Taxation (International Investment and Remedial Matters) Bill

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

March 2011

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CONTENTS

OVERVIEW

The major initiative in this bill is an active income exemption for non-controlling but significant investments in foreign companies (non-portfolio FIFs).

The exemption replaces comprehensive taxation of non-portfolio FIFs if investors can obtain enough information to undertake an active business test. When investors either cannot obtain enough information or do not wish to use the active income exemption, the bill allows the use of methods used by portfolio investors (mainly the fair dividend rate method).

Submitters are primarily focused on reducing the compliance costs of the new test. Before the bill's introduction, officials had heard these concerns and made two key changes to the initial proposal in the discussion document.

- One change was to make the active exemption available for investors holding an interest of more than 10% in a foreign company (down from 20% initially).
- Another change was to allow the active business test to be undertaken using group financial accounts of the non-portfolio FIF, if those accounts complied with international financial reporting standards (previously this was possible only if the FIF and any subsidiaries were in the same country).

This report recommends a further change which would allow the use of accounts that comply with United States generally accepted accounting principles in some circumstances. This will widen the group of non-portfolio FIFs to which the active exemption could apply.

Officials have not recommended accepting submissions that call for more radical reform, such as replacing the non-portfolio FIF regime with a targeted anti-avoidance rule. Although Australia has released draft legislation for such a measure, our judgement is that it would distort investment incentives and increase fiscal costs in the New Zealand context.

A number of other minor changes are recommended to the non-portfolio FIF rules in response to submissions, to ensure that legislation and policy intent are aligned.

The other significant initiative in this bill is an exemption from the approved issuer levy for interest payments on certain bonds. This is intended to remove an impediment to the development of a New Zealand bond market.

The exemption is limited to bonds that are listed on a recognised exchange or that are held by at least 100 people. Submissions argued for the exemption to be widened to cases in which the bond was held by, or offered to, as few as 10 people.

Officials accept that a wider exemption would be used by more issuers, which could further develop a New Zealand bond market. However, this would involve additional fiscal costs.

Officials have recommended against accepting these submissions. This is partly because of the direct fiscal costs, but more because of concerns that a wider exemption might include transactions that are – in substance – ordinary loans. This poses a potential threat to the substantial corporate banking tax base. The potential threat would increase further if a wider exemption were used as a precedent to argue for exempting similar transactions.

Other changes in this bill include a new thin capitalisation test for multinational groups based in New Zealand, the final repeal of international memorandum accounts, and some remedial amendments to the controlled foreign company rules introduced in 2009. There were few submissions on these issues. In response to some that were made, minor changes have been made to ensure clarity and correct policy outcomes.

The following table summarises the key submissions and officials' recommendations on these submissions.

CHANGES TO THE FIF RULES		
Submission	**Officials' Recommendation**	**Page number**
The FIF rules should be repealed and replaced with a specific anti-avoidance rule (in line with what Australia has recently implemented).	Decline	7
The grey list exemption for FIFs should be retained.	Decline	8
The passive income threshold for passing the active business test should be raised from less than 5% of gross income to less than 10% (or 15%) of gross income.	Decline	10
Taxpayers should be able to apply the active business test based on accounts prepared in accordance with the local GAAP standards rather than only accounts which conform to New Zealand IFRS or international IFRS.	Allow US GAAP (but not all local GAAP)	11
The amount of passive income that is actually attributed should be calculated using consolidated accounts rather than detailed tax calculations being required for each individual FIF.	Decline	14
The branch equivalent and accounting profits methods should be retained as alternative methods for calculating FIF income.	Decline	17
The comparative value method should be available for all companies, in addition to individuals and family trusts.	Decline	18
The attributable FIF income method should be able to be used by investors with less than 10% interests in certain exceptional circumstances.	Accept *(Matter raised by officials)*	19
FIFs that are held indirectly through a CFC or another FIF should be able to use the attributable FIF income method and the exemption for FIFs resident in Australia.	Accept	20

THIN CAPITALISATION RULES		
Submission	**Officials' Recommendation**	**Page number**
The thin capitalisation rules should not apply to New Zealand companies with non-portfolio FIFs.	Decline	27
The definition of interest in the new thin capitalisation test should be clarified.	Accept	30

ZERO RATE OF AIL ON BONDS		
Submission	**Officials' Recommendation**	**Page number**
The zero rate of AIL should be extended to include wholesale bonds offered to at least 10 (institutional) investors.	Decline	35
The requirement that no person hold more than 10% of the bonds should be removed.	Decline	36
The requirements that the issue of the security is not a private placement and that the security is not an asset-backed security should be removed.	Decline	37
The zero rate of AIL should be extended to include bonds issued in currencies other than New Zealand dollars. Related to this the requirement for the registrar and paying agent activities to be performed in New Zealand should be removed.	Decline	38
It should be clarified that only traded instruments qualify for the widely held bond exemption	Accept (*Consequential recommendation of officials*)	41

REMEDIAL ISSUES AND OTHER MATTERS		
Submission	**Officials' Recommendation**	**Page number**
The requirements for a Commissioner's determination should be amended so that it disregards reinsurance claim income when considering if "all or nearly all" of the CFC's income is from premiums or investments commensurate with insurance contracts.	Accept *(Matter raised by officials)*	47
A remedial amendment is necessary to ensure that bond issuers and bond holders do not become associated simply by being trustees and beneficiaries in a trust that has a principal purpose of enforcing rights under the bond.	Accept	48
Third-party royalty payments paid in relation to property owned by a New Zealand resident should be treated as "active", even if those payments pass through an upper-tier and a lower-tier CFC before being returned to New Zealand.	Accept	51

Submission	Officials' Recommendation	Page number
The proposal to alter the definition of deductible foreign equity distribution should be withdrawn.	Accept	53
The proposal to require revaluation of inherited grey list shares should not apply if they were inherited at the cost to the testator. Relatedly, tax on revaluation gains should be limited.	Accept	58
The foreign dividend exemption should be amended to ensure that all foreign dividends from greater than 10% interests in CFCs or Australian FIFs that meet the criteria in section EX 35 remain exempt.	Accept	62
The FIF rules do not apply to natural persons with attributing interests in FIFs that are below a minimum threshold of $50,000. Natural persons should have the option to disregard this threshold, and so apply the FIF rules regardless of the level of their FIF interests.	Accept	63
The exemption for new resident's superannuation schemes needs to be amended to achieve the policy intention.	Accept (*Matter raised by officials*)	65
The exemption of certain telecommunications income from the controlled foreign company rules should be altered to accommodate existing commercial arrangements.	Accept *(Matter raised by officials)*	66

Changes to the FIF rules

SCOPE OF REFORM

Issue: FIF rules should be repealed

Submission
(KPMG, Ernst & Young, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants, Millennium and Copthorne Hotels)

The FIF rules should be repealed and replaced with a specific anti-avoidance rule (in line with what Australia has recently implemented).

Comment

Were the FIF rules to be repealed, New Zealand would be close to having an outright exemption for FIF interests rather than an active income exemption.

An outright exemption could create opportunities for taxpayers to reduce their New Zealand tax burden by shifting assets offshore that produce passive income. These opportunities arise even when the New Zealand investor does not control the foreign entity. For example, a New Zealander could invest alongside foreign investors who have similar incentives to shift income into a tax-deferral arrangement.

In our view, the proposed Australian anti-roll-up fund rule would not adequately guard against this fiscal risk in the New Zealand context. Our understanding is that the Australian rule is likely to apply in very limited circumstances. Specifically, it only applies to debt investments and only when profits are retained abroad rather than distributed to Australian investors. More detail on the Australian reform can be found in the appendix.

Moreover, adopting the Australian approach would mean that the various rules applying to the taxation of outbound investment would be much less integrated. There would be stark differences in treatment depending on whether the investment was portfolio, non-portfolio or in a controlled foreign company (CFC). Differences in treatment can distort decisions about the size of an interest to hold when making an international investment. These differences in tax treatment also put pressure on the boundary between the CFC and FIF rules, since there will be incentives to argue that the entity is in the regime with the most favourable tax treatment.

Recommendation

That the submissions be declined.

Issue: Exemption for companies in eight grey list countries

Clause 24

Submission
(Corporate Taxpayers Group, KPMG, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)

The exemption for 10% or greater shareholdings in companies in one of eight grey list countries should be retained.

Comment

The grey list was removed for portfolio FIF interests in 2007 and for CFC interests in 2009. The reasons for removing the grey list exemption in those cases are the same as the reasons for removing it for non-portfolio FIF interests.

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 of investment decisions was one reason why the grey list was removed for portfolio investors when the fair dividend rate method was introduced in 2007.

The grey list exemption is based on an assumption of comparable taxation in the eight grey list countries. 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 also create opportunities for passive income to escape taxation 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.

In such cases, a grey list exemption may allow taxpayers to escape income tax anywhere in the world on their passive income. This creates incentives to shift passive income to the relevant grey list country and is, therefore, a risk to the New Zealand tax base.

Consistent with the earlier CFC changes, a "grey list of one" will be retained for greater than 10% shareholdings in foreign companies which are located in Australia.

An Australian exemption recognises that a lot of smaller businesses first operate in Australia 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 specific exemption for Australia is particularly beneficial.

There are differences between the tax systems of the two countries which, as noted earlier, can be a problem in the context of a grey list exemption. However, New Zealand's relationship with Australia, including a close relationship between Inland Revenue and the Australian Tax Office, means differences can be more readily identified and monitored than in other cases.

Recommendation

That the submission be declined.

Issue: Active income exemption for branches

Submission
(Fonterra)

The bill should include amendments so that branches are taxed consistently with CFCs (that is, an active income exemption should apply).

Comment

The main priority for this bill is to extend the active income exemption to non-portfolio FIFs. This extension is based on the CFC rules that were introduced in 2009. Reforming the taxation of branches in line with the CFC and non-portfolio FIF reforms is on the Government's tax policy work programme and will form the next stage of the international tax review.

Recommendation

That the submission be noted.

