New Zealand's International Tax Review

Extending the active income exemption to non-portfolio FIFs

An officials' issues paper

March 2010

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

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New Zealand's International Tax Review: Extending the active income exemption to non-portfolio FIFs – an officials' issues paper.
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Chapter 1

INTRODUCTION

1.1 New Zealand firms are increasingly looking for opportunities to expand into new and emerging markets. The Government recognises that the tax system should not hinder this expansion overseas and that it is important that New Zealand businesses can compete on an even footing with other foreign competitors in the same country.

1.2 New Zealand-based businesses have previously raised concerns that New Zealand's international tax rules could impose higher tax or compliance costs on offshore operations than those faced by competing businesses operating in the same country. This was because a New Zealand business that operated in a foreign country had to comply with the tax rules of that country and also attribute income (and potentially pay further tax in New Zealand).

1.3 To address these concerns the Government began a review of the international tax rules in 2006. A series of consultation documents were published (December 2006, October 2007 and December 2007) to consult on a new approach to the taxation of foreign companies that are controlled by New Zealand investors. The main feature of this new approach was the introduction of an active income exemption – an exemption from New Zealand tax on income earned through controlled foreign companies (CFCs) that carry on an active business (for example, manufacturing, distribution or sales activity). Legislation giving effect to these changes was introduced in the Taxation (International Tax, Life Insurance, and Remedial Matters) Bill in July 2008 and enacted in October 2009, with application for all income years from 1 July 2009.

1.4 However, the tax system also needs to reflect the commercial reality that direct investment overseas by New Zealand companies is not always channelled through controlled subsidiaries. When entering new markets, New Zealand firms frequently opt to establish links with a partner in the host country and set up a jointly owned entity. Although the New Zealand firm may not control the entity, it will generally have significant input in areas such as management, technical or marketing expertise. There are clear benefits to New Zealand from this kind of outbound foreign direct investment. These include access to new markets, the further development of New Zealand's skill base and the development of effective and profitable synergies (for example, when New Zealand's design or technological expertise is complemented by efficient and low-cost production facilities overseas).

1.5 This issues paper sets out a suggested approach to the taxation of non-controlling interests in foreign companies. It considers how the active income exemption might be extended to some interests in foreign companies that are not controlled by New Zealand residents, referred to as foreign investment funds (FIFs), and whether any rationalisation of the various methods for calculating FIF income is appropriate. One of the main objectives of the reform is that the FIF rules should be easy for taxpayers and advisors to understand and operate.

1.6 We are seeking the views of companies that have offshore operations or are contemplating offshore expansion on how these proposals may affect their business. The next step will be to analyse submissions on the suggestions presented here and make formal recommendations to the Government on changes to the FIF rules. The aim is to introduce a bill in August that gives effect to the reform.

1.7 The changes suggested in this issues paper should play a significant part in facilitating the expansion of New Zealand companies and ensuring the overall coherence of the tax rules for New Zealand investment in foreign companies.

SUMMARY OF SUGGESTED CHANGES

Active income exemption for interests of 20 percent or more in foreign companies

- No income will be taxable from income interests of more than 20 percent in FIFs that have passive income of less than 5 percent of their total gross income. This is the active business test and is the same test that applies to CFCs.
- If a person who has an interest of 20 percent or more in a FIF fails the active business test, only passive income will be taxable using branch equivalent calculations.
- To reflect the extension of the active income exemption to interests in FIFs, the remaining exemption for non-portfolio investments in grey list jurisdictions will be repealed. However, in line with the treatment proposed for CFCs, an exemption for greater than 20 percent interests in FIFs resident in Australia will be introduced.
- It is anticipated that most New Zealand investors with interests of 20 percent or more in a FIF should be able to perform the active business test and, if this test is failed, be able to accurately attribute the passive income arising from the FIF. In rare cases when investors cannot do the necessary calculations, they will be able, subject to certain restrictions on the choice of method, to use one of the attribution methods available for FIF interests of less than 20 percent to work out their tax liability.

- Portfolio investment entities (PIEs) will be prevented from holding income interests of 10 percent or more in a CFC (except if the CFC is a foreign PIE equivalent).

Investors with a less than 20 percent interest in a foreign company

- The active income exemption will not be available to investors with interests of less than 20 percent in a FIF (although investors with a 10 percent or greater interest in a CFC will still be able to access the active income exemption). Instead, a single harmonised regime will apply to all FIF interests of less than 20 percent.
- The methods available for attribution of interests of less than 20 percent will be:
  - fair dividend rate;
  - cost;
  - comparative value; and
  - deemed rate of return.
- There will be some restrictions on the choice of method, similar to those currently in force for FIF interests of less than 10 percent, to prevent manipulation of the attribution methods.
- The accounting profits method will be repealed completely and the branch equivalent method will not be available for FIF interests of less than 20 percent.
- The existing exemptions from the FIF rules for Australian companies listed on the ASX and certain venture capital investments made through grey list companies will be modified to apply to less than 20 percent interests in FIFs. Dividends paid from such FIFs will be subject to income tax.
- Portfolio shares that escape attribution under the $50,000 minimum threshold because they were inherited at nil value, will be subject to a deemed sale and reacquisition at market value.

