from the impaired credit adjustment.

Comment

Taxpayers using the IFRS financial reporting method are required to identify, and adjust for credit, impairments to financial arrangements accounted for at fair value.

PricewaterhouseCoopers views this as a change in policy. Previously, dealers could use the mark to market value method with no adjustment for credit impairments. Use of the market value method was restricted to dealers. The purpose of restricting the use of the market value method in this way was to protect against inappropriate bad debt deductions.

We agree with PricewaterhouseCoopers that this was an unintended change in policy for dealers.

This correction should be retrospective to the income year in which a taxpayer first adopted the new IFRS tax rules which could be the 2005–06 income year for some taxpayers. Despite this possibility, it is not anticipated that any returns will need to be refiled.

Recommendation

That the submission be accepted.

Issue: Impaired credit adjustments for financial arrangements accounted for under the (IFRS financial reporting) fair value method – decline in credit quality

Submission
(35 – PricewaterhouseCoopers)

The definition of "impaired credit adjustment" should be redrafted to align it with existing definitions in the financial arrangement rules. Alternatively, further clarification should be provided to assist taxpayers determine what constitutes a "decline in credit quality of the financial arrangement" for a financial arrangement accounted for under the (IFRS financial reporting) fair value method.

Comment

The submission considers that the present drafting is too vague and that it would be preferable to have wording consistent with other existing sections of the financial arrangement rules.

Officials consider that the present drafting reflects the terminology used in IFRS and is appropriate in these circumstances.

Recommendation

That the submission be declined.

Issue: Errors in the accounts

Submissions
(35 – PricewaterhouseCoopers)

Adjustments for accounting errors (for those following the IFRS financial reporting method) should be restricted to material errors.

Material adjustments should be brought to tax when the adjustment is made in the accounts, and no use-of-money interest or shortfall penalties should apply. Alternatively, confirmation should be provided on how errors should be dealt with.

Comment

There are no provisions in the bill related to this submission. The current legislation also does not directly deal with the issues raised but it is considered that the legislation inherently covers them in the various methods available to taxpayers for financial arrangements. It is to be noted that the pre-IFRS rules for financial arrangements did not specifically deal with these issues either.

Other areas of the 2007 Act that align tax and accounting require adjustment for immaterial errors. However, given the complexity of the financial arrangement provisions, and the operation of the base price adjustment as a "wash-up", there is good reason not to require adjustment for errors, other than as they are corrected in the IFRS GAAP financial statements, either in profit and loss or the balance sheet (equity). It should be noted that the base price adjustment will operate to include all relevant amounts when a financial arrangement matures or is disposed of.

Recommendation

That the submissions be noted and included in the wider review to follow.

Issue: Mandatory use of yield to maturity for some arrangements

Submission
(35 – PricewaterhouseCoopers)

Two choices should be available for taxpayers facing income and expenditure for foreign hybrids, finance leases and agreements for sale and purchase of property. The two methods are expected value (which is arguably a yield to maturity-type approach already permitted by the rules), which has compliance costs, and a mark to spot approach, which leads to uncertainty but is easier to calculate.

Comment

The issue is that the draft amendments do not provide a clear spreading mechanism for taxpayers with foreign denominated arrangements that fall within section EW 15I.

The proposed amendments to this section are directed at finance leases and not related to foreign denominated arrangements at all.

However, officials are aware of concerns regarding foreign denominated arrangements that fall within the section but that the position should be subject to a wide consultation process before any changes are made.

The underlying premise of the section is a yield to maturity approach. This should continue to underpin any modification to the section, but the matter will be considered in the wider review.

Recommendation

That the submission be noted.

Issue: Electricity contracts for differences – expected value approach

Submission
(35 – PricewaterhouseCoopers)

Use of the expected value method for electricity contracts for differences requires clarification, given the lack of prevailing market forward rates for electricity. Each company should be able to self-assess their expectation of the forward price, based on internal models.

Comment

This issue is outside the scope of the bill.

Officials are aware of issues surrounding contracts for differences (CFDs) generally, and note that the original legislation specifically addressed concerns at that time regarding CFDs and potential volatility in the financial statements and for tax purposes. The legislation was framed so that CFDs could be taxed on the historical cash payments basis so that volatility could be removed from tax returns.

At this time it is clear that a cash payments method is acceptable for tax under the expected value methodology. However, it is considered that any further changes to the treatment of contracts for differences are included in the wider review, as consultation is necessary.

Recommendation

That the submission be noted.

Issue: Amendments to legislation – application to filed returns

Submission
(35 – PricewaterhouseCoopers)

Taxpayers that have filed their returns based on the black letter law of the current legislation should have the choice between continuing to adopt the current law or refiling. Consideration should also be given to whether appropriate adjustments (catch-up adjustments) can be made in the next income tax return.

Comment

Officials appreciate that taxpayers are filing tax returns which may be affected by the proposed amendments before they are enacted.

Taxpayers who have relied on the black letter law of the current legislation will be required to refile. Numbers are not expected to be large.

Recommendation

That the submission be declined.

Issue: Taxation of financial arrangements held by functional currency entities

Submissions
(35 – PricewaterhouseCoopers)

There should be a rule requiring non-New Zealand dollar functional currency companies that use IFRS to use New Zealand dollars, regardless of which of the four methods specified in section EW 15C(1) is adopted. The legislation should provide guidance on the method to be followed for converting functional currency financial arrangements into New Zealand dollars.

