Tax Working Group Public Submissions Information Release

Release Document

February 2019

taxworkingroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

30 November 2018

Michael Cullen, KNZM
Chair, Tax Working Group

FROM: Graeme Olding
[1]

PARTNER: Graeme Olding
REF: 100219915/6703323.8

CHAPMAN TRIPP SUBMISSION: TAXATION OF CAPITAL GAINS AND CONTROLLED FOREIGN COMPANIES

1 We are writing to submit on the Tax Working Group's (*TWG*) proposals in response to the potential New Zealand (*NZ*) taxation of capital gains as income in relation to controlled foreign companies (*CFCs*) and to raise issues with how the financial arrangement rules interact with the CFC rules. We are raising these issues with a particular focus on when the ultimate owner is a high net worth individual rather than a corporation. The current rules work better from the perspective of a corporation than for an individual with a CFC holding, even if that NZ individual owns the CFC through a NZ corporation.

Submission: NZ should not implement a capital gains tax on CFCs or shares in CFCs

2 In our view, if NZ were to tax capital gains as income under proposed amendments to the Income Tax Act 2007, NZ tax resident shareholders should not be taxed on:

2.1 capital gains derived by the shareholder on the disposal of shares in that CFC; and

2.2 capital gains of the CFC – i.e. the capital gain should not be attributed to the shareholder as attributed foreign income.

TWG interim report: CFC related capital gains

3 We understand from the TWG's interim report that the TWG is considering:

3.1 to generally tax NZ resident shareholders on their capital gains arising on the disposal of shares, including the disposal of shares in a CFC;[1] and

3.2 taxing capital gains derived by a CFC as attributed foreign income to the extent the gain is derived from non-active assets or a non-active business (i.e. the question of whether capital gains derived by a CFC should be attributed income is to be determined by the nature of the income produced by the asset being disposed of, or by the nature of the CFC's business).

[1] We understand that the current proposal is that if a NZ resident company sells the shares in a CFC the gain on sale should not be subject to tax to the extent that the CFC is deriving active income. However, the gain is still effectively taxed when the New Zealand resident company makes a distribution to its shareholders or if its shareholders dispose of their shares.

4 We consider that this approach should not be adopted for the reasons given below. We note that the CFC position is different to the position of a portfolio investor in a FIF. The taxation regime for FIFs is more favourable for most situations for a taxpayer that is an individual compared to the CFC rules. In fact, the FIF fair dividend rate rules seem to factor in that there is already a tax burden on the business overseas (see our comments on this at Appendix 1).

Most CFCs are already subject to a comprehensive capital gains tax in their own jurisdictions

5 Most jurisdictions already have a comprehensive capital gains tax. This means that capital gains derived by a CFC are already likely to be subject to tax in the foreign jurisdiction in which the CFC is resident or the jurisdiction where the relevant asset is held. As such, NZ should not seek to tax foreign capital gains of a CFC by including the gain within attributed income of the CFC. The key focus in this area is the potential economic double taxation that may arise as a result of NZ seeking to tax capital gains that are already subject to tax.

6 Double taxation presents a high risk to NZ's reputation as being a favourable country for business innovation, investment and growth. This risk is increased by the fact that high net worth individuals and their investments are mobile. Getting these rules wrong will be a barrier to high net worth individuals moving to or residing in NZ. The CFC rules are already overly complicated with a number of fixes required (see Appendix 2 for examples).

7 High net worth individuals from overseas will frequently have extensive CFC investments. These have been structured with the rules of the home jurisdiction in mind. Once they arrive in NZ, the overseas rules may make it very difficult to restructure to mesh well with the NZ rules. As a result, the new immigrant could easily find themselves facing double tax if they stay past their transitional period. This is alleviated by having no capital gains tax applying to their CFC investments. It is compounded with a CFC capital gains tax.

Proposed rules lead to double taxation

8 Capital gains derived by a shareholder on the disposal of shares in a CFC that is "land rich" (i.e. the CFC holds a sufficient level of land in its home jurisdiction) are likely to be taxable in the CFC's jurisdiction. As such, double taxation may arise (in the absence of NZ foreign tax credits) with associated complexity and integrity issues also arising.

9 Fundamentally foreign shares represent assets that reside in other jurisdictions and an underlying capital gains tax represents a tax on those balance sheets. A capital gains tax on assets sales (giving rise to attributed income) and again on the disposal of shares by a shareholder is likely to give rise to double taxation issues. This issue, coupled with the foreign jurisdiction also seeking to tax the same income shows how further work is required in respect of the application of a tax on capital gains to CFCs.

10 For example, the current proposals are likely to lead to distorted economic behaviour, such as selling off assets in order to reduce the value of a CFC's shares and the amount of double taxation. In this case, the NZ shareholder should receive a

foreign tax credit for taxes paid in the foreign jurisdiction to credit against tax payable on attributable income. Assuming no difference in tax rates, NZ does not raise any tax revenue but has forced an uneconomic decision to be made.