ACTIVE BUSINESS TEST

Issue: Passive income threshold for active business test

Clause 29

Submission
(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants, Millennium and Copthorne Hotels)

The passive income threshold for passing the active business test should be raised from less than 5% of gross income to less than 10% (or 15%) of gross income.

Comment

A 5% passive income threshold is used for applying the active business test to CFCs. It is desirable for the active business test for non-portfolio FIFs to align with the active business test for CFCs. Otherwise, FIF investments could be preferable to CFC investments. There could also be adverse consequences if a taxpayer's investment ceases to be a FIF and falls into the CFC rules. This would have the potential to distort investment decisions and would place additional strain on the boundary between FIFs and CFCs.

While the figure of 5% may seem low, this threshold allows a typical business to have a substantial portion of its assets earning passive income. This is because the gross return on typical passive investments is much lower than the gross return on typical active investments. For example, if a FIF's active business activities generate a gross return of 75% on assets employed in those activities, and its passive investments generate a return of 10%, up to 28% of the FIF's assets could be passive investments before it would fail the active business test. The 75% assumption is considered realistic. The average gross returns for non-financial private-sector New Zealand businesses, including both passive and active returns, were 80%, 77% and 77% in the years 2004, 2005 and 2006 respectively.

Some submissions have pointed out that there is less risk when the foreign company is not a CFC, as the New Zealand investors lack control or the ability to influence passive investment. The bill recognises that there is less risk by allowing the active business test to be applied on a worldwide consolidated basis rather than on a country-by-country basis as required for CFCs. This feature of the bill allows more practicality and flexibility in the application of the active business test to FIFs while maintaining overall consistency with the CFC rules in terms of the level of the threshold.

Other submissions argue that a higher threshold is necessary because some optional rules in the proposals will over-inflate passive income in certain circumstances. The rules referred to will allow an investor to apply the active business test to a group of FIFs based on the worldwide consolidated accounts of an upper-tier FIF in that group. If the top-tier FIF has an interest in a lower-tier FIF of less than 50%, the share of income from the lower-tier FIF can be regarded as passive income for the purposes of the active business test. However, we note that it is optional to include lower-tier FIFs in the calculation, so it is expected that taxpayers are only likely to include such FIFs when doing so does not breach the 5% threshold. When inclusion would breach the threshold, an alternative FIF calculation method (such as FDR) could be applied to the lower-tier FIFs to ensure the upper-tier FIF can still pass the active business test.

Recommendation

That the submission be declined.

Issue: Accounting standards requirements for using the active business test

Clause 29

Submission
(Corporate Taxpayers Group, PricewaterhouseCoopers, Russell McVeagh, New Zealand Law Society, New Zealand Institute of Chartered Accountants)

Taxpayers should be able to apply the active business test based on accounts prepared in accordance with generally accepted accounting principles (GAAP) or the international financial reporting standards (IFRS) that apply in the FIF's jurisdiction, rather than only accounts which conform to New Zealand IFRS or international IFRS.

Comment

Under the existing CFC rules, New Zealand taxpayers will typically prepare IFRS accounts which include a line-by-line consolidation of amounts earned by a CFC. Taxpayers can use the underlying information from these accounts to distinguish active and passive items of income, and therefore check whether the CFC passes the active business test.

In the case of a non-controlling stake in a foreign company (an interest in a non-portfolio FIF), the IFRS accounts prepared by the New Zealand taxpayer will not include a line-by-line consolidation of the amounts earned by the foreign company. Instead there will be a single line item which cannot be identified as being either active or passive in nature. However, the New Zealand taxpayer will usually have access to the FIF's own accounts, which can be used to identify whether income is active or passive. If the FIF's accounts are prepared according to IFRS, taxpayers will be able to use these accounts under the current proposals.

Submitters have asked for the IFRS requirement to be relaxed so that if a FIF's accounts are prepared according to local GAAP they can still be used for this purpose.

The most compelling case concerns the United States. The United States does not require companies to prepare accounts according to IFRS, so it is common for United States companies to prepare accounts only under US GAAP. Officials agree that it could be impractical for a non-controlling shareholder to insist that a United States company prepare IFRS accounts for New Zealand tax purposes.

We recommend that taxpayers should be able to apply the active business test based on accounts prepared in accordance with US GAAP. This would be subject to the inclusion of FIF income in IFRS accounts at some level (even if only as dividends or an equity-accounted amount) and to appropriate audit and consistency requirements.

We do not consider that there is a strong case for allowing the use of GAAP of countries other than the United States, as most other countries have adopted IFRS or have standards that are close to IFRS. There are also risks from allowing local GAAP in other countries: some GAAP standards may not correctly identify passive income, meaning that significant amounts of passive income could escape tax.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Composition of test group for applying the active business test

Clause 29

Submission
(Russell McVeagh, New Zealand Law Society)

The legislation should clarify that a taxpayer can choose which FIFs make up a FIF test group for the purposes of applying the active business test.

More specifically, it should be clarified that:

- taxpayers can select the relevant companies to be included in the test group concerned (that is, it is not an "all or nothing" approach);
- taxpayers may apply the active income test to multiple test groups; and
- the existence of a CFC in a wider group of companies does not prevent taxpayers from using the test group provisions in relation to other members of that group.

Comment

Officials agree that the points raised above are consistent with the policy intention. The existing drafting in the bill already accommodates the options suggested above, so no changes are required. However, this will be spelt out in a *Tax Information Bulletin* item on the rule changes.

Recommendation

That the submission be noted.

ATTRIBUTION RULES

Issue: Calculating attributable income

Clause 29

Submission
(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants, Millennium and Copthorne Hotels)

Under the attributable FIF income method the amount of passive income that is actually attributed should be calculated using consolidated accounts, rather than detailed tax calculations being required for each individual FIF.

Comment

The purpose of the active business test is to reduce compliance costs for FIFs which have only a small amount of passive income. In such cases an approximate measure of passive income based on amounts in consolidated accounts is appropriate as there is less fiscal risk. If a FIF or FIF test group has more than 5% passive income, however, there is a higher risk associated with using an approximate measure of passive income.

There are several important differences between measuring passive income using consolidated financial accounts and measuring it under tax concepts. For example, consolidated accounts ignore transactions within a group. It would not be appropriate to exempt consolidated amounts when significant amounts of passive income are involved, because such an exemption could lead to profits being shifted from high-tax countries into low-tax countries. This proposal could reduce the overall tax impost on international investments relative to New Zealand investments, providing an incentive to shift New Zealand income or activity offshore.

Recommendation

That the submission be declined.

Issue: Exemption for royalty and interest payments between FIFs in the same jurisdiction

Clause 29

Submissions
(Russell McVeagh, PricewaterhouseCoopers, Millennium and Copthorne Hotels)

The exemption for interest, rent and royalty payments between FIFs in the same jurisdiction should be consistent with CFC rules (that is, the exemption should require the companies to be associated rather than be a parent and subsidiary).

The exemption for interest, rent and royalty payments between FIFs in the same jurisdiction should be extended further to apply to intra-group transactions between FIFs located in different jurisdictions.

Comment

The CFC and FIF rules exempt payments between FIFs that are commonly controlled. 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 (for example, if the New Zealand investor has two independent joint ventures in the same jurisdiction). Adopting the same wording as the CFC rules would extend the exemption so that it applies to payments between companies that operate independently of each other.

A problem with the existing wording is that it does not accommodate payments from a parent company to a subsidiary, or payments between two sister companies which are controlled by the same FIF holding company. The exemption should be amended to accommodate these cases.

In relation to the second submission on this matter, limiting the exemption for inter-group transactions of interest and royalties to payments within a jurisdiction is a feature of the new CFC rules.

When the active income exemption was introduced for CFCs, the policy was designed so that CFCs will generally face the normal rate of tax in the country they are operating in. If income can be shifted from high-tax to low-tax countries, this is no longer the case.

An important concern about CFCs not facing the rate of tax in the country they operate in is that it would reduce the overall (world) tax impost on international investments relative to New Zealand investments, providing an incentive to shift New Zealand income or activity offshore.

Escaping foreign tax could also encourage multinational firms to hold more debt in New Zealand, and could facilitate structured financing transactions which are harmful to the New Zealand tax base.

The reasoning underpinning the CFC rules is also relevant to non-portfolio FIFs.

Recommendation

That the first submission be accepted, subject to officials' comments.

That the second submission be declined.

OTHER FIF CALCULATION METHODS

Issue: Repeal of the branch equivalent and accounting profits methods

Clauses 25, 26, 28, 29, 33, 35 to 40, 42, 43, 97, 131, and subclauses 126(2) and (7)

Submissions

The branch equivalent method should be retained. *(KPMG, PricewaterhouseCoopers, Millennium and Copthorne Hotels)*

The accounting profits method should be retained. *(KPMG, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

Comment

The main arguments advanced for retaining these methods are that they more accurately reflect the actual income earned by the offshore entity, as opposed to the FDR and cost methods, which assume a 5% return.

We do not consider there to be strong grounds for retaining these methods, as they would rarely be used and would add significant complexity to the rules.

For interests of 10% or more in a FIF, the active income exemption replaces the branch equivalent method, and few investors with a less than 10% interest currently use the branch equivalent method. The accounting profits method is also rarely used by portfolio and non-portfolio investors.

We have identified several issues with retaining the branch equivalent and accounting profits methods.

Retaining a "full attribution" branch equivalent method or an accounting profits method alongside an active income exemption would lead to significant complexity. For example, rules would be needed to adjust ring-fenced losses and foreign tax credits when an investor moves into and out of the active income exemption.

In some situations these methods could also enable taxpayers to reduce their overall tax liabilities by initially receiving and using losses under a branch equivalent or accounting profits method, before switching to the cost or FDR methods once historic losses are used up and they are consistently making returns in excess of 5%. This is also a potential difficulty with an active income exemption, but is likely to be less severe because active losses will not be recognised.

Recommendation

That the submissions be declined.