Comment

The first submission is valid as a taxpayer may apply any one of the four IFRS methods available to financial arrangements denominated in a functional currency other than New Zealand dollars and we recommend that the bill be so amended.

The second submission is considered not to be an IFRS-only matter and is part of a wider issuer relating to foreign currencies to all taxpayers. It is not proposed to address the matter in the current bill, and it will be noted for a future work programme.

Recommendation

That the first submission be accepted.

That the second submission be noted.

Issue: Modified fair value method

Submission
(35 – PricewaterhouseCoopers)

The modified fair value method should only apply to gains and losses on foreign denominated or derivative movements recognised through equity. If this change were made, there should be no need to include an anti-arbitrage requirement in section EW 15E.

Comment

The submission is also related to the anti-arbitrage submissions above under the heading "Anti-arbitrage provisions in the legislation".

It is considered that the recommendation for that submission should address the concern here.

The concern can be further considered in the wider review if it is still relevant.

Recommendation

That the submission be noted, and the concern considered in the wider review if necessary.

Issue: Methodology for calculating taxable income on swaps – Determination G9A

Submission
(60 – CBA NZ Group)

Taxpayers should be allowed to use Determination G9A and the proposed amendments to prohibit its use should be deleted. If it is considered that the use of Determination G9A should be prohibited, the application of proposed clause 101(4) of the bill should be delayed until the commencement of the 2009–10 income year, and clause 565(4) should be deleted altogether.

Comment

Denial of the use of Determination G9A as one of the determinations available to be used under the 2007 IFRS legislation was a policy decision at that time. Direct use of the determination was denied in that legislation. It was overlooked that Determination G27 included use of Determination G9A in some circumstances, and the proposed amendments eliminate that use via Determination G27 to ensure consistency with the original policy.

Officials consider that the original policy is still valid – to reduce volatility caused by use of spot exchange rates unless the taxpayer is using the IFRS financial reporting method which accounts for volatility.

We also consider that the other methods available in the legislation allow taxpayers sufficient choice to reduce volatility for tax purposes in hedge situations.

Officials agree that the application dates as proposed are not equitable and that affected taxpayers should be given the choice of applying them from the next income year. As proposed, they are retrospective to the 2006 tax year if an early adopter IFRS taxpayer chose to use the new IFRS tax rules from 2006.

Officials also note that Determination G29 allows the use of Determination G9A in some situations, and for IFRS taxpayers this is also inappropriate in terms of the original policy. This alternative will also be removed for IFRS taxpayers as with Determination G27.

Recommendation

That the submission in respect of allowing use of Determination G9A be noted and included in the wider review.

That the application date of the proposal in the bill is changed to the income year following the enactment of the bill.

Issue: Volatility in some bond group investment funds taxable income

Submission
(61 – Trustee Corporations Association)

The legislation should return to the pre-IFRS position where bond funds had a choice of different accrual income-spreading methods. This could be achieved by removing the restriction in sections EW 15F and EW 15G whereby the expected value and modified fair value methods are only available if "the person is not in the business of dealing in financial arrangements". Alternatively, a greater number of the old determinations could be made available for use under section EW 15H.

Comment

It appears that certain group investment funds may be precluded from removing volatility on financial arrangements from tax returns where it would be otherwise appropriate.

The proposed change above regarding the limited use of Determination G3 for New Zealand currency non-derivative financial arrangements should address this issue.

Recommendation

That the submission be accepted.

Issue: Consistency and a group of companies' elections to use some methods

Submission
(Matter raised by officials)

This matter is not included in the bill, but officials consider that the 2007 legislation should be clarified for two of the methods available to IFRS taxpayers. Those methods are "expected value" and "modified fair value".

Comment

The legislation for the two methods includes a consistency requirement which reads like an election requirement. The legislation should be amended to ensure that it is both an election condition and a consistency requirement.

This is a clarification only of the drafting.

Recommendation

That the submission be accepted.

Issue: Drafting matters

Submission
(Matters raised by officials)

In section EW 31(7), the definition of "consideration" was changed by the 2007 IFRS legislation in respect of "non-integral fees" for IFRS financial reporting. The change was made for non-integral fees paid by a taxpayer but it should also have been made for non-integral fees paid to a taxpayer. This should be remedied.

Clauses 108 and 568 insert a new subsection (13) in sections EW 29 of the Income Tax Act 2007 and Income Tax Act 2004. For clarification, it is considered necessary to add the words "under section EW 15D" for the Income Tax Act 2007 and "under section EW 15C" for the Income Tax Act 2004 in the proposed subsection after the words, "who changes from the fair value method" where they appear.

Recommendation

That the clauses be amended as set out above.

Issue: Consistency of methods by groups of companies

Submission
(Matter raised by officials)

The consistency requirement for group companies in respect of the expected value and modified fair value methods should also be amended so that it applies only to intra-group transactions – that is, transactions between members of the same tax group. It is proposed that those transactions be returned for tax, based on the IFRS GAAP financial reporting method used for the ultimate parent consolidation purpose, even if non-resident.

Comment

The consistency rules for use of the above two methods will not apply to member group transactions with third parties when the transactions are entered into in the usual course of the taxpayer's business, and the usual business of the taxpayer is clearly distinguishable form other members of the group. However, consistent treatment will be required where any of those transactions are back-to-back or otherwise intended to circumvent the policy intent. This change will need to be retrospective to the income year a taxpayer first adopted the original IFRS tax rules and it may be necessary for a small number of returns to be refiled.