Proposed rules will need to align with overseas jurisdictions

11 If NZ did seek to tax a CFC's foreign capital gain, NZ's foreign tax credit rules will need to be extended to ensure there is no double taxation where such a gain is already subject to foreign tax. There is likely to be further complexities when the recognition and timing of income derivation between New Zealand and offshore jurisdictions are different. For example, where the offshore jurisdiction allows for roll-over relief in circumstances that NZ does not. As noted in Appendix 1, there may be valuation challenges related to the effective date of any capital gains tax.

Level of complexity is too high

12 The taxation of CFCs is a complex area and TWG's deadline of drafting legislation within 12 months does not provide enough time to adequately consider the existing and proposed rules in order to produce workable legislation. For example, the active/passive income distinction is flawed and without addressing these flaws, the proposed test for determining when a capital gain of a CFC should be included as attributable income should not proceed.

13 Applying the proposed rules is likely to lead to more complications and compliance issues due to the requirement to evaluate the nature of the asset and/or the nature of the CFC's business. The CFC rules are already overly complicated in a number of areas and adding extra levels of complexity should be avoided where possible.

14 We have included in Appendix 3 to this submission examples that show that the passive/active distinction is flawed.

Chapman Tripp's suggested approach

15 Our main submission (as outlined at paragraphs 2.1 and 2.2) is that there should be no tax on CFC capital gains or capital gains on shares in CFCs.

16 If officials are worried about avoidance concerns, due to people investing in non-resident companies investing back into NZ, a NZ reinvestment limit could be introduced, whereby capital gains of a CFC are taxed if over a certain threshold of the CFC's assets are in NZ.

Alternative approach

17 Alternatively, if the TWG does not accept our submissions at paragraphs 2.1 and 2.2, then we submit that the TWG should consider implementing a jurisdictional black list (containing countries that do not have a comprehensive capital gains tax), such that where a CFC is listed in a black list country:

17.1 any capital gains of that CFC should be subject to NZ tax (i.e. the capital gain should be included as attributed foreign income under NZ's CFC rules); and

17.2 any capital gain derived by a NZ tax resident shareholder on the disposal of that CFC's shares should be subject to NZ tax, albeit there has to be a mechanism to credit tax already paid on the attributed amount.

CFC capital gains should not be included in attributable income

18 If none of our submissions are accepted by the TWG, at a bare minimum, we suggest that capital gains of a CFC should not be included as attributable foreign income.

Chapman Tripp's comments on problems with how the financial arrangement rules interact with the CFC rules

19 The spreading methods for foreign denominated financial arrangements are extremely burdensome and costly to apply.

20 For example, the calculations that are required under Determination G9C: Financial arrangements that are denominated in a currency other than New Zealand dollars: an expected value approach (*G9C*) are extensive and complex. From a compliance cost perspective, a NZ resident has a strong disincentive to enter into any foreign denominated financial arrangement.

21 However, under section EX 21(7), CFCs with significant financial arrangements are forced into dealing with the spreading methods for foreign denominated financial arrangements (such as G9C). Not only is this costly, the result may be that the CFC is treated as failing the active business test.

22 There should be a functional currency test that should allow a CFC to do all of its calculations in its functional currency in order to prevent the recognition of foreign currency gains and losses that do not actually materialise.

23 We would be pleased to discuss these issues in more detail at the appropriate time.

Yours faithfully

[1]

Graeme Olding
PARTNER

[1]

APPENDIX 1:
COMMENTS ON A CAPITAL GAINS TAX

1 We understand that the interim report was intended to provide a high level summary rather than a detailed discussion on how a capital gains tax may apply to CFCs, but caution ought to be taken not to oversimplify the issue of applying a capital gains tax to a tiered ownership structure (*Tiered Structure*). A common example of a Tiered Structure is where an individual owns shares in a corporation that owns shares in another corporation, which owns an operating business.

2 The interim report seems to overlook the fact that the value of the shares at the top of the chain will often be lower reflecting the fact there is underlying tax further down the chain. Therefore, the individual owning the shares in the top company already bears some of the cost of any underlying capital gains tax that may apply to the operating company at the bottom of the chain, even if there is no direct tax paid by the individual on the sale of the shares in the top company.

3 The interim report appears to view matters strictly from the perspective of what tax a particular taxpayer has paid, as opposed to how much tax an event, such as the sale of property at the bottom of the ownership chain, has generated. The extent to which the underlying tax is reflected in the valuation will vary considerably in different fact situations.

4 Taxing the ownership of equity in a Tiered Structure can lead to complexities and if the right mechanisms are not in place there will be problems, with potentially nonsensical and punitive results. These complexities will invariably lead to issues developing between taxpayers and the Inland Revenue Department, as taxpayers seek to avoid economic double taxation. This outcome should be avoided, and the design of any capital gains tax needs to take a responsible approach to protecting New Zealand's reputation for its ease of doing business, which includes not having overly burdensome and complex tax rules.

5 Within a domestic setting, it may be that the imputation system will go a long way to resolving most if not all of the problems of Tiered Structures, assuming tax is only charged at the bottom level where the underlying asset is owned.