How to make a submission

1.8 Submissions should be made by Friday, 30 April 2010 and be addressed to:

International Tax Review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington 6140

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

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

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

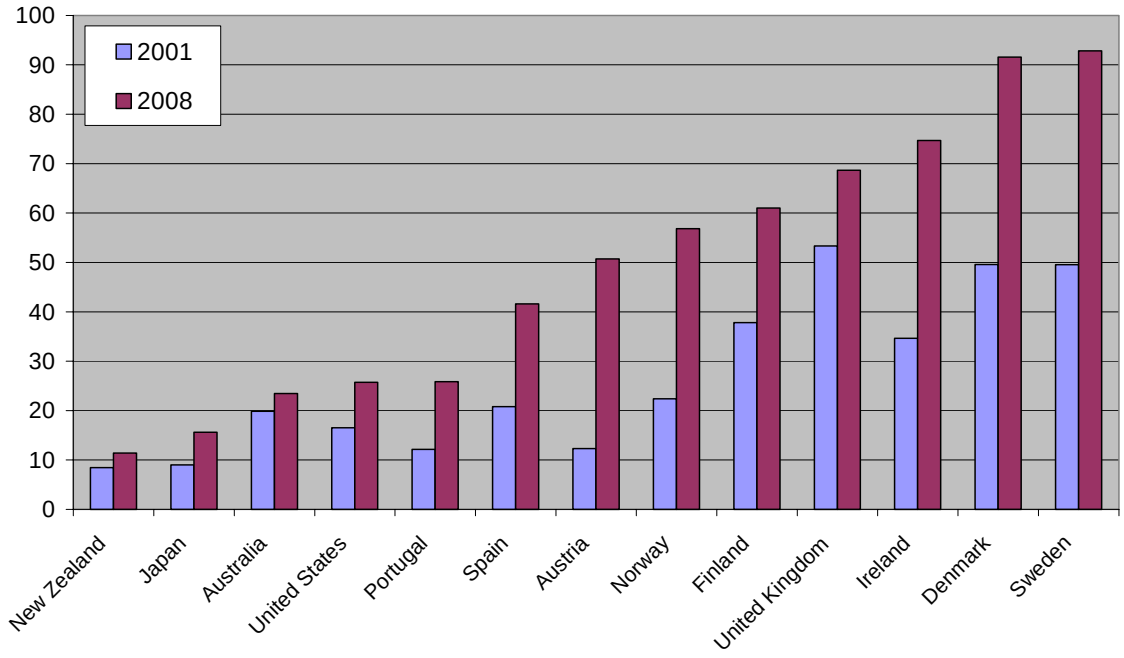
Chapter 2

RATIONALE FOR EXTENDING THE ACTIVE INCOME EXEMPTION

The current problem

2.1 Compared with other developed economies, New Zealand businesses are less engaged in operating outside of their home country. This is illustrated by figure 1, which shows the stock of outbound foreign direct investment (FDI) product as a proportion of gross domestic product (GDP). [1,2]

Figure 1: Outbound FDI as a percent of GDP



2.2 This is a concern as it suggests that New Zealand may be missing out on the economic benefits associated with businesses expanding their activities through the use of subsidiaries, joint ventures and other substantial investments in foreign markets. These benefits can include improved market knowledge, skills transfer and access to customers and suppliers. This may facilitate export growth or an increase in high-value research, design and management activities in New Zealand.

[1] FDI is debt and equity holdings of greater than 10 percent in a foreign company.
[2] GDP is a measure of the size of a country's economy.

2.3 A range of possible factors could contribute to New Zealand's relatively poor outbound FDI performance. For example, some of the difference could be due to industrial structure. Tapping into offshore markets and access to offshore distribution channels may be of varying importance for firms in different industries. Distance from markets may also be important as this could make it more difficult to invest offshore.

2.4 It is important that New Zealand businesses can compete on an even footing with foreign competitors operating in the same country. New Zealand-based businesses have previously raised concerns that New Zealand's international tax rules could impose higher tax or compliance costs on offshore operations than those faced by competing businesses operating in the same country. This was because a New Zealand business that operated in a foreign country had to comply with the tax rules of that country and also attribute income (and potentially pay further tax in New Zealand) using New Zealand tax concepts. In contrast, many other countries reduce or eliminate the additional tax or compliance burden created by a second layer of tax by exempting offshore income that is earned by active businesses. This created an incentive for New Zealand companies undertaking or considering active business ventures outside New Zealand to relocate their headquarters to countries with more favourable tax rules.

2.5 In response to these concerns, the Government introduced an exemption for active income earned by foreign companies that are controlled by New Zealand investors (CFCs). This means that a shareholder with a 10 percent or greater interest in a CFC is taxed only on their share of any passive income earned by that CFC. In very broad terms, passive income consists of "moveable" income such as rent, royalties, certain dividends and interest. Taxing such income on accrual protects the domestic tax base against income being shifted offshore to reduce tax.

2.6 Before this reform, New Zealand shareholders in CFCs were generally subject to tax on their share of all of the CFC's income (active and passive) as it accrued, with a credit provided for tax paid by the CFC in its home country. This "full accrual" approach continues to apply to most investments in foreign companies not controlled by New Zealanders (FIFs). The main exceptions are an exemption for interests of 10 percent or greater in FIFs located in one of eight grey list countries and an exemption for less than 10 percent interests in Australian companies listed on the Australian stock exchange.