The changes outlined in the previous two issues may also need to be extended to some determinations which specifically include group consistency requirements for IFRS taxpayers.

Recommendation

That the submission be accepted, and the consistency rules for the two methods be amended as set out above.

Partnerships

OVERVIEW

The Taxation (Limited Partnerships) Act 2008 came into force on 1 April 2008. It updates the income tax rules relating to general partnerships, as well as providing for flow-through income tax treatment for the new "limited partnership" vehicle created by the Limited Partnerships Act 2008. The rules for general partnerships apply from the 2008–09 tax year.

Two submissions on the partnership rules raised various technical aspects of the partnership legislation, particularly for primary sector partnerships. While the submissions relate to matters not in the bill, officials agree with some of them and have made recommendations accordingly. A significant change is to amend the partnership rules from the 2008–09 income year to ensure that death of one of the spouses in a husband and wife partnership where the other spouse inherits does not give rise to immediate tax consequences.

All other changes should apply from the 2009–10 income year.

FLOW-THROUGH PROVISIONS

Issue: Flow-through of activity, status, intention or purpose

Submission
(62 – Minter Ellison Rudd Watts)

Section HG 2(1)(a) should be amended or repealed. It is too broadly drafted, as it would treat, for example, a limited partner in a land development partnership as a land developer even in circumstances where the partner was not associated with the partnership. Further, the section is unnecessary as it is simply a statutory codification of the current common law position.

Comment

The Taxation (Limited Partnerships) Act 2008 was enacted, in part, to codify the current existing law and practice. Section HG 2(1)(a) reflects this by codifying the existing position.

Officials do not consider that the wording would have the effect of tainting the partner's other business activities in the way that the submission suggests. This is because section HG 2(1) applies to the partner "in their capacity of partner in the partnership" and therefore only affects the partner's income tax liabilities and obligations in their partner capacity.

Recommendation

That the submission be declined.

Issue: Anti-streaming rule

Submission
(62 – Minter Ellison Rudd Watt)

Section HG 2(2) should be replaced with a general purpose-based provision that prevents streaming of income when to do so would have a tax avoidance purpose or effect.

Comment

This rule ensures that different types of income cannot be streamed to take advantage of the different tax circumstances of the partners. In the absence of anti-streaming rules, certain types of income that is effectively non-taxable in the hands of the recipient (such as capital gains or income from PIEs) can be disproportionately allocated to partners on higher marginal tax rates, and taxable income can be allocated

taxpayers on lower marginal tax rates or who are exempt from paying tax – such as a charity – to reduce the amount of tax that would normally be payable.

The following example illustrates the issue.

Example

Two partners each own 50 percent of a business. Partner A is on a marginal tax rate of 39%, and Partner B is a taxpayer who is exempt from paying tax. The business earns $100 of taxable income and $100 of capital gains (non-taxable income).

1. If the profit is distributed proportionately, Partner A will have $50 of taxable income and $50 of capital gains income. Partner A's tax liability will be:

   Taxable income: $50 x 39% = $19.50
   Capital gains (non-taxable income): $50 x 0 = $0

   Partner B's tax liability will be:
   Taxable income: $50 x 0% = $0
   Capital gains (non-taxable income): $50 x 0 = $0

   Total tax payable is $19.50

2. If the partners were allowed to stream the profits to take advantage of their different circumstances, they could ensure that the exempt income is disproportionately allocated to the partner on the higher marginal rate. For example, if all the taxable income is streamed to Partner B (the exempt partner), and all the capital gains are streamed to Partner A (the partner on a 39% marginal rate):

   Partner A's tax liability will be:
   Taxable income: $0 x 39% = $0
   Capital gains (non-taxable income): $100 x 0 = $0

   Partner B's tax liability will be:
   Taxable income: $100 x 0% = $0
   Capital gains (non-taxable income): $0 x 0 = $0

   No tax is paid in this instance.

Recommendation

That the submission be declined.

Issue: Anti-streaming rule should not apply for husband-wife partnerships

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section HG 2(2) should be amended to exclude husband and wife partnerships or partnerships where the partners have a relationship that is in the nature of marriage from the ambit of the anti-streaming rule.

Comment

As noted previously, the purpose of the rules is to ensure that tax is not reduced by disproportionately allocating taxable income to a taxpayer on lower marginal tax rates, and allocating non-taxable income to partners on higher marginal tax rates. There seems no reason why this analysis should change for husband and wife partnerships.

Recommendation

That the submission be declined.

Issue: Variable profit-sharing clauses

Submission
(67 – New Zealand Institute of Chartered Accountants)

There needs to be clarification around variable profit sharing clauses, especially in relation to section HG 2 (1)(c) and the definition of "partnership share" in section YA 1.

Comment

Some partnerships contain a "variable profit sharing clause". This allows one partner's proportionate entitlement to income from the partnership to be different to his or her share in the partnership's assets.

For example, it is common in a professional services firm such as an accounting or law firm for each partner's rights to the profit from the partnership to fluctuate from year to year based on their individual performance, but for each partner's share of the partnership assets remains the same. For example, 10 partners in a firm each have a share of 10 percent in the assets of the firm. However, the partnership agreement may provide that their right to income from the partnership is partly dependent on their performance during that year. Therefore, a partner who performs particularly well may be allocated 12 percent of the partnership's profits from that year and a partner who performs less well may be allocated 8 percent of the profits.