Issue: Access to the comparative value method

Clauses 26 and 30

Submissions

The comparative value method should be available for all companies, in addition to individuals and family trusts. (*PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

The comparative value method should be available for non-portfolio shareholders. *(New Zealand Institute of Chartered Accountants)*

Comment

When the portfolio FIF reforms were enacted in 2007, a concession was made that allowed individuals and trustees of family trusts to elect to be taxed on the actual returns of all of their investments, if greater than zero (losses are ignored). People elect to use the concession by using the comparative value method. It can be used to reduce tax in years when a person makes a return of less than 5% on their entire investment portfolio (FDR would otherwise apply to tax a hypothetical 5% return). It recognises the fact that individuals and family trusts may find it more difficult to free up enough cash to pay a tax liability in years when they make only a small return or a loss.

It would be costly to extend this exemption to companies and PIEs. It would effectively reduce the FDR rate to below 5%. This is because, in years when they make much higher returns (such as 10% or 20%), taxpayers would only pay tax on a 5% return when using FDR.

We note that the bill allows for the comparative value method to be used by non-portfolio shareholders as long as they are individuals or trustees of a family trust. This is consistent with the rules for portfolio shareholders.

Recommendation

That the submissions be declined.

ATTRIBUTABLE FIF INCOME METHOD

Issue: Access to the attributable FIF income method

Clause 26

Submission
(Matter raised by officials)

Investors with less than 10% interests should be able to use the attributable FIF income method in certain exceptional circumstances.

Comment

The bill replaces the branch equivalent method with the attributable FIF income method. However, unlike the branch equivalent method, the attributable FIF income method is limited to investors with a 10% or greater interest in the foreign company. Portfolio shareholders with an interest of less than 10% are not the target for the new method, because:

- it is less likely that they will be able to obtain the information necessary to use the method; and
- they are less likely to be making decisions about where business activities of the entity they invest in will be located.

We are aware however that there are several groups of investors with less than 10% interests in CFCs for which they currently use the branch equivalent method. The bill will make these investors worse off. Instead of paying no New Zealand tax (as a result of losses or using the attributable FIF income method) they will pay tax under the cost method. The cost method applies tax based on the amount of income that would be generated if the CFC made a hypothetical 5% rate of return.

There are two reasons why this appears to be a comparatively harsh outcome.

First, if the shares in the CFC were sold to a New Zealand holding company the CFC rules could be applied to the entire investment. We understand, however, that this type of restructuring would give rise to fairly significant costs, including foreign capital gains taxes and other transaction costs.

Second, individuals and trustees of family trusts can normally choose to be taxed on the actual returns (excluding losses) of all of their investments. This means that no tax would be paid in years when a CFC made a loss. However, because shares in the affected CFCs are not widely traded (for example, listed on a stock exchange) it is not possible for the investors to use this concession.

Officials agree that shareholders with interests of less than 10% should be able to access the attributable FIF income method in exceptional cases. A pragmatic option would be to allow investors with a less than 10% shareholding to access the active income exemption if they meet the following criteria:

- The foreign company must be a CFC (that is, it is controlled by five or fewer New Zealand residents). This ensures that at least one New Zealand investor should have sufficient information to comply with the active income exemption; the other investors may be able to approach that investor for this information. It also makes it more likely that there will be economic benefits accruing to New Zealand (for example, through a link to New Zealand business or expertise) from the investment.
- The shares in the CFC must not be widely traded (for example, listed on a stock exchange). This reflects the fact that widely traded shares are close substitutes for other types of portfolio investment. In other words, the shares are more likely to be part of a wider investment portfolio and purchased because of expected dividends or share gains, rather than being a link to the investor's own business or expertise.
- The investor must not be a listed company or managed fund (and the CFC must not be controlled by a managed fund or listed company). Otherwise, there could be a tax incentive for managed funds and listed companies to buy shares in CFCs, or to sell shares in CFCs they already control to smaller investors who could then use the active income exemption. This could distort investment portfolios and reduce tax revenue.

Recommendation

That the submission be accepted.

Issue: Requirement for "direct" income interests

Clauses 24 and 26

Submissions

The proposed subsection EX 46(3) only allows the attributed FIF income method to apply to "direct" income interests. This needs to be amended to allow the method to apply to direct and indirect income interests. *(New Zealand Institute of Chartered Accountants)*

The "direct" income interest requirement in section EX 35(a) (Exemption for interest in FIF resident in Australia) should be removed. *(PricewaterhouseCoopers)*

The treatment of underlying FIF interests should be clarified. *(Ernst & Young)*

Comment

The current drafting will mean that the attributed FIF income method and the Australian exemption may not be used when a FIF is held indirectly through another FIF. This is contrary to the policy intention and should be corrected to accommodate FIFs which are held indirectly.

Recommendation

That the submissions be accepted.

Issue: Requirement that an investor not be a certain type of entity (such as a unit trust)

Clause 24

Submission
(Russell McVeagh)

The requirement in section EX 35(a) (Exemption for interest in FIF resident in Australia) that the person holding the interest in the FIF may not be a certain type of entity, such as a unit trust, should only apply to the New Zealand investor rather than, for example, a FIF holding company.

Comment

Officials agree that these entity requirements should only apply to the ultimate New Zealand investor, rather than a FIF intermediary. The requirements deny the exemption to investors who are a PIE, superannuation scheme, unit trust, life insurer or a group investment fund. They are necessary because these entities can pass income back to their shareholders with no New Zealand tax. In contrast, investors in an ordinary company which benefits from this exemption will have to pay tax when they receive unimputed dividends from the foreign company.

Recommendation

That the submission be accepted.

Issue: Exemption for inter-group loans

Submission
(Russell McVeagh)

The definition of "group funding" in section EX 20C(6)(c)(i) should be modified for the purposes of the attributable FIF income method to include funding provided to associated FIFs.

Comment

The definition of "group funding" in section EX 20C(6)(c)(i) is applied by FIFs which use the attributable FIF income method. However, in its current state that provision will only allow a FIF to provide funding to an associated CFC. It should be modified for the purposes of the attributable FIF income method to include funding provided to other FIFs, if the funder and the other FIF have the same controlling shareholder.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Exemption of income from FIFs that pass the active business test

Submission
(Russell McVeagh, New Zealand Law Society, Ernst & Young)

Sections CQ 2(1)(h) and DN 2(1)(h) of the Income Tax Act 2007 prevent income or losses arising from interests in non-attributing active CFCs. Equivalent provisions are needed for non-attributing active FIFs.

Comment

Officials agree that provisions similar to the CFC exemptions should be inserted in order to make the active income exemption for FIFs effective.

Recommendation

That the submissions be accepted.

Issue: Application date

Clause 2

Submissions

Taxpayers should be able to opt in to the new rules if the bill is enacted before the end of their income year. *(KPMG, Millenium and Copthorne Hotels*)

Taxpayers should be able to elect to use the new non-portfolio FIF rules for income years beginning on or after 1 April 2011. *(BDO Auckland)*

Comment

The approach to the application date in the bill is the same as the CFC reforms in 2009. Taxpayers were not able to elect when they adopted the new CFC rules.

There would be an additional fiscal cost if taxpayers were able to elect whether to apply the old FIF rules (for example, if they have grey list FIFs) or the new FIF rules (if they had active FIFs outside the grey list). There may also be increased compliance costs as some taxpayers may determine the outcomes under both sets of rules before electing to use the rules which produce the best tax result. Finally, it would increase legislative complexity, particularly in relation to the transitional provisions which deal with pre-reform losses and which phase out BETA and conduit accounts.

Recommendation

That the submissions be declined.

Changes to the thin capitalisation rules

APPLYING THIN CAPITALISATION RULES TO FIFS

Clauses 44 and 45

Submissions
(Corporate Taxpayers Group, KPMG, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)

The thin capitalisation rules should not apply to New Zealand companies with non-portfolio FIFs. *(Corporate Taxpayers Group, KPMG, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

The application date of the changes to the thin capitalisation rules should be deferred in order to allow New Zealand shareholders time to structure their affairs to mitigate the potential denial of interest deductions in New Zealand. *(Corporate Taxpayers Group)*

Existing non-portfolio FIF holdings should be excluded from the thin capitalisation rules. *(Corporate Taxpayers Group)*

Comment

The interest allocation rules were introduced in the 2009 CFC reforms to deal with a particular fiscal risk. That risk is that the application of an active income exemption for offshore income can create an incentive for businesses to reduce their taxable income from New Zealand operations by allocating all their debt to New Zealand even when the debt is used to fund their exempt operations located offshore.

This concern was resolved for CFCs by introducing thin capitalisation rules, which limit the amount of debt allocated to New Zealand to the greater of 75% of the investor's New Zealand assets or 110% of the worldwide group's debt-to-asset ratio.

The same issue arises for investors in FIFs which use the active income exemption. Although in some cases a New Zealand investor may be unable to manipulate the location of debt (either in New Zealand or in the FIF), there will be situations when that opportunity does arise – for example, in a 50/50 joint venture.

Further, as a matter of general principle, a New Zealand taxpayer who is exempt on offshore income should not be able to claim all their interest deductions against the New Zealand tax base. Money is fungible and New Zealand borrowings can be used to fund those offshore operations. The interest allocation rules indirectly resolve this concern by putting an upper limit on the amount of deductions that may be claimed in New Zealand.

Finally, the thin capitalisation rules have been designed to bite only when New Zealand debt levels are very high. There is a 75% safe harbour before deductions are denied. Many non-portfolio FIF investors will already be subject to the interest allocation rules by virtue of having a CFC interest. Businesses with less than $1m of interest deductions or less than 10% of their assets offshore are exempt from having to apply the interest allocation rules and so will not incur additional compliance costs.

In our view it is highly desirable to keep the CFC rules and FIF rules consistent in this respect. For this reason the bill amends the thin capitalisation rules so that they also apply to investors in FIFs that use the active income exemption or the Australian exemption. We do not consider that there is a strong case for deferring entry or grandparenting existing FIFs so they do not enter the thin capitalisation rules.

