

Regulatory Impact Statement

Insurance businesses and the controlled foreign company rules

Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to address the concern raised by tax practitioners in relation to the controlled foreign company (CFC) rules and the ability for insurance companies to qualify for the active income exemption in relation to their offshore insurance businesses.

The concern relates to the inability of new offshore active insurance companies acquired or established by New Zealand resident insurers after 30 June 2009 to pass the active business test in the CFC rules and their preference for specific active business test rules for insurance companies. However, those who expressed concern acknowledged that owing to competing priorities on the Government's tax policy work programme and limited policy resources, a short term fix would be better than the status quo.

The preferred option is that a short term fix should be implemented so that overseas active insurance businesses acquired or established after 30 June 2009 are accorded the same treatment under the CFC rules as those acquired or established before 30 June 2009.

The problem to be addressed is relevant only to a small number of taxpayers, namely, licensed insurers who are required to have financial strength ratings and have interests in active offshore insurance businesses. We are unable to estimate the number of insurers that may set up active insurance businesses in other jurisdictions in the future, so the analysis in this RIS is based on the New Zealand-based insurance companies that are currently attributing income under the CFC rules and the CFC disclosure data indicates that the CFC income relates to an insurance business. This is a very small subset of the number of licensed insurers, but we have discussed this problem with tax practitioners that represent some of these companies.

Owing to time constraints, we did not consult more widely, for example, by way of an officials' issues paper. However, the tax practitioners we did consult represent the majority of those affected.

None of the policy options would impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.



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STATUS QUO AND PROBLEM DEFINITION

Controlled foreign company (CFC) rules

1. New Zealand's international tax rules provide a framework for taxing non-residents who earn New Zealand income and New Zealand residents who earn foreign income. The CFC and foreign investment fund (FIF) regimes apply to New Zealand residents investing in foreign companies; the CFC regime applies when the foreign company is effectively controlled by New Zealand residents, and the FIF regime applies when it is controlled by non-residents. These regimes attribute overseas income arising from CFCs and FIFs back to the New Zealand shareholder, even if no distributions (for example, a payment of a dividend) are made to the shareholder.
2. Before 2009, taxpayers did not have to return attributed income in respect of their interest in a CFC if the CFC was resident in a "grey list" country. The grey list comprised eight countries that were thought to have broadly comparable tax systems to our own. Income earned in a grey list country was exempt and income earned in other countries was subject to tax.
3. Following extensive public consultation, the Government passed legislation to reform the international tax rules in 2009. The main changes to the CFC regime included the repeal of the grey list and the introduction of an "active business test". Under the active business test, if less than 5 percent of the CFC's gross income is passive income, the active business test is passed and no income is attributed to the New Zealand shareholder. If the test is failed, only the passive income (such as, highly mobile income such as interest, rent or royalties) is attributed to the shareholder.
4. The purpose of the active business test is to reduce tax and compliance costs associated with calculating and attributing small amounts of passive income and to ensure that New Zealand businesses that expand offshore by operating subsidiaries in foreign countries can compete on an even footing with foreign competitors operating in the same country. This means, for example, that a New Zealand-owned manufacturing plant in China would generally face the same tax rate as other manufacturers operating in China.
5. Owing to the complexity of the rules, on-going maintenance is required to ensure that they continue to work as intended. Since 2009, the Government has enacted a number of remedial changes to ensure that the policy intent of the reform continues to be met. This regulatory impact statement (RIS) considers the most recent issue that has been raised in discussions between officials and tax practitioners who have experience with both the CFC rules and insurance businesses.
6. In short, the issue concerns the treatment of insurance income as passive income under the CFC rules. While this is a necessary feature to protect the integrity of the CFC rules and the active business test, it means that New Zealand insurance companies with active offshore insurance businesses are required to attribute this income under the CFC rules unless they have applied for and are issued a determination by the Commissioner of Inland Revenue ("the Commissioner") that deems the CFC to have passed the active business test. However, this determination is only available if the CFC was controlled by a New Zealand insurance company and carried out an insurance business in its country of residence before 30 June 2009.

Insurance companies

7. Under the CFC rules, income from insurance is considered to be passive income and therefore must be attributed to the New Zealand shareholder. As a result, New Zealand insurance companies with foreign subsidiaries operating active insurance businesses in foreign markets do not pass the active business test and are required to attribute income back to New Zealand under the CFC rules.

8. Initially, the Government did not intend to introduce special rules for financial institutions (including insurance companies) as it did not believe that there were CFCs that would use them. However, consultation revealed that there were at least some insurance companies that would.

9. Because of a number of constraints, including the complexity of the issues involved in drafting special rules for financial institutions (including insurance companies), it was not possible to do so at the same time the active income exemption was introduced.