Officials consider that the current legislation allows a partner's share in the income to be different from the partner's share in the assets for tax purposes. This is because the definition of "partnership share" in section YA 1 refers to the "relevant share that a partner has in the rights and obligations and other property…in a partnership".

We note that section HG 2(2) does not prevent this outcome. Rather, section HG 2(2) is concerned about streaming.

Officials will include the explanation above in a future *Tax Information Bulletin*.

Recommendation

That the submission be noted.

Issue: Measuring partner capacity

Submission
(67 – New Zealand Institute of Chartered Accountants)

The time that partner capacity in the partnership is measured under section HG 2 needs to be clarified.

Comment

Officials consider that the partnership capacity should be flexible in its application, and therefore consider that it should not be rigidly defined.

Recommendation

That the submission be declined.

Issue: Deductions for exiting and entering partners

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section HG 2(3) should clarify that the exiting partner can claim a deduction for expenditure incurred up to the exit date and that the entering partner would be able to claim a tax deduction for the full income year.

Comment

This section clarifies that a partner may be allowed to deduct expenditure incurred by a partnership before he became a member. It does not mean than an earlier partner cannot deduct anything.

Recommendation

That the submission be declined.

DISSOLUTION

Issue: Death of a spouse

Submission
(Matter raised by officials)

The rules that apply on the cessation of a partnership should not apply to a two-person partnership where the partners are married, in a civil union or in a de facto relationship, and one partner dies.

Comment

The partnership is treated as being dissolved in these circumstances. Where the surviving partner inherits the deceased partner's partnership interests there is a tax base rollover. However the partnership cessation rule deems the surviving partner to have disposed of and reacquired his or her partnership interests at market value for tax purposes. This result is inappropriate and should be undone in these circumstances.

We recommend that this applies from the commencement of the 2008–09 income year, which was the date that the codification of the partnership rules applied from.

Recommendation

That the submission be accepted.

Issue: Relationship property settlements

Submission
(67 – New Zealand Institute of Chartered Accountants)

An exemption should be provided in section HG 4 for relationship property settlements such as divorce, similar to the provisions that deal with the consequences for when a husband or wife dies and the surviving spouse inherits the deceased partner's interests.

Comment

As noted above, officials recommend that the partnership rules should be amended from the 2008–09 income year to ensure that death of one of the spouses in a husband and wife partnership does not give rise to immediate tax consequences where the surviving partner inherits from the deceased. A similar issue arises for relationship property settlements, and officials agree that the proposal should extend to these situations.

Recommendation

That the submission be accepted.

DISPOSAL OF PARTNERSHIP INTERESTS

Issue: Disposal at market value

Submission
(67 – New Zealand Institute of Chartered Accountants)

Section HG 4(2) and (3) should be amended to remove the need to have all partnership disposals treated as being at market value.

Comment

Officials consider that this rule can be clarified so that while its original object is met, the apparent overreach can be removed.

Recommendation

That the submission be accepted.

Issue: Threshold at which partners must account for tax is too low

Submission
(67 – New Zealand Institute of Chartered Accountants)

The $50,000 minimum threshold in section HG 5(1) should be increased to $100,000.

Comment

The $50,000 minimum threshold in section HG 5(1) was chosen as an appropriate balance to minimise compliance costs.

Recommendation

That the submission be declined.

Issue: Thresholds at which partners must account for tax

Submission
(67 – New Zealand Institute of Chartered Accountants)

If the $50,000 minimum threshold in section HG 5(1) is not increased to $100,000, then capital assets not subject to income tax should be exempt by amending the formula in section HG 5(1).

If capital assets not subject to income tax are not exempt, a partnership should be allowed to revalue its capital assets before the admission of a new partner. This will effectively take non-taxable capital assets out of the formula in section HG 5(1) without the fear of being challenged as tax avoidance.

If capital assets not subject to income tax are not exempt, the definition of "gross tax value" in section HG 5(2)(c) should be amended by treating non-taxable assets at their market value.

Comment

Officials agree that the definition of "gross tax value" in section HG 5(2)(c) should be amended by including assets whose sale or disposal does not have taxation consequences at their market value. Further, the treatment of assets, such as forestry, that have no carrying value for the purposes of this Act should be clarified.

Recommendation

That the submission be accepted.

Issue: Clarification of section HG 5

Submission
(67 – New Zealand Institute of Chartered Accountants)

The rules around application of the $50,000 exemption in section HG 5 and its relationship with the exemptions in sections HG 6 to HG 10 should be clarified.

Comment

Officials agree with the submission and consider that this can be done by amending section HG 3. We agree that it should be clarified in section HG 3 that where HG 5 applies, then sections HG 6 to HG 10 cannot apply. We also note that section HG 3 should be further amended to clarify subpart HG overall.

Recommendation

That the submission be accepted.

TRADING STOCK

Issue: Trading stock definition

Submission
(67 – New Zealand Institute of Chartered Accountants)

“Trading stock” should be defined in section HG 6.

Comment

Trading stock is defined in section YA 1 as per section EB 2. This definition appropriately excludes revenue account property that is land and forestry and consumables.

Recommendation

That the submission be declined.

Issue: Clarification

Submission
(67 – New Zealand Institute of Chartered Accountants)

The reference to “quantum of turnover” in section HG 6(1) should be clarified so that it is clear when the quantum is measured.

Comment

This should be measured for the immediately preceding partnership income year.