Recommendation

That the submissions be declined.

Issue: Matter raised by officials

Clause 51

Submission
(Matter raised by officials)

For the thin capitalisation rules to apply to FIFs which use the attributable FIF income method or are exempt under section EX 35 (as is intended and was signalled in the bill commentary), a reference to these FIFs needs to be added to the rules.

Comment

Section FE 16(1B) should be amended so that it also includes a reference to a FIF for which a member of the New Zealand group uses the attributable FIF income method or has an interest in a FIF that meets the requirements of section EX 35.

Recommendation

That the submission be accepted.

DRAFTING OF THIN CAPITALISATION RULES

Clause 49

Submission
(Ernst & Young)

Sections FE 13(3)(a)(ii) and FE 12B(3)(b) should be amended to refer to income "other than non-resident passive income". Alternatively, clarification is required of the intended meaning of the reference in those provisions to *relief* from New Zealand tax under a double tax agreement being available for all income with a New Zealand source.

Comment

The issue raised in the submission relates to the application of thin capitalisation rules to non-resident companies that invest in New Zealand.

The thin capitalisation rules apply to non-resident companies with New Zealand-sourced income that is not relieved under a double tax agreement, even if the company does not have a taxable presence (such as a branch) in New Zealand. This limits the ability of such companies to use debt to reduce their exposure to New Zealand tax by claiming excessive interest deductions.

When the income derived from New Zealand by the non-resident company is "non-resident passive income" (dividends, interest and royalties), it is subject to non-resident withholding tax as either a final tax or a minimum tax. Non-resident withholding tax is based on gross payments, which are not affected by interest deductions. Therefore, if a non-resident company derives only non-resident passive income from New Zealand and does not have a taxable presence here, it is not necessary to apply the thin capitalisation rules to that company.

In view of this, the bill amends various provisions in the Income Tax Act 2007 to stop the thin capitalisation rules applying to non-resident companies merely because they derive non-resident passive income from New Zealand. The submission points out that equivalent changes are needed to section FE 13(3)(a)(ii) and to new section FE 12B(3)(b). These consequential changes are needed to ensure that the thin capitalisation rules operate consistently in the circumstances described.

Recommendation

That the submission be accepted.

NEW THIN CAPITALISATION TEST BASED ON EARNINGS

Clauses 47 to 49

Submissions

Taxpayers should be allowed to use accounting classifications of items and amounts for non-resident entities when performing group calculations for the new thin capitalisation test. *(Ernst & Young)*

The intended meaning of interest income should be clarified. *(Ernst & Young)*

Taxpayers should be able to meet the requirements of the test if the interest-to-earnings ratio for the group is less than 50% *or* (not and) less than 110% of the ratio of the worldwide group. *(PricewaterhouseCoopers)*

The test should be extended to entities that are not "excess debt outbound entities". *(PricewaterhouseCoopers)*

Comment

The new thin capitalisation test requires measures of net profit or loss, income from a CFC or FIF, depreciation, amortisation and net interest expense.

Officials consider that the drafting in the bill already allows the use of accounting classifications in determining net profit or loss and income from a CFC or FIF for the purpose of the thin capitalisation rules.

Officials agree that the bill should be changed to make it clear that accounting classifications are to be used for determining depreciation and amortisation as well.

For interest, tax concepts are to be used. This is explicit in the legislation. This is in part to prevent exploitation of important differences between the tax and accounting treatment of income from some financial assets. It is noted that the existing thin capitalisation test – based on debt and assets rather than interest expense and profits – requires debt to be calculated using New Zealand tax principles, and that this requirement was introduced as a base maintenance measure.

Officials agree that the meaning of interest income should be clarified and made consistent with the definition of interest deductions. We recommend that both interest deductions and interest income be restricted to amounts arising from arrangements that provide funds to the relevant entity (such as loans). This is consistent with existing thin capitalisation rules that restrict "debt" to instruments that provide funds to the entity.

The new thin capitalisation test is based on the ratio of interest deductions to profits. There are two main requirements. The first is that the ratio calculated for the New Zealand entities in a multinational group is 110% or less of the ratio of the entire multinational group. The second is that the ratio calculated for the New Zealand entities is less than 50%.

The first, and main, requirement ensures that deductions of a multinational group are not concentrated in New Zealand and are instead fairly spread around.

The second requirement puts an absolute cap on deductions, which is common practice abroad (the United States uses 50%, some European countries use 30%). This limits the risk of unusual outcomes in which very small changes in profit can lead to large changes in the ratio. 50% is an unusually high interest-to-profit ratio and we expect it would rarely be exceeded by a solvent non-financial business.

The test is limited to New Zealand-based multinationals because they are the most likely to be in the position that was envisaged when the policy was formulated – having high-value intangible assets in New Zealand (not recognised for accounting purposes) and acquiring significant overseas assets (recognised for accounting purposes). Foreign-based multinationals are more likely to be in the opposite position of not recognising their foreign intangible assets but recognising their New Zealand assets.

Recommendation

That the submissions relating to the definition of interest and the use of accounting concepts be accepted, subject to officials' comments.

That other submissions be declined.

Zero rate of AIL on bonds

ZERO RATE OF AIL ON BONDS

Issue: Scope of the proposal

Clause 142

Submissions

The zero rate of AIL should be extended to include wholesale bonds offered to at least 10 (institutional) investors. *(Kiwibank, New Zealand Post, New Zealand Bankers Association, Corporate Taxpayers Group, Russell McVeagh)*

Concerns about the fiscal risk of extending the proposal to wholesale bonds could be dealt with either by excluding syndicated loans or loans to related parties, or by allowing issuers to apply [to the Commissioner] for an exemption for programme debt or for wholesale funding programmes. *(Kiwibank)*

More needs to be done to make New Zealand a more attractive investment destination for foreign capital and to reduce offshore borrowing costs for New Zealand business. At a minimum, there should be greater discussion about the relative merits of extending the proposal [beyond widely held bonds]. *(KPMG)*

Comment

The current tax policy settings already distinguish between related-party debt and unrelated-party debt. Related-party debt is subject to NRWT of 15%, or 10% if a treaty applies. The AIL regime was introduced in 1991 to dramatically reduce the tax impost to 2% if the lender and borrower are unrelated.

The purpose of this proposal is to provide a very targeted exemption from the AIL rules. It is narrowly aimed at removing a potential tax impediment to the development of a traded bond market, rather than reducing the cost of corporate debt across the board. Thus, the measure is intentionally restricted to retail bonds that are traded in the New Zealand market. In this respect, the main test is the "listed on a securities market" test, with a widely held test as a back-up option for bonds that are not listed.

The proposal does not apply to wholesale bonds which are generally issued in offshore markets to a small number of institutional investors (typically through a private placement). If traded at all, such bonds are traded in foreign bond markets and so do not add to the development of a New Zealand bond market. Wholesale bonds can be close substitutes for bank loans.

Extending the proposal to wholesale bonds could have a high fiscal cost. In addition to the foregone AIL revenues (up to $50m per year), there is an unquantifiable risk that it could encourage some domestic lending activity to shift offshore, undermining the corporate tax base.

Some submitters suggested that New Zealand should follow Australia's rules, which exempt interest from withholding tax when debt is offered to 10 institutional investors.

An "offered to 10 investors" test would provide inadequate protection against the risk of exempting closely held debt. For example, a debt instrument could be offered to 10 investors but be taken up by only one. This could occur if the terms of the investment were designed so they would only appeal to the intended lender (who, for example, could be compensated through a separate transaction).

The context for the Australian rules is fundamentally different from that in New Zealand. In Australia, the equivalent rules are the main rules for distinguishing between related-party debt to which NRWT applies and unrelated-party debt for which no NRWT is imposed (comparable to our 2% AIL rate).

Unlike Australia, the New Zealand banking sector is predominantly foreign-owned. This makes it critical to ensure that foreign banks cannot lend directly to New Zealand residents while facing no New Zealand tax on the interest received. An exemption that applies to wholesale bonds could encourage some domestic lending activity to shift offshore (that is, an Australasian banking group may do more lending out of Australia as opposed to lending through a New Zealand subsidiary). This could have a very high fiscal cost.

Because of this concern, the proposal in the issues paper is much more restrictive than the comparable exemption which operates in Australia.

Recommendation

That the submissions be declined.

Issue: Requirement that no person hold more than 10% of the bonds

Clause 142

Submission
(Kiwibank, New Zealand Post, New Zealand Bankers Association, Corporate Taxpayers Group, Russell McVeagh)

The requirement (in proposed section 86IB(2)(d)) that no person hold more than 10% of the bonds should be removed.

Comment

Officials consider that a maximum ownership threshold is necessary to support the integrity of the widely held test. Interest paid to investors who hold more than 10% of a company's bonds should be subject to 2% AIL, as in certain circumstances holdings of this size can resemble closely held debt as opposed to publicly traded bonds.

Recommendation

That the submission be declined.

Issue: Requirement that the bonds not be a private placement

Clause 142

Submission
(Kiwibank, New Zealand Post, New Zealand Bankers Association, Corporate Taxpayers Group, Russell McVeagh, New Zealand Post)

The requirement (in proposed section 86IB(1)(b)(ii)) that the issue of the security is not a private placement should be removed.

Comment

It is not intended that the exemption be available for private placements, even if these are widely held. This is because the objective is to remove a potential obstacle to the development of a traded bonds market as opposed to reducing the cost of corporate debt more generally.

Recommendation

That the submission be declined.

Issue: Requirement that the bonds not be an asset-backed security

Clause 142

Submission
(New Zealand Bankers Association)

The requirement that the bond not be an asset-backed security should be removed.

Comment

The purpose of this requirement is to deny the zero rate of AIL in cases where a group of loans have been bundled together and securitised into a bond. The concern is that such securities could be used to effectively shift the margin earned on closely held loans (such as mortgages) outside the New Zealand tax base.

Recommendation

That the submission be declined.