10. As a result, a transitional measure was introduced which allows the Commissioner to issue a determination under section 91AAQ of the Tax Administration Act 1994. This measure allows a New Zealand insurance company to pass the active business test in relation to an offshore active insurance business if it can demonstrate that the offshore insurance business is an active business. The determination facility was not made available for other types of financial institutions because the boundary between active and passive income is less apparent.

11. One of the requirements that must be met for the Commissioner to be able to issue a determination is that before 30 June 2009, the offshore insurance business must have been controlled by a New Zealand resident and it must have operated a business of insurance in its country of residence. This date requirement was deemed necessary as the determination facility was only intended to be a transitional measure until further work could be completed on extending the active business test to financial institutions more generally.

12. The financial institution work was due to be taken forward in the second phase of the international tax review, alongside the work on non-portfolio FIFs¹, and offshore branches. Legislation for the extension of the active income exemption for non-portfolio FIFs was enacted in 2012 and work on the application of the active business test to financial institutions would have followed the work on offshore branches, but other priorities took precedent.

13. The problem with the 30 June 2009 requirement is that as the date becomes more historical, more CFCs that are active insurance businesses are unable to qualify for the active business test determination. It creates an uneven playing field between active offshore insurance businesses that were in existence prior to 30 June 2009 and those established since then. Insurance companies looking to expand offshore face greater tax and compliance costs than those faced by competitors with already-established operations.

14. This runs counter to the purpose of the active business test, which is to reduce tax and compliance costs associated with calculating and attributing passive income and to ensure that New Zealand businesses (in this case insurance businesses) that expand into offshore markets

¹ A non-portfolio FIF is a FIF where the shareholder's ownership interest is more than 10% but less than 50%.

through foreign subsidiaries can compete on an even footing with competitors (including New Zealand insurers with pre-existing operations) operating in the same country.

Scale of the problem

15. The scale of the problem is very small, as it only affects New Zealand licensed insurance companies that are required to have a current financial strength rating given by an approved rating agency who also happen to have an income interest in an active insurance business overseas. Further, the problem of not being eligible for the active business test determination is relevant only to those with offshore active insurance subsidiaries acquired or established after 30 June 2009.

16. According to public information on the financial strength ratings of licensed insurers from the Reserve Bank of New Zealand, there are approximately 75 licensed insurers that have a current financial strength rating; some of these insurers will be solely focused on the New Zealand market and will not have offshore operations. It is unknown how many of these purely domestic insurance companies will look to expand offshore in the future.

17. We are aware that only a very small number of these licensed insurers with financial strength ratings are currently attributing income under the CFC rules. Of these we estimate that only some of them would be eligible for an active business test determination under section 91AAQ, if it were not for the 30 June 2009 ownership requirement. The reason for this is that not all CFCs owned by New Zealand insurers are active insurance businesses and so income is being attributed in line with the policy intent of the active business test.

18. Overall, the amount of New Zealand tax at stake is also likely to be very small, because under the CFC rules, the taxpayer is provided a foreign tax credit for income tax paid overseas in relation to the CFC income against their New Zealand income tax liability. If the foreign tax credit exceeds or is equal to the New Zealand income tax liability, there is no tax to pay.

19. However, owing to confidentiality concerns we are unable to publicly state the number of insurance companies affected by the problem.

OBJECTIVES

20. The **main objective** is to ensure the CFC rules result in the correct amount of income being attributed to a New Zealand taxpayer who has an income interest in a non-resident company. In particular, this means ensuring that income from an active business is not required to be attributed under the CFC rules. The underlying policy intent of the active business test is to minimise tax and compliance costs associated with attributing income under the CFC rules, so that New Zealand businesses operating in offshore markets through foreign subsidiaries can compete on an even footing with competitors.

21. All options are assessed against the status quo in relation to the main objective and the following criteria:

- (a) **Fairness and equity:** to support fairness in the tax system, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.

(b) **Efficiency of compliance and administration:** the compliance cost impacts on taxpayers and the administrative costs to Inland Revenue should be minimised as far as possible.

22. Although both criteria are important, the fairness and equity criterion is more important than the efficiency of compliance and administration, for small movements in the latter.

23. In addition, the options must be considered against constraints on the time and resources available to the Government. These constraints form part of the trade-offs when evaluating the available options.

REGULATORY IMPACT ANALYSIS

24. Officials have identified three options to address the problem:

- Option 1: the status quo
- Option 2: remove the 30 June 2009 requirement from the determination provision
- Option 3: introduce rules that extend the active business test to financial institutions, including insurance companies.