Recommendation

That the submission be accepted.

DEPRECIABLE PROPERTY

Issue: Depreciable intangible property

Submission
(67 – New Zealand Institute of Chartered Accountants)

Depreciable intangible property should be included as depreciable property for relief under section HG 7.

Comment

Officials consider that including depreciable intangible property as depreciable property for relief under section HG 7 could result in significant revenue risk.

Recommendation

That the submission be declined.

LIVESTOCK

Issue: Technical issues related to livestock

Submissions
(67 – New Zealand Institute of Chartered Accountants)

A number of technical issues were raised in relation to the livestock provisions. These are:

- Section HG 10 should be amended to apply to non-specified livestock.
- Section HG 10 (1) should be amended to allow other valuation methods other than national standard cost.
- The policy decision regarding having section HG 10 apply only to entering partners should be reviewed.
- It should be confirmed whether or not high-priced livestock were intended to be included within section HG 10.
- The policy rationale for a five-year spreading option under sections CB 27B and DO 11B should be reviewed.
- The rules around valuation methods for partners as separate from the partnership should be clarified.
- Sections CB 27B and DO 11B should be amended to include a mechanism for the exiting partner to disclose their net revenue gain or loss to the entering partner. This could be through the partnership being required to maintain the livestock schedule and advising all partners (exiting, entering and existing).
- The tax effect of not accepting the rollover under section HG 10 should be clarified.
- Section HG 10 should be incorporated into sections CB 27B and DO 11B.
- If section HG 10 is not incorporated into sections CB 27B and DO 11B, signposts should be inserted from section HG 10 to sections CB 27B and DO11B.

Comment

Officials agree that the livestock rules should be amended so that:

- There should be a new section HG 10 which states that:
  - An incoming partner may elect to spread any difference between the price they paid for specified livestock that the partnership has valued at cost at the end of the immediately preceding income year where the partnership has breeding livestock.
  - The details for this spread are contained in section E (see suggested new section below).

- There should be a new section in Part E which provides that:
  - Where an incoming partner has elected to spread the difference between the price they paid for the specified livestock and the partnership's cost base carrying value of that livestock, then the spread shall be calculated as follows:
    - At the end of the income year that the incoming partner acquired the livestock:
      - The partnership shall perform its specified livestock cost calculations as if the partnership had not changed.
      - To the extend the partnership is using a cost basis, the incoming partner shall also calculate their value of specified livestock based on the price they paid.
      - At the end of the next x years, the incoming partner may amortise on a straight line basis the difference between their calculation of the cost of livestock and their share of the partnership calculation.
      - NB: x is 4 where the partnership change occurred before 2 July; x is 5 where the partnership change occurred on or after 2 July.
      - This only applies when the partnership continues to value the relevant specified livestock at cost.

Recommendation

That the submissions be accepted in part, subject to officials' comments.

RESTRUCTURING PARTNERSHIPS TO COMPANIES

Issue: Partnership structure

Submission
(67 – New Zealand Institute of Chartered Accountants)

A partnership (and sole trader or trust) should be permitted to restructure its affairs to take advantage of the reduction in the company tax rate without penalty (that is, it should not be viewed as tax avoidance).

Comment

Avoidance is determined on the facts of the case. Therefore, whether the restructure of a partnership into company form is avoidance will depend on the actual circumstances of the restructuring. Officials do not consider that introducing such a provision in legislation is appropriate.

Recommendation

That the submission be declined.

Issue: Rollover relief

Submission
(67 – New Zealand Institute of Chartered Accountants)

Statutory rollover relief should be provided to allow partnerships to restructure into companies without the tax consequences that would normally arise.

Comment

The general policy concern with providing rollover relief is that it would set a precedent for business restructuring to be treated in this way in the future. Changes to entity-specific tax rules occur every so often and there appears little justification to provide rollover relief in this situation and not others. Further, rollover relief has the potential to be fiscally expensive. The corporatisation of a business is often part of the business's life cycle and generally the private sector is able to plan for this.

Recommendation

That the submission be declined.

OHER ISSUES

Issue: Non-resident partner's partnership income

Submission
(62 – Minter Ellison Rudd Watts)

Inland Revenue should publish some guidance or commentary to clarify that a non-resident partner deriving what would otherwise be treated as foreign-sourced income through a New Zealand partnership will not be brought within the New Zealand tax net merely because:

- the partnership is a New Zealand limited partnership formed and registered in New Zealand; or
- the general partner is a New Zealand tax resident or has a fixed establishment in New Zealand.

Comment

The policy intention of the limited partnership rules is to provide flow-through treatment and limited liability to limited partnerships. The changes were not intended to change the rules on whether non-resident limited partners are taxable on income attributable to a permanent establishment in New Zealand. Whether or not a non-resident has a permanent establishment in New Zealand will depend on the facts of individual cases.

Recommendation

That the submission be declined.

Issue: Approved issuer levy

Submission
(62 – Minter Ellison Rudd Watts)

It should be clarified that the approved issuer levy (AIL) rules should be available for loans made by a New Zealand limited partnership with both resident and non-resident partners.

Comment

Under section RF 12(1), where interest is derived jointly by a non-resident and a resident (for example, by a partnership with at least one resident partner), the non-resident's share of interest is subject to withholding at the RWT rate (the non-resident can apply to Inland Revenue for a refund if a lower rate is available under a double tax agreement). AIL is not available to them. This is a longstanding rule. The policy behind the limited partnership rules is to treat limited partnerships the same as

partnerships as far as possible. Officials do not consider that there is any reason to treat limited partnerships differently to partnerships in respect of the AIL rules.