Issue: Requirement that the bonds be issued in New Zealand

Clause 142

Submission
(Kiwibank, New Zealand Post, New Zealand Bankers Association, Corporate Taxpayers Group, Russell McVeagh, Ernst & Young)

The zero rate of AIL should be extended to include bonds issued in currencies other than New Zealand dollars. Related to this, the requirement for the registrar and paying agent activities to be performed in New Zealand should be removed.

Comment

To qualify for the zero rate of AIL, the bonds must be issued in New Zealand and be denominated in New Zealand dollars.

The objective of the policy is to remove a potential tax impediment to the development of the New Zealand bond market, and thus improve its depth and liquidity. A well-functioning bond market has a number of important signalling and support roles which affect the performance of the capital markets and the wider financial system.

Submissions have generally sought a different objective, which is to reduce the cost of capital for New Zealand businesses by removing tax on New Zealand corporates that issue bonds to non-residents.

Submissions point to the fact that many New Zealand corporates issue bonds in offshore bond markets. Such bonds are usually issued to a small number of institutional investors (typically through a private placement). If traded at all, such bonds are generally traded in foreign bond markets (for example, on the Australian, London or New York exchanges) and so do not contribute to the development of the New Zealand bond market.

Recommendation

That the submission be declined.

Issue: Requirement that the bonds be an offer to the public

Clause 142

Submission
(Kiwibank, Russell McVeagh, New Zealand Post)

The requirement that the bonds be an offer to the public under the Securities Act 1978 should be removed.

Comment

For reasons mentioned earlier, the zero rate is not intended to apply to bonds that are issued through a private placement. One feature of private placements is that they are offered to a select group of investors rather than the general public. For this reason, there is a requirement that the bonds be an "offer of securities to the public" under the Securities Act. The Securities Act does not expressly define "an offer of securities to the public" but section 3 of the Act provides guidance as to how the phrase should be interpreted.

Submitters were concerned that this condition would prevent bonds issued offshore from qualifying for the zero rate of AIL. If a decision is made that bonds issued offshore should qualify (we have recommended against it) the condition could be altered. An altered condition might be that that the bond issue would meet the definition of offer of securities to the public under the Securities Act if they were issued in New Zealand.

Recommendation

That the submission be declined.

Issue: 100 holder test should be an alternative to the requirement that the bonds be an offer to the public

Clause 142

Submission
(Corporate Taxpayers Group)

If the scope of the exemption is to remain narrow, the 100 holder test should be an alternative to the requirement that the bonds be an offer of securities to the public under the Securities Act 1978.

Comment

As mentioned earlier, there could be a significant risk to the corporate tax base if the zero rate of AIL applied to closely held debt (such as loans, syndicated loans and private placements).

Officials have developed a "belt and braces" approach to manage this risk through the use of requirements, tests and exclusions. The offer of securities to the public requirement is intended to ensure that the bonds are available to any investor, rather than only a certain group (such as a private placement that is only offered to a foreign bank).

We do not consider it prudent to rely only on the bonds being an offer of securities to the public, as this requirement could be subjective. This test is best supported by an additional test that the bonds be either listed or issued to 100 persons.

Although the 100 holder test is outside the issuer's control, the consequences of failing this test are not severe given that AIL is only 2%. Concerns about uncertainty deterring investors can be dealt with by having the issuer or underwriter absorb any AIL cost if it arises.

Recommendation

That the submission be declined.

Issue: Proposal should include government bonds

Clause 142

Submission
(KPMG)

The zero rate of AIL should be extended to cover government bonds.

Comment

The government already bears the cost of AIL on government bonds. This means that non-residents receive the same interest payments on government bonds as New Zealand residents. Therefore it is not necessary for the zero rate of AIL to include government bonds, although we note that it does not expressly exclude them either.

Recommendation

That the submission be declined.

Issue: Applying the widely held test on a programme basis

Clause 142

Submission
(New Zealand Bankers Association)

The widely held test should apply on a programme basis rather than on a tranche-by-tranche basis.

Comment

As currently drafted, the widely held test would be applied to a group of identical securities, rather than to each individual issue. This would accommodate issuers which choose to issue additional tranches of the same bond. It would also allow issuers to gradually build up to 100 investors in their bonds, so that bonds which did not initially qualify for the zero rate may qualify from a later date. (It is not proposed that such bonds would get the zero rate applied retrospectively.) Note that this requires each tranche of the bonds to be identical (that is, fungible).

Allowing the test on a programme basis would allow the bonds to have different rates, terms and conditions. For example, so long as a corporate had an existing bond programme, they would be able to add a loan from a foreign bank to this programme and the loan would qualify for a zero rate of AIL. This would be contrary to the policy intent of the measure which is that the zero rate of AIL should only be available on publicly traded bonds.

Recommendation

That the submission be declined.

Issue: Clarification of coverage and requirements

Clause 142

Submission
(Kiwibank)

The following points should be clarified:

- Bank term deposits – do these qualify or not?
- Asset-backed security – if a company issues bonds and then on-lends all of the funds to a related party, is this an asset-backed security?
- 10% holding requirement – does this look through widely held vehicles and does it disqualify all investors or just investors with holdings of more than 10%?

Comment

The purpose of the proposal is to remove a potential tax impediment to the development of the corporate bond market. Accordingly it is only intended to apply to tradeable debt instruments, such as bonds, and so should not apply to bank term deposits. To clarify this point, we recommend adding an additional requirement that the debt securities be traded.

The purpose of the exclusion for asset-backed securities is to deny the zero rate of AIL when a group of loans have been bundled together and securitised into a bond. The concern is that such securities could be used to effectively shift the margin earned on closely held loans (such as mortgages) outside the New Zealand tax base. In most cases, when a company issues bonds and then on-lends the funds from those bonds to a related party it would not be an asset-backed security. However, this does depend on the exact circumstances. If, for example, the related party was set up to hold a bundle of mortgages and the bond issuer was interposed merely to lend against those asset-backed securities, it might well be considered that the bond was asset-backed. We will clarify this in the guidance material prepared as part of the *Tax Information Bulletin* item on the changes.

For the requirement that no person holds more than 10% of the bonds at the time the widely held test is applied, a widely held vehicle holding the bonds should be treated as a single person. Otherwise, this would effectively extend the proposal to wholesale bonds and possibly bank loans, as bonds issued to institutional investors would easily satisfy the 100 persons requirement. This is because nearly all banks or managed funds invest on behalf of other investors.

The requirement that no person holds more than 10% of the bonds would disqualify all investors in the bonds. If it only disqualified a person with a 10% or greater holding, it would be much easier to organise arrangements that undermine the intention of the widely held test, given that this test need only be satisfied on one occasion.

Recommendation

That the submission be declined, and that officials' consequential recommendation to add a "traded" requirement be accepted.

Issue: Clarification of whether 100 holder test needs to be re-applied

Clause 142

Submission
(Ernst & Young)

It is unclear whether securities meeting the widely held criteria need to continue to meet those criteria for subsequent interest payments, or if not, whether they are intended to be disqualified in another way. Policy and legislative clarification are required.

Comment

In general, bonds will continue to satisfy the widely held test if they have passed it on one occasion. However, there is an anti-avoidance rule to prevent transactions that temporarily increase the number of persons holding the bonds. If such an arrangement occurs, the test will no longer be satisfied and the issuer will be required to pay AIL of 2%.

The legislation already provides for this result, and it will be explained as part of the guidance material in the *Tax Information Bulletin* item on the changes.

Recommendation

That the submission be declined.

Issue: Title of the proposal

Clause 142

Submission
(Russell McVeagh)

The proposal is an exemption from the requirement to pay AIL in order to obtain a zero rate of NRWT, rather than a zero rate of AIL. Either the legislation should be amended to provide a zero rate, or the section title and Inland Revenue guidance should refer instead to an exemption.

Comment

The drafting of the provision in section 86IB means that there is not technically a zero rate of AIL. However, a zero rate of AIL is a more intuitive concept than an exemption from the requirement to pay AIL, as an exemption from AIL may imply that a person would have to pay NRWT.

Recommendation

That the submission be declined.

Remedial amendments

INSURANCE CFCS WITH REINSURANCE CLAIM INCOME

Clause 140

Submission
(Matter raised by officials)

The requirement for a Commissioner's determination should be amended so that it disregards reinsurance claim income when considering if "all or nearly all" of the CFC's income is from premiums or investments commensurate with insurance contracts.

Comment

Section 91AAQ of the Tax Administration Act 1994 sets out requirements for obtaining a special exemption from the controlled foreign company (CFC) rules. The exemption is for companies with active insurance businesses.

Section 91AAQ(4)(b) requires "all or nearly all" of the CFC's income to be produced from premiums from insurance contracts that cover risks in the same country that the CFC is located in, or from proceeds from investment assets that have a value which is commensurate with those insurance contracts.

This income test covers the main types of income generated by an insurance business. The problem is that insurers can receive another type of income in the form of reinsurance claim income for liabilities which they have reinsured. This additional income can mean that the "all or nearly all" requirement is no longer satisfied. At least one company would be adversely affected if reinsurance income is not carved out of the test.

Officials recommend that the test be amended to disregard any reinsurance claim income. This means that reinsurance claim income would not count towards either the active income portion (numerator) or the total income amount (denominator) when applying the "all or nearly all" test.

Recommendation

That the submission be accepted.

ASSOCIATED PERSONS REMEDIAL (BOND ISSUERS AND BOND HOLDERS)

Submission

(Corporate Taxpayers Group, Russell McVeagh, New Zealand Law Society)

A remedial amendment is necessary to ensure that bond issuers and bond holders do not become associated simply by being trustees and beneficiaries in a trust that has a principal purpose of enforcing rights under the bond.

Comment

This is an unintended consequence that arose as a result of the associated person changes in 2009. The main problem is that the bond issuers will be required to pay non-resident withholding tax (NRWT) on interest payments to non-resident bond-holders. Prior to 2009 they were able to pay the approved issuer levy which applies at a lower rate than NRWT. In cases where the bond issuers and bond holders are only associated due to the use of trust whose principal purpose is enforcing rights on the bond, they should be able to pay the approved issuer levy as opposed to NRWT.