Extending the active income exemption to other types of offshore investment

2.7 CFCs are a key vehicle for expanding New Zealand businesses beyond the domestic market. However, businesses access new markets and opportunities through a variety of structures, and New Zealand companies wanting to expand overseas may have good commercial reasons for not operating through a wholly or majority-owned subsidiary.

2.8 For example, firms wanting to expand abroad may establish links with a local partner and establish a joint venture, meaning that the New Zealand company has a substantial but non-controlling, interest in an overseas entity. Typically, the New Zealand partner will provide significant input, through management expertise, technical or specialist input and funding. The host country partner may provide raw materials and a manufacturing base or labour force, as well as an established set of business relationships and an understanding of the market. Although the entity is not controlled by the New Zealand partner, the New Zealand firm will have a major say in the entity's operations.

2.9 In some countries joint ventures may be the only option for New Zealand businesses. This is because some countries do not allow the entry of companies that are wholly or mainly foreign owned into particular markets.

2.10 As with the former CFC rules, the existing FIF rules can impose additional tax and compliance costs on New Zealand businesses that operate in offshore markets through non-controlling stakes in FIFs. This may create an incentive for these companies to relocate their headquarters to countries with more favourable tax rules as a number of other countries have an active income exemption for FIFs as well as for CFCs.

2.11 One way to reduce tax and compliance costs would be to exempt all types of income derived from a non-portfolio interest in a FIF. However this would create opportunities and incentives for taxpayers to shift moveable (passive) income into low-tax jurisdictions to minimise their tax liabilities. This type of offshore investment is unlikely to enhance New Zealand's economic potential or wellbeing and could result in a large loss of tax revenue.

2.12 For this reason the CFC rules make a distinction between active and passive income. Restricting the exemption to active income (or active businesses) can be an effective way to reduce tax and compliance costs in cases where the economic benefits are highest and the risks to the tax base are low.

2.13 The remainder of this paper is concerned with developing a similar active income exemption for non-portfolio interests in FIFs. The following design issues are discussed:

- Should the active income exemption for FIFs be the same as the active income exemption applying to CFCs? (*chapter 3*)
- Which FIF interests should be eligible for the active income exemption? (*chapter 4*)
- How should the active income exemption rules be applied to FIFs? (*chapter 5*)
- What alternative methods should be available for holders of FIF interests that are eligible for the active income exemption but are unable to comply with it? (*chapter* 6)

Questions for submitters

What types of entities and structures are most commonly used by New Zealand businesses to expand their activities offshore?

When investing and competing in foreign markets, how important are tax and compliance costs? Do New Zealand's existing FIF rules create a significant disadvantage?

Is an active income exemption for non-portfolio interests in FIFs an effective way to reduce this disadvantage? Are there other ways to reduce tax and compliance costs?

Chapter 3

EXTENDING THE ACTIVE INCOME EXEMPTION TO FIFs

Summary of suggested changes

- The active income exemption for FIFs, like that applying to CFCs, would use an active business test as a gateway.
- If a FIF passes the active business test, no income will be taxable, if a FIF fails, only passive income will be taxable.

Existing rules for taxing FIF interests

3.1 As described in chapter 2, a "full accrual" approach still applies to most investments in foreign companies not controlled by New Zealand residents (FIFs). The main exceptions are an exemption for 10 percent or greater interests in FIFs located in one of eight grey list countries and an exemption for less than 10 percent interests in Australian companies listed on the Australian stock exchange.

3.2 The methods used for calculating FIF income differ depending on whether the investor has a portfolio (less than 10 percent) or non-portfolio (10 percent or greater) shareholding in the foreign company.

3.3 Subject to certain restrictions, non-portfolio investors have a choice of four possible attribution methods.

- *The branch equivalent method:* This involves the taxpayer doing a full calculation of FIF income using New Zealand tax rules as though the FIF were a New Zealand company. It requires access to very detailed financial information, so is usually only suitable for larger shareholders. The current branch equivalent method for FIFs is identical to the old rules for calculating CFC income.
- *The accounting profits method:* This method is essentially the same as the branch equivalent method but is easier to apply as it is based on accounting information. FIF income is the investor's share of the foreign company's accounting profit less credits for foreign tax paid.
- *The comparative value method:* Under this method, FIF income is the difference between the value of the investment at the end of the year (plus any gains during the year) and the value at the beginning of the year (less costs during the year).

- *The deemed rate of return method:* This method calculates FIF income as a percentage of the book value of the investment at the end of the previous year. Each year the Government sets what percentage is to be used, and investors are required to make adjustments to update the book value of their investment.

3.4 Portfolio investors can also choose from the four attribution methods described above. However, the main attribution method for portfolio investors is the fair dividend rate method. Under this method the investor's FIF income is 5 percent of the market value of their investment at the start of the income year (with an adjustment if the investment is bought and sold in the same year). If a market value is not available, the cost method can be used, under which the 5 percent return is based on either the net asset value, the cost of the investment or an independent valuation.

3.5 For shares that are equivalent to debt the only methods that can be used are the comparative value or deemed rate of return methods (this restriction applies to portfolio as well as non-portfolio investors).

Should the active income exemption for CFCs also apply to FIFs?