Recommendation

That the submission be declined.

Issue: New partnership

Submission
(67 – New Zealand Institute of Chartered Accountants)

Clarification is required on Inland Revenue processes, such as PAYE, when there has been a change to the members of the partnership.

Comment

This is a processing matter, not a legislative matter. Inland Revenue is currently working on this.

Recommendation

That the submission be noted.

Issue: Income equalisation schemes

Submission
(67 – New Zealand Institute of Chartered Accountants)

Sections EH 3, EH 37 and EH 63 regarding income equalisation should be amended to widen the definition of "person" in those sections to include a partnership.

Comment

Section 29 of the Interpretation Act 1999 provides the rule that a reference to "person" in legislation includes an unincorporated body. Officials therefore consider that it is clear that the definition of "person" includes a partnership.

This means that partnerships are included for the purposes of the main income equalisation scheme in section EH 3 (for farmers and fishers, but not foresters, because foresters cannot use the main income equalisation scheme if they are an unincorporated body), and for the purposes of the adverse event income equalisation scheme in section EH 37.

Recommendation

That the submission be declined.

MINOR DRAFTING ISSUES

Submission
(67 – New Zealand Institute of Chartered Accountants)

The reference to section HG 4 in section HG 4(4) should be replaced with section HG 5, as section HG 4 cannot override itself.

Comment

Officials agree.

Recommendation

That the submission be accepted.

Submission
(67 – New Zealand Institute of Chartered Accountants)

The words “or all” should be omitted from section HG 5 (2)(b).

Comment

This submission has been referred to the drafter for consideration.

Recommendation

That the submission be noted.

Submission
(Matter raised by officials)

All references to “small partnerships” in sections HG 5 to HG 9 should be deleted because sections HG 5 to HG 9 are elective under section HG 3(2).

Recommendation

That the submission be accepted.

Miscellaneous remedial amendments

ACC PAYMENTS

Submission 1
(67 – New Zealand Institute of Chartered Accountants)

An amendment should be made to the taxation of ACC loss of earnings payments received in relation to an accident occurring in an earlier income year.

A person can be overtaxed on an ACC loss of earnings payment that is paid in relation to an accident occurring in an earlier income year. For example, a person has an accident in the 2008 income year and is unable to work. A dispute arises with the ACC regarding the right to loss of earnings. The dispute is not resolved and loss of earnings payment is not paid until after the person returns to work in the 2009 income year. In the 2009 income year the person has a higher amount of taxable income and is therefore subject to a higher tax rate. If the loss of earnings payment had been paid in the 2008 income year when the accident occurred the amount of tax payable on it would have been less.

Submission 2
(67 – New Zealand Institute of Chartered Accountants)

The ACC loss of earnings payment received in the circumstances described above should be eligible for a rebate or taxed at the marginal rate applying to the taxpayer in the income year the accident occurred.

The situation described above is inequitable. Similar to the redundancy situation, the issue is one of timing. The incident giving rise to the loss of earnings payment occurred in an earlier income year; however, due to a delay in payment (the delay being out of the control of the taxpayer) the income is derived in a later income year.

Comment

Current tax law requires that ACC arrears payments be taxed in the year of receipt.

Lump sum payments may range from just a few days or weeks to periods exceeding 20 years. With the former, although the payment may straddle two tax years, the amount that relates to the first tax year may have no or little impact on the recipient's marginal tax rate in the second tax year. On the other hand, arrears that relate to a number of earlier tax years may result in the majority of the payment being taxed at the top marginal tax rate.

Officials will report to the Minister of Revenue later this year with proposals to address the issues raised in the submissions.

Recommendation

That the submissions be noted.

FIFTY-THREE (53) WEEKLY INSTALMENTS OF WORKING FOR FAMILIES TAX CREDITS IN THE 2008–09 TAX YEAR

Clause 19

Submission
(Matter raised by officials)

Remedial amendments are required to correct inequities in the write-off of certain Working for Families instalments.

Comment

The Taxation (Business Taxation and Remedial Matters) Act 2007 included amendments to provide an automatic write-off of a 53rd interim weekly instalment or a 27th interim fortnightly instalment of the family tax credits in the years in which those events occur, regardless of whether the instalments had been paid by Inland Revenue or by the Ministry of Social Development. The additional instalments arise in some years as a consequence of a year not dividing equally into 52 weeks or 26 fortnights. There were 53 weekly interim instalments in the 2008–09 tax year.

However, in the process of translating the provisions from amendments to the Income Tax Act 2004 to amendments to the Income Tax Act 2007, some aspects were inadvertently omitted. The effect is that while the law currently allows the write-off of a 53rd weekly instalment paid by the Ministry of Social Development in the 2008–09 tax year, it does not allow the write-off of a 53rd weekly instalment paid by Inland Revenue.

In addition, it was believed at the time of the earlier amendments that enhancements to Inland Revenue’s computer systems would ensure that families who received some instalments from the Ministry of Social Development and some instalments from Inland Revenue could not receive more than 52 weekly instalments. This has proved not to be the case and those taxpayers now need to be included in the scope of the provisions so that they are not required to refund an excess payment that arose in circumstances beyond their control.