Recommendation

That the submission be accepted.

AIL CLARIFICATION

Submission
(Corporate Taxpayers Group, Russell McVeagh)

It should be clarified that AIL is available in cases when a guarantor discharges an issuer's obligation to pay interest.

Comment

This issue falls outside the scope of the current bill. However, it may be considered at a later date as resources permit.

Recommendation

That the submission be noted.

EXCLUDING QUALIFYING COMPANIES FROM HOLDING INCOME INTERESTS OF 10% OR MORE IN FIFS

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

The legislative change should not be retrospective to income years beginning on or after 1 July 2009. At the earliest it should apply to income years beginning on or after 1 July 2011.

Comment

As part of the Taxation (International Tax, Life Insurance, and Remedial Matters) Act 2009, an exemption was introduced for foreign dividends derived by companies. This means that the exemption applies to qualifying companies even though these companies are able to pass exempt income on to their shareholders with no further tax impost. This is inconsistent with exempt foreign income usually being taxed if received directly by an individual taxpayer, or when unimputed dividends are paid by a company to individual shareholders.

An amendment was made in the Taxation (International Tax, Life Insurance, and Remedial Matters) Act 2009 to deal with this issue. However, the amendment refers to "attributing interests" in a FIF. This means that non-attributing active FIFs and FIFs that qualify for the grey list exemption could be under-taxed as these are not attributing interests.

It is unlikely that any qualifying companies will be affected by this change as there is an existing limit whereby qualifying companies cannot have more than $10,000 of foreign non-dividend income. We have not been contacted by any affected qualifying companies.

Nevertheless, there could be a fiscal cost if this remedial change is not backdated to income years beginning on or after 1 July 2009.

Recommendation

That the submission be declined.

ROYALTIES REMEDIAL: PRESERVE EXEMPTION FOR ROYALTIES WHEN THIRD-PARTY ROYALTIES ARE RECEIVED BY A LOWER-TIER CFC

Submission
(KPMG)

The wording of section EX 20B(5)(d) of the Income Tax Act 2007 should be consistent with the policy intention of the new CFC rules, so that:

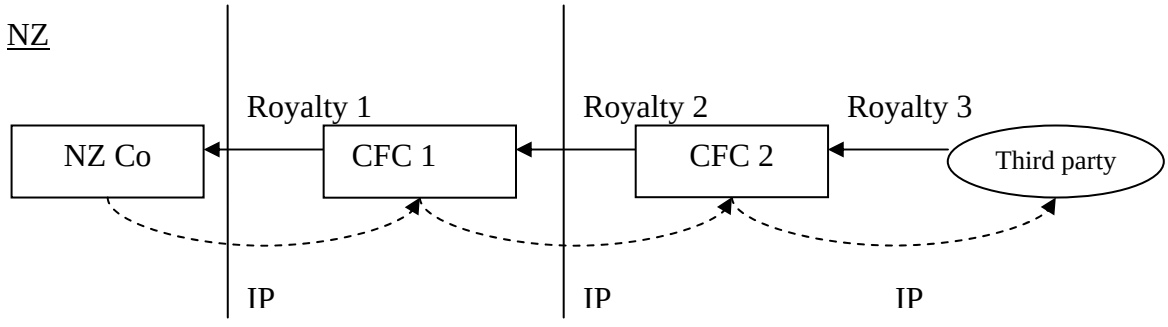
- the royalty income derived by an upper-tier CFC from intellectual property licensed to a lower-tier CFC, which in turn licenses the property to a non-associated third party, is excluded from "attributable CFC amount"; and
- the royalty income derived by the lower-tier CFC from the non-associated third party is also excluded from being an attributable CFC amount.

Comment

The current drafting of section EX 20B(5)(d) does not achieve the desired policy intent of the provision. That is, third-party royalty payments paid in relation to property owned by a New Zealand resident should be treated as "active", even if those payments passed through an upper-tier and lower-tier CFC before being returned to New Zealand.

Currently, the provision only takes into account the payment that is made between the upper-tier and lower-tier CFCs. It does not provide for the initial payment made by the third party to the lower-tier CFC. As such, that third-party payment will be considered as "passive income" and will be subject to attribution.

To illustrate, the existing drafting fails to accommodate the following scenario.



Recommendation

That the submission be accepted.

RESIDENCE OF CONTROLLED FOREIGN COMPANIES

Clauses 19, 21 and 22

Submission
(PricewaterhouseCoopers)

Subparagraph (d)(ii) of new sections EX 20B(16), EX 21D(10) and EX 21E(14) should be removed, to allow certain "flow-through" entities to qualify for exemptions.

Comment

A number of exemptions and special treatments apply to controlled foreign companies (CFCs) when CFCs are resident in the same country, on the basis that tax outcomes will be relatively similar for all the CFCs in such a case.

The new sections dealing with the residence of a CFC have been introduced for two reasons.

First, they put restrictions in place to make it more likely that tax outcomes will in fact be similar for all the CFCs. For example, they require that the CFCs *not* be dual-residents (a dual-resident CFC might end up being taxed elsewhere and not in the country in question).

And secondly, they recognise that there are some situations in which, although an entity resident in a country is not subject to tax there (because it is a "flow-through" entity), the outcome for a group of CFCs is as if all were subject to tax in that country.

The submission argues that other cases involving "flow-through" entities should also be addressed. In the two examples given, we could have no confidence that the income would face the normal company tax in the country in which the "flow-through" entity is present. This would allow income to be shifted between countries without New Zealand tax consequences, including from high-tax to low-tax countries. This is contrary to the policy that underlies the new CFC rules, which is that New Zealand will exempt income from active CFCs but expects that they will face the host-country tax rate on their income.

Recommendation

That the submission be declined.

DEDUCTIBLE FOREIGN EQUITY DISTRIBUTION CHANGE SHOULD BE WITHDRAWN

Subclauses 126(16) and 126(17)

Submission
(PricewaterhouseCoopers)

The proposed change to the definition of deductible foreign equity distribution should not proceed until there has been further consultation. Alternatively, the amendment should be prospective.

Comment

The rule was introduced to address issues of potential tax arbitrage caused by New Zealand regarding some entities as non-taxable when they are regarded as taxable in other countries.

We agree that there should be further consultation about this issue. The proposed amendment is unlikely to be effective in its current form and a more general rule to prevent arbitrage may be desirable.

We recommend withdrawing the proposed change at this time.

We also note that Inland Revenue has now made taxpayers aware that this type of arbitrage may be inconsistent with the intent of the policy to exempt most foreign dividends.

Recommendation

That the submission be accepted.

Other matters

DEADLINE FOR ELECTION TO USE BETA DEBITS

Clauses 101 and 114

Submission
(New Zealand Institute of Chartered Accountants)

The requirement to make an election before the end of the third income year in order to use branch equivalent tax account (BETA) debits should be removed.

If a time limit is to be applied, the limit should instead be the time by which the company is required to have filed its tax return for the second income year in which attributed CFC income has been allocated. The Commissioner should also be given the discretion to accept a late election.

Comment

BETA accounts of companies are being repealed because they are no longer necessary under the new CFC rules.

Credit balances in BETA accounts have already been cancelled, and debit balances remain only for exceptional cases in which dividends have been received in advance of the underlying income being derived by a CFC.

In these exceptional cases, there is a possibility of double taxation because the dividend may have been taxed already and the underlying income will also be taxed when it is derived. Commonly though, debit balances that remain have arisen from fixed-rate share dividends paid by CFCs in Australia. Such CFCs are very unlikely to ever have New Zealand tax imposed on their underlying income (owing to the exemption for Australian CFCs). The potential risk of double taxation is therefore low.

At the time the repeal of credit balances was publicly announced, it was also announced that BETA debit balances would be retained only for a two-year period (that is, for the first two years of application of the new CFC rules). In practice, a conservative approach has been taken and they are remaining for three years, to allow more time for debits to be used against the first two years of income.

Given the low probability of double taxation and the fact that a full additional year has been allowed to use debit balances against the first two years of income under the new CFC rules, officials do not recommend that the submission be accepted.

Recommendation

That the submission be declined.

REVALUING INHERITED FORMER GREY LIST SHARES

Clause 41

Submissions
(New Zealand Institute of Chartered Accountants)

The amendment should not proceed if the existing law is sufficient to deem these interests to have a market value.

The rule in proposed section EX 67B should cover gifts, trust distributions and in-specie company distributions.

The rules in sections EX 71 and GC 4 should be statutorily reconciled with the rules in subpart FC.

Comment

The amendment is necessary because a major change in the law in 2007 did not apply to some inherited foreign shares. As a consequence these inherited shares slipped through the cracks and retained a cost base of nil instead of being re-valued at market value, as was the case for other foreign shares.

The problems we have observed relate to inherited shares as opposed to shares that were transferred as gifts, trust distributions and in-specie company distributions. When originally designing the proposal we thought about extending the provisions to these other types of transfer but decided they were likely to be insignificant. It would not be appropriate to extend the proposal without consulting on the extension first.

The interaction between sections EX 71 and GC 4 (which revalue non-market transactions in FIF shares at market value) and subpart FC (the general inheritance rules) is a separate issue that is outside the immediate scope of this bill. Further work and consultation would be needed to establish how these provisions should interact, and what changes, if any, were necessary.

Recommendation

That the submissions be declined.

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

Section EX 67B(1)(b)(i) should be deleted. *(Ernst & Young)*

The way the provision is worded, it overrides the rules in section FZ 6. Taxpayers who inherit FIF interests in former grey-list countries should be given the option of valuing these interests at the cost to the testator. *(New Zealand Institute of Chartered Accountants)*

Taxpayers who inherited shares after 1 October and when either section FC 3 or section FC 4 would have applied had the shares been tax base property should be given the benefit of being able to value the shares at cost if available. *(New Zealand Institute of Chartered Accountants)*

Comment

Officials agree that taxpayers should have the option of inheriting the shares at the cost of the person who they inherited the shares from where the taxpayer would have been able to use the cost to the testator under subpart FC (if inherited from a close family member) or section FZ 6 (inherited before inheritance rules).