3.6 The 2006 Government discussion document, *New Zealand's International Tax Review: a direction for change*, considered three broad options for applying an active income exemption to CFC interests. In theory, the same three options should also be available for implementing an active exemption for FIF interests. They are:

- An *entity* approach: an assessment is made of a foreign company's business activities or assets as a whole. If the entity is predominantly "active" no income is attributed. If not, the shareholder is taxed on its share of the foreign company's income (regardless of whether the underlying income is active or passive).
- A *transactional* approach: shareholders in the foreign company calculate their attributable income and pay tax based on their share of the foreign company's income, and the proportion of that income that is passive.
- A *hybrid* approach: an entity test is first applied to the foreign company's activities. For example, using financial accounts, the active business test looks at whether less than 5 percent of the gross income of the foreign company is passive. If the test is passed, the New Zealand-resident shareholder is not taxed on any income from the shareholding. If the test is failed, only passive income is attributed to the shareholder on a transactional basis, so active income continues to be exempt from attribution.

3.7 A concern with the entity approach in the context of the CFC rules is that it can lead to significant amounts of passive income being exempted. The entity approaches used in other countries generally have a high tolerance (up to 50 percent) for passive income or assets. This implies that a pure entity approach could lead to considerable amounts of passive income escaping New Zealand tax. This is problematic given that passive income can be shifted offshore to avoid or defer New Zealand tax. At the same time, for those entities that fail the test all income, including active income, is taxed on accrual.

3.8 A pure transactional approach would avoid these problems, but would involve significant compliance costs for investors in entities with mainly active income.

3.9 For CFCs, the hybrid approach offered a sensible compromise between the various concerns associated with the entity and transactional approaches. Similar considerations seem to arise in relation to FIF interests. A further consideration is that adopting either a pure entity approach or a pure transactional approach for FIF interests would create boundary concerns between the CFC and FIF rules. These could result in tax considerations driving commercial decisions. Taxpayers who preferred the CFC hybrid approach would be motivated to hold a level of offshore interest that brought them within CFC rules. By the same token, taxpayers who preferred the entity approach could structure their investment so that they stayed outside the CFC rules.

3.10 It is therefore suggested that the hybrid approach adopted in the new CFC rules should also form the basis on which the active income exemption is applied to interests in FIFs.

3.11 Having the same design for CFCs and FIF interests would reduce the potential complexity of the international tax rules and make the exemption easier for companies and advisors to understand and operate.

3.12 In particular, some New Zealand companies will have CFCs as well as non-portfolio interests in FIFs, so it could be efficient for these companies to have only one set of active income exemption rules to operate. Changes in the level of stake held, or even changes in the composition of shareholders can result in a CFC interest becoming a FIF interest and vice versa. It would be simpler if these kinds of changes could be dealt with under a common exemption framework.

The Australian experience

3.13 The broad design of New Zealand's new CFC rules (particularly the hybrid approach) is similar to the design of the current Australian CFC rules.

3.14 To date, Australia has had an entity approach for calculating income from FIF interests, using two possible methods. Under the stock exchange listing method, a company passes the active income test if it is listed in a class of companies designated by an approved stock exchange as engaged in active business activities, or the company is included in an approved industry classification system as engaged in such activities. Under the balance sheet method, a company passes the active income test if the gross value of the company's assets for use in active business exceeds 50 percent of the gross value of all its assets.

3.15 The Australian Government has recently announced the repeal of its FIF rules and the reform of its CFC rules.

Chapter 4

ELIGIBLE FIFs

Summary of suggested changes

- The rules for applying the active income exemption to CFCs should be extended so that they also apply to income interests in FIFs of 20 percent or more.
- Portfolio investment entities (PIEs) will be prevented from holding income interests of 10 percent or more in a CFC (except if the CFC is a foreign PIE equivalent).

Which FIF interests should be eligible for the active income exemption?

4.1 In policy terms, the active income exemption should only apply to interests where the investor is directly involved in the operations of the foreign company. Portfolio shareholders should not have access to the active income exemption. They typically focus on investment returns rather than seeking to directly influence management decisions or exchange knowledge and skills that may help grow a New Zealand business.

4.2 Also, if the active income exemption were to apply to portfolio FIFs, it could create a bias toward investing in offshore stock markets as opposed to domestic investments. Exempting such interests would increase the revenue cost of the active income exemption for little additional economic benefit. Excluding portfolio investors from the scope of the exemption would be consistent with international norms. Other countries do not generally exempt active income from portfolio FIFs.

4.3 Another factor in determining the availability of the active income exemption is the ability for investors to comply with the terms of the exemption. Obviously, an investor who has insufficient information to apply the active business test would need to attribute their income under an alternative method (see chapter 6). But other investors in FIFs fall into two categories.

4.4 In the first category, there are investors who have access to sufficient information to comply with all elements of the rules. They have sufficient information to determine whether or not the FIF has passed the active business test. They also have information to enable them to calculate the amount of income that is required to be attributed if the FIF fails the test.

4.5 In the second category are investors who, like those in the first category, have sufficient information to determine whether the FIF has passed the active business test. However, they do not have the information needed to calculate the amount to be attributed if the FIF fails the test. This category may include investors with access to audited account data but without the detailed information that would allow them to apply the branch equivalent method on a transactional basis.

4.6 Ideally, the active income exemption would be available only to investors in the first category described earlier. This is because an investor's access to the information needed to comply with all the requirements of the exemption is a strong indication that the person has an appropriate level of involvement in the management of the company. In other words, it demonstrates that they are the type of investor that the active income exemption is aimed at in a policy sense. It also makes more sense from a tax administration perspective that the taxpayer can consistently use the active income exemption from year to year. Investors in the second category only have sufficient information to rely on the exemption in years when the entity passes the active business test.

