



CONSULTATIVE DOCUMENT
ON
INTERNATIONAL TAX REFORM

DECEMBER 1987



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PREFACE BY THE MINISTER OF FINANCE

Introduction

In my Budget of 18 June 1987, I announced that the Government would be introducing anti-tax haven measures. This move is necessary to strengthen the tax system and facilitate further tax reform. The resulting measures are set out in this consultative document.

Reasons for the Measures

New Zealand residents are subject to tax on their worldwide income. However, some residents, notably larger companies and wealthy individuals, are avoiding tax on their foreign income, some of which is income that is diverted from New Zealand. This places an unfair tax burden on others and undermines the integrity of the tax system. The Government is determined to prevent the erosion of the income tax base by cross-border transactions which enable the deferral or complete avoidance of tax properly payable in New Zealand. The use of tax havens in particular has become widespread and has been a drain on government revenue. This concern to protect the tax base and to preserve the integrity of the tax system underpins the measures.

Another objective is to remove artificial incentives for taxpayers to invest offshore. Offshore investment is generally to be welcomed, but it should not be subsidised by ordinary taxpayers. Existing tax provisions are encouraging greater offshore investment than is economically and socially desirable. Hence, the measures attempt to ensure that investment and other decisions are based on commercial merit rather than tax avoidance.

Evolution of the Measures

An overview of the proposed reforms was sketched in Annex 4 of the 1987 Budget. It was stated then that the outline of the proposed regime was not definitive or complete. There were good reasons for this.

First, anti-tax haven provisions are among the most complex in international tax law and are typically subject to continual legislative and administrative refinement. The measures outlined in Annex 4 of the Budget have been modified to better meet the Government's reform objectives and to ensure that, as far as possible, the measures themselves will not be vulnerable to abuse.

Secondly, I indicated in the Budget that the anti-tax haven measures would be the first step towards a comprehensive tax regime designed to combat international tax avoidance. Given the progress which has been made in developing further aspects of that regime, this first step will now be larger than earlier envisaged. Thus, the complexion of the original proposals has been altered significantly.

Main Elements of the Regime

In brief, the measures will tax New Zealand residents on income derived from an interest in a non-resident company or trust. Residents have been able to divert income and accumulate it in such entities and thereby avoid or defer New Zealand tax. Income which is already taxed in New Zealand as it is derived will not be subject to these measures. The main elements of the proposed regime, including changes to the original proposals, are highlighted below.

Basis of Taxation

Under the original proposals, all taxpayers required to report income earned through a non-resident company or trust would have been subject to New Zealand tax on a 'branch-equivalent' basis. An alternative basis has now been introduced. Where residents are unable to obtain sufficient information to report on a branch-equivalent basis, tax will be levied on the annual change in value of their interests. This 'comparative-value' basis is a proxy for taxing the underlying income.

Control

There are now no detailed rules relating to the control of a company. However, control can affect the amount of information a taxpayer can provide about the income of a company and may therefore affect whether a taxpayer will be able to report income on a branch-equivalent or a comparative-value basis.

Nature of Income

The distinction between tainted and non-tainted income has been eliminated. There are three related reasons for this: first, the Government has decided that it wishes to prevent as much tax avoidance and tax deferral as it reasonably can, not just the worst and most visible forms; secondly, the distinction would produce uncertainty, and possibly unintended consequences, as a result of inevitably arbitrary definitions; and thirdly, after further detailed consideration, the Government has decided that such a distinction, which has no economic basis, would be extremely difficult, if not impossible, to enforce adequately.

Sources of Income

The distinction between low-tax and high-tax countries has been eliminated. The new measures will apply to foreign income earned through any non-resident entity. Statutory rates of tax are an unreliable indicator of the real impact of taxes given the myriad of possible tax rules and the degree of enforcement in other countries. This new approach removes the need to make piecemeal and often inaccurate distinctions between high-tax and low-tax countries.

Exemption from Measures

A de minimis rule has been introduced. This rule will exempt from the measures natural persons with small shareholdings in non-resident companies. Such a rule balances the need for reducing the avoidance and deferral of tax against the need for effective compliance and administration.

Trusts

The measures that apply to trusts are essentially of an anti-avoidance nature. As with companies, there will be no distinction between tainted and non-tainted income. The taxation of foreign income earned through non-resident trusts will be consistent with that of income earned through non-resident companies.

Foreign Portfolio Dividends

Resident companies will be subject to tax on foreign portfolio dividends (dividends from non-resident companies in which the resident has less than a 10 percent interest). This treatment is in line with international norms. Resident individuals will continue to be subject to tax on all foreign dividends received. Appropriate double-tax relief will be provided.