We will accommodate this by only requiring the revaluation if the inheritance was at nil value, not if it was inherited at the cost to the testator.

This can be achieved by deleting section EX 67B(1)(b)(i) as submitters suggest.

Recommendation

That the submissions be accepted.

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

The only income arising on deemed disposal of these foreign shares should be the difference between the market value at the time of inheritance and the market value on the date section EX 67B applies. *(New Zealand Institute of Chartered Accountants)*

Clarification is needed regarding the time that the proposed disposal and reacquisition provisions would apply and the income tax liability that may be spread. *(Ernst & Young)*

Comment

Officials agree that if there is a revenue account gain as a result of a deemed sale under section EX 67B, the affected taxpayers should only be taxed on the difference between the market value at the time of inheritance and the market value at the time section EX 67B applies (as opposed to facing tax on the entire market value of the shares).

It will be very unlikely for a person to have a revenue account gain on inherited shares in any case, as these shares will generally be held on capital account (except perhaps if the person is a share trader). We note that the main intention of the proposal is to require persons with more than $50,000 in FIF interests (including inherited interests which may have previously not counted to towards the $50,000 de minimis) to begin to apply the FIF rules on a prospective basis.

The proposed disposal and reacquisition provisions will apply on the date the bill is enacted. The income tax liability that can be spread is most likely to be a liability that relates to revenue account gains which, as noted above, are expected to be rare. The liability to be spread will not include FIF income arising after the deemed reacquisition. Both of these points will be clarified in the *Tax information Bulletin.*

Recommendation

That the submissions be accepted.

DEFINITION AND MEASUREMENT OF ACCOUNTING PERIOD

Submissions
(Russell McVeagh, New Zealand Law Society)

An amendment should be made to the definition of "accounting period" in section YA 1 to take account of the buying and selling of interests in a FIF part way through a FIF's accounting year. Without this amendment, the active income exemption will not be available for the relevant part year in which an acquisition/disposition occurs in circumstances where, in policy terms, it should be available.

It is also not entirely clear whether the concession in relation to the quarterly measurement of income interests (section EX 26) applies when determining whether a person has a direct income interest of 10% or more at all times in an accounting period, which is required for the attributable FIF income method to be available (proposed section EX 46(3) – see clause 26(2) of the bill).

Comment

The issue outlined above is an existing feature of the CFC and FIF rules. Officials recognise that averaging a person's income interest over the entire year can lead to an inappropriate treatment in certain cases. However, attempting to correct this result would add complexity and would most likely produce other incorrect treatments and unintended consequences.

For example, changing the definition of "accounting period" as suggested could also lead to double taxation, as the same income could be attributed under two different methods for the same year. It would require taxpayers to perform complex apportionments of income and expenses to different periods within the same year.

Similarly, it would not be prudent to define a person's income interest to be the same as their highest level of ownership in the FIF that year, as this would allow investors to swap shares with each other for short periods in order to access a more favourable tax treatment.

The consequences of the current rule which averages a person's income interest are usually offset by other features of the FIF rules. For example if a person buys 30% of a FIF in the last quarter of the year they would not be able to use the active income exemption as they will only have a 7.5% income interest for that year. However, they will still effectively get an exemption as the FDR or cost methods do not attribute income in the year that a FIF interest is first acquired.

Recommendation

That the submissions be declined.

FOREIGN DIVIDEND EXEMPTION

Clauses 9 and 19

Submissions

The foreign dividend exemption should be amended to ensure that all foreign dividends from greater than 10% interests in CFCs or Australian FIFs that meet the criteria in section EX 35 remain exempt. *(PricewaterhouseCoopers, Ernst & Young)*

The intended scope of the section CW 9 dividend exemption should be clarified. *(Ernst & Young)*

Comment

In general, foreign dividends are exempt when received by a New Zealand company. However, there are exceptions to the general rule when exemptions apply. This is appropriate when some exemptions from the FIF rules apply (such as for FIFs listed on the ASX). It is not appropriate when other exemptions from the FIF rules apply (such as when the CFC rules apply or when there is a greater than 10% interest in an Australian FIF that meets the criteria in section EX 35). The complication is that both types of exemption from the FIF rules can apply to the same investment. In such cases the dividend should be exempt. Some minor changes to section CW 9 are required to achieve this result.

Recommendation

That the submissions be accepted.

OPTING OUT OF THE NZD$50,000 MINIMUM-VALUE THRESHOLD EXEMPTION, IN ORDER TO APPLY THE FOREIGN INVESTMENT FUND (FIF) RULES

Submission
(New Zealand Institute of Chartered Accountants)

The foreign investment fund (FIF) rules do not apply to natural persons with attributing interests in FIFs that are below a minimum-value threshold of $50,000. Natural persons should have the option to disregard this minimum-value threshold, and so apply the FIF rules regardless of the level of their FIF interests.

This would simplify compliance for some shareholders. For example, if a person who currently uses the FIF rules reduced their foreign portfolio holdings in a year so that the cost was less than $50,000, they could no longer use the FIF rules; instead, they would have to change the basis of taxation to use the dividend-only method.

To prevent arbitrage arising from taxpayers switching between the FIF rules and dividend-only methods, a person with less than $50,000 of attributing interests in a FIF and who chooses to file their return on the basis of the FIF rules applying, should be required to apply that same basis in each subsequent tax year. Only if the person ceases to hold attributing interests in a FIF for four complete tax years could the minimum-value threshold then apply to any future FIF interests.

Comment

The $50,000 threshold applies to smaller FIF interests because officials considered this to be simpler for smaller investors to understand. The original policy intent was to provide a balance between accuracy and simplicity for individuals with relatively small amounts invested offshore.

Officials consider that this remains the case, and that the minimum-value threshold is appropriate for many investors. However, it is agreed that if, in some cases, the minimum-value threshold instead adds to the complexity, those investors should have the ability to apply the FIF rules. This places smaller investors in the same position as all other investors with portfolios above $50,000.

Officials agree that the continuous application of FIF rules following an opt-out from the minimum-value threshold will reduce arbitrage concerns. The reinstatement of the minimum-value threshold after four years with no FIF holdings resolves concerns about future compliance and complexity.

Recommendation

That the submission be accepted.

MINIMUM-VALUE EXEMPTION FROM THE FIF RULES

Submission
(New Zealand Institute of Chartered Accountants)

The minimum-value threshold of $50,000 for attributing FIF income should be reviewed and adjusted to reflect the increase in compliance costs that will occur with the enactment of the non-portfolio FIF rules. The legislation should be amended to allow adjustment by Order in Council.

Comment

The current minimum-value threshold means that natural persons and certain family trusts with less than $50,000 worth of FIF interests do not apply the FIF rules.

We note that the proposed non-portfolio FIF reforms will mainly apply to a different set of investors: New Zealand companies with substantial shareholdings in foreign companies. Furthermore, any individual with a non-portfolio interest in a FIF is likely to have far more than $50,000 worth of FIF interests.

In other words, the reforms do not create a case for reviewing the minimum-value threshold, which affects a much larger and entirely different set of investors. As such, we do not recommend that the minimum-value threshold be increased as part of this reform package.

If a decision is made to review the minimum-value threshold, it would be appropriate to consult with the affected investors and report to Cabinet, given that increasing the threshold would involve a fiscal cost.

Recommendation

That the submission be declined.

NEW RESIDENTS' SUPERANNUATION SCHEMES

Issue: FIF exemption for interests in foreign employment-related superannuation schemes

Submission
(Russell McVeagh)

Section EX 42 of the Income Tax Act 2007 contains an exemption from attribution under the FIF rules for rights held in a foreign employment-related superannuation scheme that accrued while the taxpayer was non-resident. The exemption applies up to the end of the fourth full income year after that taxpayer became a New Zealand tax resident.

However, the current drafting in section EX 42(3) and (4) does not take into account investment gains or exchange rate fluctuations on those exempt contributions which accrued after the end of the fourth full income year.

This can result in situations where a portion of a person's foreign superannuation interest is non-attributable one year and attributable the next, even if that person has made no further contributions after the end of the fourth full income year. This does not make sense given the absence of further contributions to the scheme, and is contrary to the original policy intent.

Section EX 42(4) should be amended to provide that the opening and closing values, used to calculate the non-attributing interest in the foreign superannuation scheme, should be the market value at the current time of contributions made while non-resident or during the first four years after becoming resident.

Comment

Officials agree. The policy intent is for contributions made before becoming resident or during the first four income years after becoming resident, as well as ongoing gains and losses on those contributions, to be non-attributing FIF interests.

It is intended that a person only needs to calculate their FIF income arising from interests in a foreign superannuation scheme if they continue to make contributions after the end of the fourth full income year since becoming resident (subject to the $50,000 minimum-value threshold). If no further contributions are made after that period, the person's foreign superannuation interest will be exempt from the FIF rules.

The current formula does not currently achieve the appropriate outcome and is inconsistent with the original policy intent of the exemption. Section EX 42 should be amended in line with the submission.

Recommendation

That the submission be accepted.

ATTRIBUTABLE (PASSIVE) TELECOMMUNICATIONS INCOME

Clause 19

Submission
(Matter raised by officials)

Sections EX 20B(11)(c) and (d), relating to attributable (passive) income from telecommunications activities of a controlled foreign company, should be replaced.

Comment

Most income of a controlled foreign company (CFC) from services performed in New Zealand is attributable (that is, subject to New Zealand tax under the CFC rules). This is to prevent income that should properly be entirely within the New Zealand tax base from being diverted to an exempt offshore company.

However, a concession was made for certain telecommunications income, on the grounds that a service is unavoidably performed in New Zealand when a CFC connects calls from its country to New Zealand. This concession is currently limited to cases in which the CFC does not use its own equipment or staff, or those of an associated CFC, to perform the service in New Zealand. These limitations have caused difficulties in practice.