25. There are no social, environmental or cultural impacts associated with any of the identified options.

Option 1

26. This option would maintain the status quo. CFCs that were controlled by a New Zealand resident and operating an insurance business in their country of residence before 30 June 2009 would continue to be eligible for a determination, but no offshore insurance businesses that commenced or were purchased by a New Zealand resident after this date would be eligible to apply.

Assessment against objective and criteria – option 1

27. The status quo does not meet the main objective because the CFC rules (and in particular, the active business test) do not apply equally to New Zealand-resident insurance companies with interests in offshore insurance businesses. The active business test does not apply to some insurance businesses solely because of when they were acquired or established rather than whether or not they are actually active businesses. This results in some New Zealand residents with an insurance business CFC having attributed foreign income while others do not.

28. This option is not fair and equitable as it creates an uneven playing field between two otherwise identical insurance businesses where the only difference is when the two businesses were acquired. In the most extreme case, one day could be the difference between being eligible for an active business test determination and being required to calculate, attribute, and pay New Zealand tax on CFC income.

29. This option does not minimise compliance impacts on taxpayers nor administrative costs borne by Inland Revenue. This is because this option imposes significant compliance costs on active insurance businesses simply because they were acquired or established after 30

June 2009, but there are also administrative costs in considering determination applications for those that were acquired or established before 30 June 2009.

Option 2

30. This option would retain the ability for insurance companies to apply for an active business test determination in relation to an offshore active insurance CFC under section 91AAQ, but would remove the requirement that the active insurance business must be owned by a New Zealand resident before 30 June 2009.

Assessment against objective and criteria – option 2

31. This option meets the main objective because the CFC rules would apply equally to New Zealand-resident insurance companies with interests in offshore insurance companies, as long as they meet the requirements for being an active insurance business. This means that active insurance businesses would be able to pass the active business test and would not be required to attribute income under the CFC rules, which conceptually is the correct result under the CFC rules.

32. In terms of fairness and equity, this option is an improvement on the status quo because New Zealand insurers that control offshore active insurance companies would be able to pass the active business test (by applying for a determination) regardless of when those offshore insurance companies were acquired or established. This creates a level playing field in terms of compliance costs and tax costs for New Zealand licensed insurers with active insurance subsidiaries overseas. It also creates a more level playing field for those with active insurance businesses when compared with more generic active businesses.

33. Regarding the efficiency of compliance and administration, this option is an improvement on the status quo because it reduces the compliance costs faced by active insurance businesses. Although there are some additional administrative costs involved in considering an application for an active business test determination, officials consider that these are outweighed by the compliance cost benefits. This is because a determination is able to be issued for more than one income year at a time and Inland Revenue already has the necessary processes in place to issue these determinations, so would be able to capitalise on existing knowledge required to consider applications.

34. Overall, this option represents an improvement on the status quo. Although this option is not necessarily a larger improvement on the status quo than option 3 it is still an improvement over the status quo and can be executed in the light of current resource constraints. Furthermore, implementing option 2 would not prevent option 3 from being considered or implemented at a later date if it is found to be necessary and resource constraints permit.

Option 3

35. This option would introduce specific rules for financial institutions (including insurance companies) to enable them to pass the active business test when their CFCs are engaged in an active business. This option would require the significant use of resources to design effective rules that are able to distinguish between active income and passive income for financial institutions, which is inherently more difficult than for other types of businesses. In addition,

the determination facility in section 91AAQ would no longer be required, so would be removed altogether under this option.

Assessment against objective and criteria – option 3

36. This option meets the main objective because it would enable the CFC rules to correctly attribute income to the New Zealand shareholder when the CFC is an active insurance company or another type of financial institution.

37. This option is a significant improvement on the status quo in terms of fairness and equity. Like option 2, New Zealand insurers with interests in offshore active insurance companies would be able to pass the active business test regardless of when those offshore insurance companies were acquired. This creates a level playing field in terms of compliance costs and tax costs borne between New Zealand licensed insurers with active insurance subsidiaries overseas. Option 3 is also an improvement on the status quo for other types of financial institutions with active offshore businesses, as it would no longer matter what type of business the active business is to determine whether income needs to be attributed under the CFC rules.

38. Regarding the efficiency of compliance and administration, the effect of this option is mixed and overall, it is a slight improvement on the status quo. In terms of administration costs, while it would remove the need for Inland Revenue to issue determinations, designing active business test rules for financial institutions would be a complex undertaking and would require a significant use of resources. Specific active business test rules for financial institutions would naturally be complex, which means that taxpayers would incur compliance costs in complying with them and these compliance costs might not be substantially less than under the status quo.