Effective Dates

The scope for tax avoidance during the period of public consultation, prior to the application of the new tax law, means that the effective implementation of the measures must necessarily entail an element of retrospectivity. I announced in the Budget that the measures to be enacted would apply from the accounting years of the entities concerned commencing after 18 June 1987. However, given the changes to the original proposals and the time required for consultation and to enact legislation, as well as the need for administrative preparation, the effective date will be altered. This decision is necessary in the circumstances. It should not be regarded as a precedent.

As described in chapter 2, the measures will take effect from 17 December 1987 in respect of distributed income and from 1 April 1988 in respect of undistributed income.

Role of the Measures in the Government's Tax Reform Programme

In proposing these measures, I would stress that the purpose is not to increase the total tax burden on the community. It is to spread the tax burden more evenly and more fairly. To the extent that the tax base is broadened and more people pay their fair share of tax, rates of taxation can be lowered.

The changes are an integral part of the Government's continuing programme to improve the efficiency and equity of the tax system. It is overwhelmingly clear that the New Zealand tax base must be protected from international tax avoidance; without a broader base, further tax reform will be prejudiced if not precluded. I am confident that the proposed changes to New Zealand's international tax regime will provide a solid platform for further tax reform. In particular, the expected gains from the new international tax regime have helped make possible the further major reform of the tax and benefit system which I have recently announced. Reductions in tax avoidance and lower rates of tax go hand in hand.

Consultative Process

This is the fourth time the Government has initiated a consultative process on a major taxation change. With the assistance of the business sector and members of the public, the previous consultations resulted in significant improvements to the reform proposals. The Government has appreciated this participation and hopes that it will again be forthcoming in the current consultative process. In particular, the Government is grateful to those who have agreed to serve on the Consultative Committee. It can be expected to complete its task in a thorough and professional manner.

The timetable for implementation is tight. The period allowed for consultation and review reflects the need to give adequate time for interested parties to make submissions and the need for timely decisions in order to

reduce uncertainty. The Government invites public consideration of the proposals and welcomes comment on ways that may improve the implementation, operation and administration of the new measures.

Conclusion

The proposals outlined in this consultative document provide the basis for a substantial strengthening of New Zealand's international tax provisions. The need for such upgrading is overdue. The measures will reduce the problem of tax avoidance by residents diverting New Zealand income, and earning tax-favoured returns, through the use of offshore entities. Resources will flow to areas where they will generate the highest return for the nation as a whole. There will be a greater compatibility between private and national interests in investment decisions. Such reform will therefore contribute directly to creating a fairer and more prosperous society.

I believe that the development of a sound and secure domestic tax base is a prerequisite to further significant domestic tax reform. I commend a close scrutiny of this consultative document to those affected by the measures, as well as to those interested in the further reform of New Zealand's tax system.

A handwritten signature in black ink, appearing to read "R. Douglas". The signature is stylized and cursive, with a large initial "R" and a long, sweeping underline.

Roger Douglas
Minister of Finance

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CHAPTER 1 - INTRODUCTION

1.1 Purpose of the Consultative Document

The Minister of Finance, the Hon R O Douglas, announced in the Budget of 18 June 1987 that the Government would introduce measures to broaden the New Zealand tax base and to limit international tax avoidance.

The purpose of this consultative document is to set out the details of the structure and operation of the proposed new measures so that interested parties have an opportunity to consider them and to submit their views and suggestions before final decisions are made.

The document focuses on the taxation of income earned by New Zealand residents through offshore entities. The taxation of income earned in New Zealand by non-residents is not addressed.

1.2 Reasons for the Measures

The measures are part of a major upgrading of New Zealand's international tax regime. They reinforce the Government's drive to create a fairer and more efficient tax system. They seek to ensure that all residents of New Zealand pay their proper share of tax.

Moreover, the measures will make possible other desirable reforms. In particular, they will facilitate a reduction in income tax rates. They will also stimulate efficient investment in New Zealand. In this way, the measures will contribute to a better use of resources and have a positive influence on savings, investment and the creation of more productive and permanent jobs for New Zealanders.

In summary, the measures are designed to:

- a protect the domestic tax base from arrangements which seek to avoid or defer New Zealand tax by the accumulation of income in offshore entities;
- and

- b reduce the extent to which the tax system encourages offshore investment relative to investment in New Zealand and biases the form in which offshore investment is made.

1.3 Consultative Committee

The Government invites the public to make submissions on the matters set out in this document. A Consultative Committee has been appointed to receive and consider submissions and to advise the Government on implementation.

The Committee comprises:

Mr Arthur Valabh (Chairman), a tax partner and partner in charge of Deloitte, Haskins and Sells, Auckland;

Dr Robin Congreve, a tax consultant with Russell, McVeagh, McKenzie, Bartleet and Company, Auckland;

Mr Stuart Hutchinson, a tax partner with Simpson Grierson Butler White, Auckland;

Dr Susan Lojkine, a tax partner with McLeod Lojkine Associates, Auckland;

Professor John Prebble, a Wellington tax barrister and Dean of the Law Faculty at the Victoria University of Wellington; and

Mr Tim Robinson, an economist with Jarden and Company Limited, Wellington.