Officials recommend replacing the existing limitations with requirements that the person performing the service in New Zealand:

- is not the CFC; and
- is subject to New Zealand tax on income they receive for performing the service (either because they are resident here or because they earn the income through a fixed place of business in New Zealand); and
- performs the service as part of a substantial telecommunications business in New Zealand.

These requirements are intended to maintain protection of the New Zealand tax base while accommodating commercial arrangements that existed prior to the new CFC rules being enacted.

Recommendation

That the submission be accepted.

DRAFTING ISSUES

Issue: Suggestions to fix / improve the drafting of the bill

Submissions
(New Zealand Post, Ernst & Young, Russell McVeagh, PricewaterhouseCoopers)

Clause 126(30) amends the definition of "New Zealand banking group" in section YA 1. The words in brackets after "section FE 36B" should be replaced with "Identifying members of New Zealand banking group: Crown-owned, no interest apportionment" so as to align with the heading in that section. *(New Zealand Post)*

Clause 44: The reference to "derived from New Zealand" should be replaced with a reference to "has a source in New Zealand" to be consistent with clause 64 of the Taxation (GST and Remedial Matters) Act 2010. *(Ernst & Young)*

Clause 112(1): The reference to "before the paragraphs" should be to "before the formula". *(Ernst & Young)*

Clause 126(18): The reference to "GDP ratio" should be replaced with "FDP ratio". *(Ernst & Young)*

Clause 141: The amendment appears to be effected already by clause 174 of the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010. *(Ernst & Young)*

Clarification is required of the various references to situations where taxpayers "use the attributable FIF income method" and the implications of doing so. *(Ernst & Young)*

There are various references to "the CFC", "another CFC" or "CFCs" in sections EX 18 to EX 21. Clarification is needed as to how these references would apply to FIFs. *(Ernst & Young)*

References to the terms "domestic law" and "permanent establishment or fixed establishment" should be clarified. *(Ernst & Young)*

Clause 29(3): The reference to "net attributable CFC income or loss" should be replaced with a reference to "attributed CFC income or attributed CFC loss". *(Russell McVeagh)*

Clauses 19, 21, 22, 29 and 126 duplicate information and should be rationalised using a common definition of "host country". (*PricewaterhouseCoopers*)

Clause 26(6): Consequential to the repeal of section EX 46(7), the reference to that section in section EX 46(8) is no longer valid. *(PricewaterhouseCoopers)*

Clause 29: Consequential to the repeal of the branch equivalent method for FIFs, the term should be replaced with attributable FIF income method in section EX 50(5)(a). *(PricewaterhouseCoopers)*

Comment

Clarification about taxpayers who use the attributable FIF income method

Some sections such as the thin capitalisation rules apply to taxpayers with CFCs or taxpayers who use the attributable FIF income method. The submission suggests it is unclear whether a person uses the attributable FIF income method when the FIF passes the active business test as in this case no income is attributed. The policy intention is that these sections should apply when a FIF passes the active business test as well as when a taxpayer attributes income under the attributable FIF income method. Officials agree that this issue should be clarified by changing the reference to something more explicit such as taxpayers who apply section EX 50 (attributable FIF income method), as section EX 50 applies even if taxpayers have FIFs that satisfy the active business test.

Various references to "the CFC", "another CFC" or "CFCs" in sections EX 18 to EX 21

When a taxpayer applies the attributable FIF income method in section EX 50, they effectively apply the CFC rules (with certain modifications), as if the FIF were a CFC. This means that references to the "CFC" in sections EX 18 to EX 21, should be read as references to the FIF for which the taxpayer is applying section EX 50. In these cases there is no need to change the legislation (as it already achieves the desired result) but the references and how they should apply will be noted in the *Tax Information Bulletin.* The references to "another CFC" and "CFCs" will require legislative amendments as in many cases these references should also apply to "another FIF for which the person applies section EX 50" or "FIFs for which the person applies section EX 50".

Reference to section FE 36B

The words in parentheses apply to both sections FE 36 and FE 36B, and both of those sections identify members of a New Zealand banking group. We therefore consider that the words "which identify the members of a New Zealand banking group" are appropriate.

Domestic law, permanent establishment and fixed establishment

The terms "domestic law" and "permanent establishment" are not explicitly defined.

However, "permanent establishment" is a term that has been the subject of extensive legal interpretation in the context of double tax agreements, which is where the term is relevant (see, for example, clause 22(14)).

The term "fixed establishment" is already defined in section YA 1 of the Income Tax Act 2007.

There may be some uncertainty about the application of the words "under an agreement" to fixed establishments. It is intended that they apply only to the words "permanent establishment". We recommend this be clarified.

"Domestic law" is intended to be given its ordinary meaning; it would therefore include tax law but also non-tax law. This could be useful, for example, in cases when there is no specific tax law relating to residence, and could also discourage the use of dual-resident entities. No change is required to the existing wording to achieve this effect.

Clause 141

This is a correction to an incorrect application date in another bill. We will make a further minor change to ensure the old application date does not persist.

Duplicated provisions

Clauses 19, 21, 22, 29 and 126 do duplicate information about the relationship between a CFC or FIF and a company or territory. We agree the duplication should be reduced, though not specifically by defining "host country" as suggested by the submitter. Clause 29 is different from the others because it refers to the relationship between a FIF, rather than a CFC, and the country or territory.

Other submissions

Officials agree with the other submissions.

Recommendation

That the submissions be accepted, subject to officials' comments.

Issue: Ordering and structure of the CFC and FIF rules

Submission
(PricewaterhouseCoopers, Ernst & Young)

The whole of the CFC and FIF rules should be rewritten and restructured into portfolio and non-portfolio sections.

Comment

Officials agree that as a result of reforms in 2007, 2009 and in this bill, the structure of existing CFC and FIF rules may not be ideal.

Any restructuring of the provisions would be a complex exercise which would be likely to require several rounds of consultation. It is therefore not practical to include the restructuring as part of this bill.

However, a rewrite of these provisions may be considered for inclusion as part of a future tax policy work programme.

Recommendation

That the submission be noted.

Issue: Structure of the CFC and FIF rules

Submissions
(Corporate Taxpayers Group, Ernst & Young)

The new non-portfolio FIF rules plug into the existing CFC rules. A simpler and cleaner drafting option could be to have a separate stand-alone section for FIFs.

There should be a clear provision for a "non-attributing active FIF" category, and a clear distinction between determining that status and using a method to calculate any attributable FIF income or loss.

Comment

The drafting of the new non-portfolio FIF rules is based on the existing provisions for the branch equivalent method. This has some advantages as it minimises the legislative change and means that the legislation highlights the few areas where non-portfolio FIFs are treated differently to CFCs.

However, as submitters have pointed out it also means that taxpayers need to refer to both the CFC and FIF rules when applying the new non-portfolio FIF rules.

A rewrite exercise may be desirable in future, but is not practical at this time.

Recommendation

That the submission be noted.

TAXATION OF FOREIGN INVESTMENT IN NEW ZEALAND

Submission
(Green Party Member)

The bill should increase taxation on all properties owned by non-resident, or non-New Zealand citizens and increase GST on all earnings by those property owners, from that land.

Comment

The requested tax changes are both fundamental and outside the scope of the proposals in this bill.

Recommendation

That the submission be declined.

Appendix

AUSTRALIAN FIF REFORMS

Australia has released draft legislation to replace its FIF rules with a special anti-avoidance rule that targets "roll-up" funds (offshore funds that do not distribute income back to investors). The anti-avoidance rule is likely to apply in very limited circumstances. Specifically, it only applies to debt-like investments and only when profits are retained abroad rather than distributed to Australian investors.

Under the Australian plans there will be a significant difference in tax treatment depending on whether the Australian investor is a portfolio investor, a non-portfolio investor or has control of the foreign company. By contrast, the New Zealand approach is to provide overall consistency of treatment by providing similar options for attribution across the various tranches.

	NEW ZEALAND	**AUSTRALIA**
Portfolio FIF	**FDR** is main attribution method No tax on dividends or capital gains	No tax on attribution (unless a roll-up fund) **Tax dividends and capital gains**
Non-portfolio FIF	Either: Attribute **passive income** (if more than 5% passive income); OR Use **FDR**, Cost etc.	**No tax** on attribution (unless a roll-up fund)
CFC (in Aus will include joint ventures)	Attribute **passive income** (if more than 5% passive income)	Attribute **passive income** (if more than 5% passive income)

In the case of portfolio investment the Australian investor is taxed on dividends and any capital gains from sale. This is broadly equivalent to the New Zealand approach of applying the fair dividend rate (FDR) method. Accordingly, no major difference between the two countries arises.

Similarly, in cases when the Australian investor has control, the Australian approach broadly lines up with the New Zealand approach. That is, passive income will be attributed unless the foreign company passes an active business test.

The main difference relates to the treatment of non-portfolio FIFs. In cases when an Australian investor does not control the foreign company, no foreign income is attributed, regardless of whether the income is active or passive. Under the Australian approach no tax liability will arise except in very limited circumstances. By contrast, the New Zealand approach will be to allow investors to use either the active income exemption or FDR.

We think the Australian approach is likely to be unsuitable in New Zealand (where, for example, there is no general capital gains tax).

First, there are fiscal risks associated with this approach. It would allow non-controlling investors to shelter or defer tax on domestic-sourced income by shifting it into an offshore company. For example, under this approach a New Zealand investor could invest alongside foreign investors who had similar incentives to shift passive income into a tax-efficient arrangement.

Second, the approach creates disparity in tax treatment between situations where an investor has control and situations where the investor's interest falls short of control. This puts pressure on the design of the control test. It also provides preferential treatment for investors who may have effective control in commercial terms but don't meet the tax control test.

Finally the approach might distort commercial decisions by providing an incentive to invest offshore as opposed to in the domestic economy. The objective of the New Zealand reforms is to reduce tax barriers to New Zealand businesses expanding offshore. This is not the same as explicitly encouraging foreign investment.