4.7 It would be difficult to devise and enforce a rule that expressly limited the availability of the active income exemption to the first category of investors. It is therefore suggested that the exemption be limited to investors with a minimum level of income interest in a FIF.

4.8 In determining what level of income interest is most appropriate as a threshold, two factors must be considered.

- *Proxy for effective control.* The level of interest must be set at a point at which there is a reasonable presumption that the investor has influence on the management of the foreign company. It needs to reflect the point at which a shareholding could generally be expected to give the investor an active and direct involvement in the running of the company.
- *Proxy for ability to access information.* The level of interest must be set at a point where there is a reasonable presumption that the investor has sufficient information in respect of the foreign entity to comply with the elements of the active income exemption, including both the active business test and, if the test is failed, the calculation of attributable income. Any extension of the active income exemption needs to be workable in practice, and take account of the level of information that is likely to be available to shareholders with various levels of holdings.

4.9 In this context, it is instructive to look at some of the thresholds used for tax and company law purposes in New Zealand that try to capture the point at which an investment becomes "significant" or "substantial".

4.10 Under the current New Zealand regime, 10 percent is the dividing line between portfolio and non-portfolio interests in FIFs in terms of the application of the fair dividend rate method. Also, investors with a 10 percent income interest in a CFC are able to access the active income exemption for CFCs – although the context is different for CFCs because the 10 percent threshold only applies when the entity is controlled by a single or small group of New Zealand residents.

4.11 Under the entity shareholding investment requirements in the portfolio investment entity (PIE) rules, a PIE must hold less than 20 percent ownership interests (denoted by voting interests) in companies (including unit trusts) that it invests into (other than other PIEs or foreign entities that would be PIEs if they were resident in New Zealand). This means that if the threshold for using the active income exemption was set at 10 percent, a PIE could hold an interest of between 10 to 20 percent in an active FIF or CFC and not be taxed on the foreign income at all, including on distribution to individuals with an interest in the PIE. This is not an appropriate outcome. (PIEs, as their name suggests, are not supposed to have an active role in the management of the companies they invest in, and should not be able to benefit from the tax treatment extended to non-portfolio foreign investments.)

4.12 This difficulty could be resolved for FIF interests by limiting access to the active income exemption to investors with at least a 20 percent FIF interest. In relation to CFCs, it is suggested that PIEs would be prohibited from holding a 10 percent or greater interest in a CFC. PIE holdings of more than 10 percent in a CFC are expected to be rare, and in any case an exception will be made to allow greater than 10 percent holdings in any CFCs that would be PIEs if they were resident in New Zealand.

4.13 Twenty percent is also the threshold for the "fundamental rule" in the New Zealand Takeovers Code – signalling effective control of an entity. Over this threshold additional voting securities can only be acquired in accordance with the rules set out in the Code.

4.14 Finally, the 2001 Tax Review suggested a 30 percent ownership threshold as the appropriate point for an active income exemption to apply.

4.15 Since a threshold based on the level of interest held in a company can only be a proxy measurement for management influence and ability to comply with an active income exemption, there is no threshold that will give the "right" answer in every case. A 10 percent threshold seems too low in this respect. On the other hand, pushing the threshold up to 30 percent seems too strict. On balance, it seems appropriate to extend the active income exemption to income interests of 20 percent or more in a FIF.

4.16 A threshold of 20 percent should ensure that:

- most investors who have an influence on the management decisions of a foreign company have access to the active income exemption;
- any additional revenue cost associated with the active income exemption applying to investors without management influence is minimised; and
- there is generally sufficient access to detailed financial information for the eligible investors to be able to perform both the active business test and, if the test is failed, the relevant transactional calculations.

4.17 The remainder of this issues paper is premised on the active income exemption being limited to income interests of 20 percent or more in a FIF (or income interests of 10 percent or more in a CFC).

Questions for submitters

Is having an income interest of 20 percent a reasonable proxy for having influence on how the FIF is run as well as access to sufficient financial information to apply the active business test and, if necessary, undertake a transactional calculation? If not, what other proxy or threshold should be used?

Are there any other options that should be considered?

Chapter 5

RULES FOR APPLYING THE ACTIVE INCOME EXEMPTION TO FIF INTERESTS

Summary of suggested changes

- The active business test and the definition of "passive income" for interests of 20 percent or more in a FIF should follow the rules developed for the CFC active income exemption.
- Consistent with the CFC changes, the grey list exemption for non-portfolio FIFs will be replaced with an exemption for shareholders with a 20 percent or more interest in a FIF that is resident in Australia.
- Interest, royalties or rents received from a related foreign company in the FIF's jurisdiction will be disregarded under the new rules.
- The interest allocation rules that apply in relation to CFCs should also apply to FIF interests benefiting from the active income exemption.

5.1 As noted in chapter 3, having similar rules for CFC and FIF interests should make the active income exemption easier to operate. Many companies have interests in CFCs as well as non-portfolio interests in FIFs, and some FIFs may subsequently become CFCs or vice versa. On the other hand, an investor in a company that is controlled by non-residents may find it more difficult to access detailed financial information, and the potential revenue risks associated with FIF investments can be different from those that can arise from CFC investments. This chapter takes the new CFC rules as a starting point and then sets out some of the potential issues that could arise from applying these rules to investors with income interests of 20 percent or more in FIFs. We invite comments on these and any other practical concerns that might arise for investors.