39. Although overall this option might be an improvement on the status quo, it is not considered desirable at this time. It would meet the main objective and would be an improvement over the status quo in most criteria, but it would also require significant resources to develop a comprehensive package of amendments to accurately identify the boundary between passive and active income in relation to insurance companies and other financial institutions. This option would take much longer to progress than option 2. In addition to option 3 being a very complex undertaking, we believe it would impact very few taxpayers beyond the small number of insurance companies identified for the purposes of option 2. The tax policy work programme is set by the Government with reference to the Government's priorities. Given other work already scheduled on the Government's tax policy work programme and limited policy resources, trade-offs would need to be made to progress option 3.

CONSULTATION

40. The problem analysed in this RIS was independently raised by some tax practitioners. These tax practitioners have experience with the CFC rules and how they apply to insurance companies.

41. In general, these tax practitioners noted that option 3 would be the preferred and more sustainable solution in the longer term, but also agreed that at least in the interim, option 2 would be preferable to the status quo. They understood that competing priorities and limited resources mean option 3 is not a feasible option in the short term in the same way that option 2 is.

42. Owing to time constraints, no wider consultation was undertaken, for example, in the form of an officials' issues paper.

43. Only a very small number of these licensed insurers with financial strength ratings are currently attributing income under the CFC rules and we estimate that only some of these would be eligible for an active business test determination if it were not for the 30 June 2009 ownership requirement. Based on the taxpayers we were able to identify in this exercise, we believe the tax practitioners we consulted represent the majority of those most affected by the problem analysed in this RIS.

CONCLUSIONS AND RECOMMENDATIONS

44. The table below summarises our analysis of the options. Within this table the following symbols are used:

- ✓✓ Significantly better than the status quo
- ✓ Better than the status quo
- × No better than the status quo
- ×× Worse than the status quo

Options	Analysis against the objective and criteria
Option 1: status quo	<p>Does not meet the main objective</p> <p>Fairness & equity: ×</p> <p>Compliance and administration: ×</p> <p>Overall comment: Does not meet the main objective or criteria</p>
Option 2: remove 30 June 2009 requirement	<p>Meets the main objective</p> <p>Fairness & equity: ✓</p> <p>Compliance and administration: ✓</p> <p>Overall comment: Improvement on the status quo</p>
Option 3: introduce an active business test that is specific to financial institutions	<p>Meets the main objective</p> <p>Fairness & equity: ✓✓</p> <p>Compliance and administration: ✓</p> <p>Overall comment: Improvement on the status quo, but not feasible in the short to medium term owing to limited resources and competing priorities on the Government's tax policy work programme.</p>

45. Inland Revenue prefers option 2 which is to remove the 30 June 2009 ownership requirement from the active business test determination provision for the following reasons:

- It achieves the main objective to make the CFC rules apply on a consistent basis and, in particular, to ensure that active insurance businesses are able to pass the active business test.
- Competing priorities mean that there is insufficient space on the Government's tax policy work programme to implement option 3 at this time. Implementing option 3 would require substantial policy resource and time because of the complexities in determining the boundary between active and passive income in relation to financial institutions. Trade-offs would need to be made to progress option 3. In addition, option 3 would affect a very small number of taxpayers relative to the resources required to implement it.
- The implementation of option 2 would not preclude option 3 from being considered and, if appropriate, implemented at a later date.

IMPLEMENTATION

46. Legislative changes to the Tax Administration Act 1994 would be required to implement option 2. These amendments could be included in the bill which is scheduled to be introduced later this year.

47. No systems changes would be required to implement option 2. However, it would require the use of the Commissioner's resources to consider applications for a determination. There are processes in place to issue determinations for active insurance businesses already, so the implementation of option 2 would just be an extension of these existing processes. As the relevant group affected by the issue is relatively small (licensed insurers in New Zealand that are required to have a current financial strength rating and also have offshore active insurance businesses), the existing processes should be able to be appropriately managed.

48. The implementation of option 2 has the effect of reducing compliance costs for affected parties as they would no longer be required to calculate and attribute income under the CFC rules. Some of these compliance cost benefits would be offset by compliance costs associated with completing an application for a determination under section 91AAQ. However, it is important to note that the determination is able to be issued for more than one income year at a time (currently they tend to be issued for two income years), so this means that determination-related compliance costs would not need to be borne every year.

49. In implementing option 2, Inland Revenue would be required to update forms and communication material to ensure that licensed insurance companies are aware that they may be eligible for a determination that deems them to have passed the active business test in the CFC rules in relation to offshore insurance businesses.

MONITORING, EVALUATION AND REVIEW

50. Inland Revenue would monitor the effectiveness of the proposed changes in the first 12 months of operation. In general, Inland Revenue monitoring, evaluation and review of tax changes takes place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation

are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.