The problem of extra instalments will next occur in the 2011 tax year when there will be 27 interim fortnightly instalments paid. Officials will continue the development of an enduring solution that can be put into effect for that and future tax years.

Recommendation

That the submission be accepted, and remedial amendments made to correct the deficiencies outlined above.

Issue: Transitional imputation penalty

Submission 1
(35C – PricewaterhouseCoopers)

The rule concerning the transitional imputation credit account penalty should be repealed.

Submission 2
(35C – PricewaterhouseCoopers)

The penalty should be based on the amounts by which the dividends were imputed above the standard ratio of 30/70.

Submission 3
(3 – Vector, 35C – PricewaterhouseCoopers, 60 – ASB Bank)

The rule concerning the transitional imputation credit account penalty should be relaxed so it does not apply to the extent the dividend was paid out before the 30% tax rate applied *(ASB and Vector)*; or before the later of 1 April 2008 or the commencement of the 2008–09 income year.

Submission 4
(35C – PricewaterhouseCoopers)

The rule concerning the transitional imputation credit account penalty should be amended so it does not apply to qualifying companies.

Submission 5
(60 – ASB Bank)

The rule concerning the transitional imputation credit account penalty should be relaxed so it does not apply where the dividend is wholly paid to non-residents as there is no tax issue here.

Comment

Companies are allowed to "over-impute" their dividends for a "transitional period" so that appropriate shareholder benefit can be taken from credits arising from tax paid at the old 33% company tax rate, rather than the new 30% tax rate. The "transitional period" begins at the same time as the 30% tax rate applies, the start of the company's 2008–09 income year, and finishes on 31 March 2010.

The transitional imputation credit account penalty, which was part of the tax rate change package, is intended to ensure that during the transitional period company income taxed at 30% is not credited at 33%. Put another way, it ensures that excess "over-imputation" does not happen. This is meant to loosely match tax-paid income and tax credits available and protects the fiscal base. The methodology chosen was made as simple as possible to reduce compliance costs.

Submission 1

We still believe that this rationale for the transitional penalty is appropriate and therefore we do not agree that it should be repealed. Officials understand it is having its intended effect of protecting the tax base.

Submission 2

Officials acknowledge there may be an issue with the quantum of the penalty, but want to review this outside the tax bill.

Submission 3

Officials agree with the submissions that point out that it should not apply where the dividend was paid out before the 30% tax rate applied. A number of companies pre-pay their tax so they can fully impute their dividends. It is quite possible that some companies in this position may have paid the dividends that now give rise to the penalty before the tax-rate change amendments were even announced. In this situation the rationale for the transitional penalty falls away. Thus we recommend that the transitional penalty rules be amended so that they only apply to dividends paid after a certain date.

The question then is "what date should the new rule apply from?". ASB and Vector recommend that it should apply to dividends paid out from when the 30% tax rate could first apply – the start of the "transitional period" (the start of the 2008–09 income year). Conceptually this submission is correct as this best meets the policy objective of (loosely) matching credits against income.

PricewaterhouseCoopers recommends that it should apply from the later of 1 April 2008 or the start of a company's 2008–09 income year, but provide little guidance as to why this is appropriate.

In talking to those who have made submissions we have been made aware of several situations where over-imputed dividends have been paid out in the transitional period, but before the 2008 tax return has been filed. These dividends have been paid out based on the tax refund position shown in the 2008 financial statements, but this position has changed substantially after the dividend was paid, but before the tax return was prepared. We believe the penalty should also not apply in this situation as there was no intentional over-crediting.

Accordingly, we recommend that the transitional penalty not apply where the dividends were paid out before the earlier of the date the company's 2008 tax return was filed and the date this relief was announced, 25 March 2009.

Submission 4

Officials do not agree with the submission that the penalty should not apply to qualifying companies, as their imputation rules are much more prescribed. However, accepting the submission above that the penalty should not apply to dividends paid out before the 30% tax rate became effective addresses the major problem illustrated in the submission. That is, a refund relating to the 2007–08 or earlier income year being paid out in the 2008–09 or later income year where the dividend was paid out in the 2007–08 or earlier income year.

Submission 5

Officials disagree with the analysis that suggests that where a dividend is wholly paid to non-residents there is no problem and the penalty should not apply. As discussed above, the penalty is designed to ensure that, to the extent reasonable, profits taxed at 30% can also be credited at 30% and there is no unnecessary build up of profits that have been taxed, but which cannot be covered by tax credits. The question of who the dividends are paid to does not affect this analysis.

Recommendation

That the submissions that the overreach the transitional penalty currently be accepted as indicated above.

That the other submissions be declined.

Issue: Attribution rule issues

Submission
(69 – Deloitte)

To prevent an element of double taxation, companies that are subject to the attribution rule and who elect to use the qualifying company dividend mechanism should not receive an imputation credit gross-up.

Comment

Companies that are subject to the attribution rule (a rule that, in defined circumstances, attributes personal services income to the individuals who personally provided the services) are left with accounting income which is then taxable on distribution as a dividend. To minimise double taxation, the company is granted an imputation credit to reduce the taxation liability on the dividend.

However, the submission points out that under the present rules, the dividend from a company that elected to use the relief provided by using the qualifying company dividend mechanism, would be exempt if it wasn't credited, and that this outcome is appropriate from a policy perspective.

We agree with this remedial, but already have in place a process that will include it in the next tax bill.

Recommendation

That the submission be noted.