Active business test

5.2 Under the new rules, a CFC is not required to attribute income if its passive income is less than 5 percent of its total gross income. It is anticipated that most CFCs will pass this active business test. Investors are able to calculate the percentage of passive income based on information from audited accounts that comply with IRFS or NZ GAAP (for smaller entities that are not required to use IFRS), or based on New Zealand tax concepts of passive and total income.

5.3 It is suggested that the same active business test would be available to investors with interests of 20 percent or more in a FIF. In most circumstances, a FIF should be able to pass the active business test based on data from audited accounts. This has the advantage of requiring less information than the test based on tax concepts and the branch equivalent calculation that will be used to attribute passive income (if a FIF fails the test). Chapter 6 discusses the attribution methods that will be available to investors with insufficient information to apply the active income exemption.

5.4 Under the new CFC rules, New Zealand companies that have more than one majority-owned CFC in a jurisdiction are allowed to use consolidated accounts for all their majority-owned CFCs in that jurisdiction for the purposes of the active business test. The purpose of this measure is to simplify the application of the test when accounting information is available at a consolidated level, such as when a group produces segmental reporting by country.

5.5 In cases where the CFCs or FIFs are not majority owned, the benefits from allowing consolidation are more questionable, as it would be unusual for line-by-line consolidated accounts to have been prepared in those circumstances. Allowing consolidation of non-majority-owned interests could lead to increased risk or more complex rules, as such interests are not subject to the same accounting treatment as majority-owned interests. There could also be complex interactions if more than one owner seeks to consolidate the same FIF.

Replacement of the grey list exemption

5.6 To limit the risk to the New Zealand tax base, it is essential that FIFs with significant amounts of passive income are subject to tax on this income. For this reason the remaining eight-country grey list exemption for greater than 10 percent interests in FIFs should be replaced with:

- the active business test; and
- an exemption for FIFs that are resident and subject to tax in Australia (if a 20 percent or greater interest) or that are listed on the Australian stock exchange (if a less than 20 percent interest). These Australian exemptions are consistent with the Australian exemptions that currently apply to CFC and portfolio FIF investments.

Passive income definition

5.7 It is suggested that the definition of "passive income" that currently applies for CFCs will also generally apply to interests of 20 percent or more in FIFs. The types of income that come under the passive income definition for CFCs include interest, royalties and rents, being income that is highly mobile and not location-specific. However, exceptions apply when the income is associated with an active business and there is limited risk to the New Zealand tax base.

5.8 The broad categories of passive CFC income are:

- certain types of dividend;
- interest;
- royalties;
- rents earned outside the jurisdiction of the CFC;
- income from services performed in New Zealand;
- personal services income;
- income from offshore insurance businesses;
- income from life insurance policies;
- income from the disposal of revenue account property; and
- certain income related to telecommunications services.

5.9 A more detailed description of the composition of passive income can be found in the report on the earlier CFC and foreign dividend reforms published in the October/November 2009 *Tax Information Bulletin* (Part II, Vol. 21, No. 8).

Payments from related CFCs or FIFs

5.10 Under the new CFC rules, interest, rent and royalties received by a CFC (CFC A) from an associated CFC (CFC B) are not treated as passive income if CFC B passes the active business test and both CFC A and CFC B are resident in the same jurisdiction. To be associated the CFCs are required to have at least 50 percent common ownership. The objective of these concessions is to ensure that taxpayers are not penalised when a holding company is used to control an active business in the same jurisdiction (relative to holding the active business directly). The concession is not intended to apply to companies that operate independently from each other.

5.11 There does not appear to be a strong case for reducing the required common ownership threshold below 50 percent. There are risks from exempting passive income and it seems less appropriate to disregard intra-group payments when there is not a control relationship.

Treatment of indirect income interests in other foreign companies

5.12 A New Zealand shareholder that uses the branch equivalent method to calculate FIF income will have an indirect income interest in a second FIF if the first FIF has an income interest in another foreign company. The indirect interest is calculated by multiplying the New Zealand shareholder's direct income interest in the first FIF by the first FIF's direct income interest in the second FIF.

5.13 If an indirect interest arises, the New Zealand resident needs to make two separate FIF income or loss calculations: one for the direct income interest held in the first FIF, and one for the indirect income interest in the second FIF. The investor can use a different method to calculate the income or loss from the indirect FIF interest from the branch equivalent method used for the direct FIF interest. If the branch equivalent method is used for that second FIF, the indirect interest rules apply in the same manner so that any direct interest held by that FIF in another entity may also be a FIF.

5.14 It would be sensible to keep broadly the same approach under any new regime for FIFs. This would be consistent with the rules for CFCs, under which income from foreign shares owned by CFCs is attributed back to the New Zealand shareholder. Under the suggested approach the active income test would be applied to the FIF. If the FIF has an interest in another company, the shareholder would need to calculate any income to be attributed in respect of that indirect FIF interest. Under the suggested approach, it would be possible, if the indirect interest were 20 percent or over, for the shareholder to apply the active income exemption to the indirect interest.

Interest allocation rules

5.15 The interest allocation rules for CFCs place an upper limit on the level of New Zealand debt that a company can use to finance its CFCs. This limit is necessary as New Zealand loses tax revenue when interest costs are taken against New Zealand income to finance a CFC which earns exempt income. The interest allocation rules for investors with CFCs are designed to prevent a New Zealand company allocating a disproportionate amount of interest deductions to New Zealand, with its foreign subsidiary being disproportionately funded through equity.