6 However, the issues are more difficult and nuanced with a Tiered Structure in relation to CFCs. As you will be aware, a New Zealand corporate holding an interest in a CFC will, generally, receives tax free dividends from its CFC, and pays no capital gains tax on its shares in the CFC. In effect, a corporate shareholder in a CFC is relived from any tax cash liability – reflecting in part the underlying tax liability that arises in the foreign jurisdiction where the CFC operates.

7 The same is not true for an individual who owns CFCs. The Tiered Structure means two levels of tax are involved, being tax in the foreign jurisdiction and the proposed capital gains tax on any disposal by the New Zealand shareholder of the shares in the CFC.

8 Furthermore, there are real difficulties in ensuring that capital gains or losses that arise offshore and within a Tiered Structure prior to the enactment of a capital gains tax are not incorrectly ignored on the subsequent sale or liquidation of the Tiered Structure after enactment.

9 Under our current rules for determining the ability of a company to return tax-free proceeds to shareholders on liquidation, the totality of historical gains and losses are considered. This will give rise to inappropriate outcomes in situations where a capital gains tax is intended to be imposed only on gains accruing after enactment.

10 In short, for any amount that a taxpayer is entitled to recover tax free prior to the valuation date, there must be a way for them to collect the same amount free from tax after the enactment of a capital gains tax. For instance, if prior to the valuation date, a shareholder was distributed capital gain proceeds derived by a CFC in some taxable manner, such as a dividend with no imputation credits (and paid NZ tax on the dividend), then in principle any loss on the capital proceeds of their investment in the CFC should be able to be offset against the tax on the dividend. This is an example of how a capital gains tax in the context of CFCs can create unintended tax liabilities for taxpayers.

11 Finally, where capital gains tax could be attributable from a CFC, there will need to be a valuation undertaken of the CFC's assets as at the effective date. This is impractical in the best of circumstances but may be impossible as well. For example, the CFC interest could well be acquired considerably after the date a capital gains tax becomes effective, but the CFC could have owned the assets from before the valuation date, but had no reason to do a valuation on the effective date.

APPENDIX 2
CURRENT EXAMPLES OF COMPLEXITIES/FLAWS IN THE CFC RULES

1 If a CFC does not have audited statements it frequently has to apply NZ rules to its overseas accounts for NZ purposes. This can be very complicated and expensive. And it seems to serve little purpose, since there is already a big disincentive, in the form of double taxation, to have any attributable income in a CFC in a jurisdiction subject to a full income tax regime.

2 Any attempt to work through the debt allocation rules in relation to complicated CFC holdings can be very difficult and subjective, with potentially significant negative consequences if the 5% test is failed.

3 An interest in a CFC in one country, which has an interest in a FIF or a CFC (in either another country or in the same country but that can't be part of the group) can create double tax in some circumstances, such as deductible dividends paid up through a chain of ownership.

4 Trying to apply debt forgiveness rules to an insolvent CFC and attribute the debt forgiveness rules up to its NZ owner is punitive. The owner of the CFC likely has no economic gain. The attribution of debt forgiveness is an oversight but it does show how complicated rules can easily have major flaws (there are others) that take years, in the best case, to identify and resolve.

5 In summary, the CFC rules are so complicated for individuals with extensive holdings that it is not only very difficult and expensive to comply with the rules, it is also hard to get the professional help needed as there are a limited number of qualified people.

APPENDIX 3
EXAMPLE REASONS WHY PASSIVE/ACTIVE TEST IS NOT A GOOD BASIS FOR DETERMINING WHETHER A CAPITAL GAIN AT A CFC SHOULD BE ATTRIBUTED

1 In this appendix we have included examples that show how the CFC rules (in particular the active/passive distinction) sometimes do not work as intended and should not be used as a reliable distinction for when a capital gain derived by a CFC should be included as attributable foreign income.

Example 1 – financial arrangements over $1m

2 Where the total value of financial arrangements to which a CFC is a party is more than $1,000,000 at any time during the relevant accounting period, generally it will be required to calculate the part of the attributable CFC amount and net attributable CFC income or loss arising from financial arrangements in NZ currency.[2]

3 A CFC that only holds financial arrangements denominated in its own functional currency will not have foreign exchange gains or losses. However, for the purposes of the CFC rules, foreign exchange income (i.e. passive income) may arise as a result of converting an amount of interest or principal into NZ dollars. As a result of applying NZ's CFC rules, the CFC may be classified as passive (i.e. failing the active business test).

4 The CFC rules should allow for calculations to be done in the CFC's functional currency regardless of whether it has audited statements to prevent unprincipled outcomes.

Example 2 – start-up companies

5 Start-up companies may be deemed to be passive/active based on their current income streams but the income of the company (including minimal interest income and perhaps foreign exchange gain, but no revenue as it is developing its products and there is a long development period) may not truly represent the nature of the CFC's business, but is rather a result of a certain phase of the CFC's business cycle. If the CFC's only income is from a financial arrangement, then the CFC can't qualify as active.

---

[2] Section EX 21(7).