Issue: IFRS and R&D expense deductions

Submission
(35C – PricewaterhouseCoopers

The compulsory use of International Financial reporting Standards (IFRS) to determine certain R&D deductions limits the ability of taxpayers who are not required to use IFRS to claim deductions. The reference to IFRS should be extended to deal with this.

Comment

The problem arises because of a late decision to limit the application of IFRS GAAP (generally accepted accounting practice) and extend the timeframe in which "old" GAAP (GAAP that preceded IFRS) can be used.

Officials agree that there is a problem, but it is already being dealt with as part of the next tax bill.

Recommendation

That the submission be noted.

SCHEDULE 13 DEPRECIABLE LAND IMPROVEMENTS

Clauses 423, 614, 620, and 622

Submission
(35A – PricewaterhouseCoopers)

Because pipes are a subset of "conduits" the word "pipes" is unnecessary and only conduits should be added to schedule 13. Alternatively, if the reference to pipes is retained in schedule 13, then "channels, aqueducts, canals and other conduits" should be added.

Comment

Adding "pipes and conduits" to schedule 13 provides certainty for taxpayers who have relied upon a Commissioner's determination that includes various depreciation rates for different types of pipes. That is why the amendment is retrospective. Adding "pipes and conduits" was not intended to add canals, channels or aqueducts to the list of depreciable land improvements.

We agree that "conduit" by itself is a very broad term. What is being added to schedule 13 is the term "pipes and conduits". Legal interpretation suggests that in this context the term "conduit" is limited to only those kinds of items that are similar to a pipe – for example, ducts, and does not include all things that allow water to flow from one place to another. However, to remove any potential ambiguity, it is recommended that the term "and conduits" be deleted.

Recommendation

That the submission be declined, but the words "and conduits" be deleted.

CORRECTION OF CROSS-REFERENCE

Submission
(Matter raised by officials)

A minor technical amendment is needed to correct a cross-reference in section RB 1 of the Income Tax Act 2007 (Payment of terminal tax). The cross-reference should be to section RA 13 (Payment dates for terminal tax).

Recommendation

That the submission be accepted, and the cross-reference to section RA 3 replaced by a cross-reference to section RA 13 (Payment dates for terminal tax).

APPLICATION OF LATE PAYMENT NOTIFICATION TO PROVISIONAL TAX

Submission
(35 – PricewaterhouseCoopers)

Section 139B(1) of the Tax Administration Act 1994 should clearly state that late payment notification should not apply to provisional tax.

Comment

The Taxation (Business Taxation and Remedial Matters) Act 2007 included a late payment penalty notification. Inland Revenue will now notify a taxpayer the first time their payment is late rather than imposing an immediate late payment penalty. If payment is not made by a certain date the penalty will be imposed.

One of the submissions on the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill noted that it was unclear how the taxpayer will be relieved by way of a notification from the late payment penalties for provisional tax payments as the penalty cannot be assessed until the final tax liability is calculated.

Officials agreed with the submission and noted that the late payment notification should not apply to provisional tax and this would be clarified in the legislation. Under section 139B(1)(a), a late payment penalty is payable if the taxpayer does not pay by the due date an amount of tax calculated by the taxpayer or for which the taxpayer is assessed and the unpaid tax is provisional tax or a penalty relating to a failure to pay provisional tax. Section 139A(1)(b) and (c) then set out the notification period for other tax types and when the late payment penalty will be applied.

Officials consider that section 139A(1)(a) already clearly states that the late payment notification should not apply to provisional tax.

Recommendation

That the submission be declined.

RESIDENT WITHHOLDING TAX ON FOREIGN DIVIDENDS

Submission
(71 – Deloitte)

When a nominee receives a dividend on behalf of a New Zealand-resident investor from a foreign company and that investment is subject to the fair dividend rate (FDR) method of calculating taxable income, the nominee is not required to withhold resident withholding tax (RWT) on the dividend, as it is exempt from tax. Correspondingly, the nominee will be required to withhold RWT on a foreign dividend where the FDR method does not apply. Income is subject to the FDR method where an investor's foreign investment fund (FIF) interests are above $50,000 at any time during the income year.

The issue raised by the submission is that RWT may be deducted in error by a nominee. This may occur where a dividend is received by the nominee at a time when the investor is below the $50,000 threshold but the investor may later breach the threshold in the same income year, meaning that the FDR method will in fact apply to exempt the dividend from RWT.

Deloitte states that the legislation requires amendment to ensure that an appropriate solution is in place where RWT is deducted from foreign dividends by nominees in such cases.

Comment

Officials consider that an appropriate solution is available under existing law, in the form of a credit for over-deducted RWT. The treatment of RWT deducted in excess is that it can be applied to the taxpayer's income tax liability or, to the extent that there is no liability, refunded.

While this approach is clear under section NF 7(5) of the Income Tax Act 2004, officials consider that the re-written version of this rule in the 2007 Act (section RM 8) should be clarified to ensure that the same result is achieved. The way to clarify the rule's intended effect is through the ongoing Income Tax Act rewrite process. In the interim, the transitional rules under section ZA 3 of the 2007 Act should help to achieve the intended treatment. Under section ZA 3, the provisions of the 2007 Act are intended to have the same effect as the corresponding provisions of the 2004 Act.

In practice, the application of any over-deducted RWT against a taxpayer's income tax liability would be by way of the taxpayer recording a credit for the over-deducted RWT in the RWT credit box on their income tax return.

Recommendation

That the submission be noted.