5.16 The principle underlying the extension of the active income exemption to FIFs is that it should apply to investments where there is a substantial stake in an active foreign company. If there is a substantial stake, there will sometimes be scope to manipulate how a FIF is funded. For example, in the case of a joint venture or a closely held FIF, the New Zealand shareholder could easily have tax incentives that are aligned with those of foreign shareholders, in which case they could negotiate financing arrangements which produce a mutual tax benefit.

5.17 Accordingly, it is suggested that the interest allocation rules should apply to New Zealand residents with FIF interests of 20 percent or more in the same way that they apply to New Zealand residents with CFC interests.

5.18 This should ensure that tax considerations do not drive the decision of whether to hold a CFC or FIF interest. It would also eliminate some potential complications (such as a FIF interest becoming a CFC interest) and inconsistencies (such as a taxpayer with a 10 percent interest in a CFC being subject to the interest allocation rules and a taxpayer with a FIF joint venture being outside the rules).

Questions for submitters

How important is it for the active income exemption for FIF interests to be consistent with the rules for CFCs?

Are there any areas where there is a strong case for deviation?

Are there any practical issues with applying the active business test developed for CFCs to a greater than 20 percent interest in a FIF?

Chapter 6

ALTERNATIVE METHODS FOR HOLDERS OF FIF INTERESTS

Summary of suggested changes

- Investors with a 20 percent or greater income interest in a FIF who are not able to perform the calculations necessary for the active income exemption will need to calculate their tax liability using an alternative attribution method.
- The possible methods of attribution will be the fair dividend rate, cost, comparative value and deemed rate of return. Rules will be put in place to prevent any abuse of these methods.

Attribution methods when the active income exemption cannot be applied

6.1 A New Zealand investor with an income interest of 20 percent or more in a foreign company would usually be able to apply the active income exemption. Indeed, as discussed in the previous chapter, one of the reasons for requiring an investor to have a 20 percent or greater interest in a FIF to access the active income exemption would be to ensure that investors eligible for the exemption would generally have the ability to perform the necessary calculations.

6.2 However there will be instances when investors with interests of 20 percent or more in a FIF are unable to benefit from the active income exemption either because they cannot apply the active business test itself, or because having failed the test they are unable to make the calculations necessary to apply the exemption on a transactional basis.

6.3 Situations can arise where it is difficult to access financial information. For example, if a business relationship collapsed the majority shareholder might withhold financial information on the company from the minority New Zealand partner. Similarly, if a joint venture was running into financial problems the New Zealand partner might find it difficult to get accurate financial information on its investment.

6.4 Consequently, it is necessary to provide alternative attribution methods that can be operated with less financial information.

6.5 It is important that the "safety net" of alternative methods made available for investors with insufficient information is not too generous. Otherwise there is a risk that some investors who are capable of performing the calculations necessary for the active income exemption will choose the safety net mechanism if it provides a more favourable tax treatment (for example, if the FIF generates a high proportion of passive income).

6.6 The active income exemption will effectively replace the branch equivalent and accounting profits methods for FIF interests of 20 percent or more. It is suggested that investors who cannot use the active income exemption will be able to use one of four alternative attribution methods:

- comparative value;
- deemed rate of return;
- fair dividend rate; or
- cost.

6.7 It could be argued that the fair dividend rate and cost methods are too broad-brush to apply to non-portfolio interests in FIFs. It is certainly not an ideal method for these sorts of interests. In most cases, a company with a 20 percent or greater interest in a FIF engaged in an active business will want to benefit from the active income exemption, and will have access to the information needed to make any active/passive apportionment required. Only in very exceptional circumstances would a company with a large interest in a FIF generating active income have to use the fair dividend rate or cost methods.

6.8 If this approach is taken, rules will be needed to prevent abuse of the fair dividend rate and cost methods. Otherwise an investor with an interest of over 20 percent in a FIF that had mainly passive income could choose these methods if they provide a more beneficial tax treatment than apportionment of active and passive income. The rules for restricting the choice of method would be modelled on those already in place for FIF interests of less than 10 percent. Those rules require taxpayers to use the comparative value method (or the deemed rate of return method if it is not practical to find out the market value of the investment) for shares that are considered equivalent to debt (such as fixed-rate shares). They also prevent an investor from using the fair dividend rate or cost methods if they use the comparative value method for one of their other investments.

Questions for submitters

How should taxpayers be treated if they have insufficient information to apply the active income exemption?

Which FIF attribution methods are most appropriate in these circumstances?

Chapter 7

FIF INTERESTS OF LESS THAN 20 PERCENT

Summary of suggested changes

- A single set of rules will apply to all interests in FIFs of less than 20 percent.
- The accounting profits method will be repealed completely, and the branch equivalent method will not be available for FIF interests of less than 20 percent. (FIF interests of 20 percent or more will apply the active income exemption using a branch equivalent calculation.)
- The existing exemptions from the FIF rules for Australian companies listed on the ASX and certain venture capital investments made through grey list companies will be modified to apply to less than 20 percent interests in FIFs. Dividends paid from such FIFs will be subject to income tax.
- Portfolio shares that escape attribution under the $50,000 minimum threshold because they were inherited at nil value, will be subject to a deemed sale and reacquisition at market value.

7.1 The introduction of an active income exemption for CFCs and 20 percent or greater interests in FIFs provides the opportunity to look at the overall coherence of the rules covering investment by New Zealand residents in foreign entities. One of the main objectives of the reform is that the FIF rules should be easy for taxpayers and advisors to understand and operate.

Repeal of accounting profits and branch equivalent methods

7.2 There are currently six different methods for attributing income from FIF interests. These are:

- branch equivalent;
- accounting profits;
- comparative value;
- deemed rate of return;
- fair dividend rate; and
- cost.

7.3 The active income exemption will replace the branch equivalent and accounting profits methods for FIF interests of 20 percent or more. The question that arises is whether either of these methods should be retained for FIF interests below 20 percent.

7.4 Most portfolio shareholders are focused on securing returns from an increase in share price or from dividend yields. In this context, the accounting profits and branch equivalent methods are not really appropriate as they are based on the company's accounts rather than the shareholder's investment return, and allow for losses.

7.5 Moreover, few taxpayers with interests of less than 20 percent use the branch equivalent or accounting profits methods for attribution. It seems that smaller shareholders have insufficient information to use the branch equivalent method and prefer not to use the accounting profits method even though accounts are frequently available.

Concessions for individuals

7.6 The rules currently applying to FIF interests of less than 10 percent distinguish between individuals and companies in certain respects, particularly the following.

- A $50,000 minimum threshold applies to an individual's investments in foreign companies other than Australian-resident listed companies. If the original cost of these shares totals $50,000 or less, the FIF rules do not apply to the individual.
- Where an individual is using the fair dividend rate and the total return on their entire investment portfolio (dividends and capital gains) is less than 5 percent, then tax can be paid on the lower amount, with no tax payable when the total return is nil or negative. This outcome is achieved by allowing individuals (and family trusts) to switch freely between the fair dividend rate and comparative value methods in different income years.

7.7 It would be appropriate to extend these features to cover interests of less than 20 percent in a FIF.

Exemption for Australian companies listed on the Australian stock exchange

7.8 The existing FIF rules contain an exemption for a less than 10 percent income interest in an Australian company that is listed on the Australian stock exchange (ASX). It is suggested that this exemption be extended to cover less than 20 percent income interests in ASX-listed companies. This would ensure that a single set of rules applied to all interests in (non-CFC) FIFs of less than 20 percent.

Exemption for venture capital investment

7.9 The current rules covering FIF interests contain a special provision to cater for venture capital investments in New Zealand-resident start-up companies that migrate offshore to gain access to additional equity funding. The provision ensures that, provided certain conditions are met, New Zealand investors who acquired shares before the company migrated from New Zealand do not come within the FIF rules until the end of a 10-year exemption period.

7.10 A similar 10-year venture capital exemption applies to shares purchased in a grey list company that owns a New Zealand company. This variation is designed to cater for situations when shares in a grey list company are received in exchange for shares in a New Zealand-resident company.

7.11 The introduction of an active income exemption for 20 percent or greater interests in FIFs raises the question of whether the exemptions from the FIF rules for certain venture capital investments in the grey list in sections EX 36, EX 37 and EX 37B of the Income Tax Act 2007 should be limited to FIF interests of less than 20 percent. Ideally, these FIFs should be applying the active income exemption, as otherwise they could be used to shelter passive income. In most cases it should be reasonably practicable for investors with a 20 percent or greater interest in a venture capital FIF to access sufficient information to use the active income exemption. We are interested in feedback from the venture capital industry on this issue.

Taxation of dividends

7.12 As part of the earlier international tax changes, an exemption was introduced for most types of foreign dividends received by companies. However, as a general principle the foreign dividend exemption should **not** apply to dividends from an interest of less than 20 percent in a FIF that is not an attributing interest. Otherwise such investments would be more favourably taxed than attributing portfolio investments.

7.13 Accordingly, dividends from a less than 20 percent interest in a FIF (or a less than 10 percent interest in a CFC) described in sections EX 31 (Exemption for ASX-listed Australian companies), EX 32 (Exemption for Australian unit trusts with adequate turnover or distributions), EX 36, EX 37, EX 37B (Exemptions for certain venture capital investments made through grey list companies) or EX 39 (Terminating exemption for grey list company with numerous New Zealand shareholders) should be subject to tax when received by a company. All foreign dividends received by individuals are subject to income tax.

Inherited former grey-list portfolio investments

7.14 The treatment of portfolio interests (stakes of less than 10 percent) in FIFs changed from 1 April 2007. At that time, the grey list exemption for portfolio interests was repealed and it was intended those interests would be made subject to tax under – generally – the "fair dividend rate" rules. It has come to light that certain former grey list investments are still not subject to tax. Most commonly, this is because the investor has inherited the shares and claims they have a nil cost, which means they qualify for the $50,000 "de minimis" exemption from the FIF rules. It is not appropriate that these interests continue to be indefinitely exempt from tax. It is proposed that there will be a deemed sale and reacquisition of affected shares at market value. This amendment will have prospective effect.

Questions for submitters

When do small shareholders use the accounting profits and branch equivalent methods? Is there a strong case to keep these methods for FIF interests of less than 20 percent?

Are there other ways in which the FIF rules could be simplified?

Appendix

TAXATION OF INTERNATIONAL INVESTMENT – CURRENT AND SUGGESTED NEW RULES