1.4 Terms of Reference

The Committee's terms of reference are:

- a to receive and hear public submissions on matters concerning the implementation and operation of the measures proposed in this consultative document;

- b to report to the Minister of Finance on:
- i matters covered in this document, or raised in submissions, on the introduction of measures to protect the New Zealand tax base, and
 - ii such amendment to the detail of the proposed measures as the Committee may consider necessary for their effective implementation and operation
- having regard to the Government's firm objective of eliminating the avoidance and deferral of New Zealand tax on foreign income as a means of broadening the tax base and facilitating a reduction in income tax rates;
- c to prepare draft legislation to give effect to the proposed measures referred to in this document.

The Committee is to report to the Minister of Finance by 31 March 1988.

1.5 Submissions

Submissions should contain a brief summary of their main points and recommendations. They should be typed in double space and be lodged by 12 February 1988 with:

The Chairman
Consultative Committee on
Full Imputation and International Tax Reform
c/- The Treasury
PO Box 3724
WELLINGTON

Submissions received by the due date will be acknowledged.

1.6 Outline of the Document

This Consultative Document comprises eight chapters, as follows:

- Chapter 1:** This introductory chapter describes briefly the purpose of the document and the reasons for the proposed reforms. Members of the Consultative Committee, its terms of reference and submission procedures are detailed.
- Chapter 2:** This chapter summarises the main elements of the measures set out in this document for the reform of New Zealand's international tax provisions.
- Chapter 3:** This chapter discusses the importance of preventing international tax avoidance and strengthening international tax provisions. Existing problems and the consequences are highlighted. The objectives of tax reform, which have guided the measures proposed in this document, are presented.
- Chapter 4:** This chapter outlines the scope of the proposed measures. It indicates that taxpayers resident in New Zealand must include in their assessable income foreign income earned through non-resident companies or trusts on either a branch-equivalent or a comparative-value basis.
- Chapter 5:** This chapter discusses the branch-equivalent basis for the taxation of income subject to the measures. The determination of assessable income and how it will be attributed to resident taxpayers are described.
- Chapter 6:** This chapter discusses the comparative-value basis for the taxation of income subject to the measures. The annual change in value of a taxpayer's interest in a non-resident entity will be taxed as a proxy for tax on the underlying income.

Chapter 7: This chapter addresses the taxation of dividends from non-resident companies and distributions from non-resident trusts. Provisions for double-tax relief are described.

Chapter 8: This final chapter discusses disclosure and administrative issues.

1.7 Meaning of Terms Used

A glossary of the technical terms used is provided at the end of this document.

CHAPTER 2 - SUMMARY

2.1 Income Subject to the Measures

The reforms described in this consultative document apply to foreign income derived by residents of New Zealand from interests in non-resident companies and trusts.

An interest in a non-resident company will be defined in terms of a resident's expected return of dividends from a non-resident company, and will also include such interests held indirectly through one or more non-resident entities. A taxpayer's percentage interest in the income of a non-resident company will be the greater of the taxpayer's percentage entitlement to, or entitlement to acquire rights to, dividends or voting rights in relation to distributions or changes to the company's constitutional rules.

A taxpayer's percentage interest in the income of a non-resident trust is the market value of the property contributed by the taxpayer to the trust, directly or indirectly, as a percentage of the market value of the net assets of the trust. A New Zealand taxpayer will be required to include in assessable income his or her percentage interest in the income of a non-resident company or trust.

Individuals who have interests in non-resident companies, where those interests have a total market value of not more than \$10,000 at all times in a year, will not be subject to tax under this regime. Similarly exempt will be individuals who have contributed property with a market value of less than \$500 to non-resident trusts.

The amount of foreign income derived by a resident of New Zealand from an interest in a non-resident company or trust will be determined on either a branch-equivalent basis or a comparative-value basis.

Any losses from interests in non-resident companies may be used to offset branch-equivalent or comparative-value income in respect of interests in other non-resident companies in the current year or may be carried forward to offset such income in future years. Any loss from an interest in a non-resident trust may only be carried forward to offset future income from that trust. Losses may not be used to offset other assessable income.

2.2 Branch-Equivalent Basis

The branch-equivalent basis for reporting income may be used if the taxpayer has sufficient information about the income of the non-resident entity and elects to adopt this basis.

New Zealand residents who elect to report income on a branch-equivalent basis will include in assessable income their percentage interest in the income of any non-resident company or trust in which they have a direct or indirect interest. For this purpose, the income of a non-resident company or trust must be computed in accordance with New Zealand tax law. In addition, dividends received by a non-resident company from another non-resident company whose income is reported on a comparative-value basis must also be included in the recipient company's income. Distributions of income received by a resident may be deducted, subject to certain limitations, in calculating branch-equivalent income. A taxpayer's percentage interest in the income of a non-resident trust will not include any amount which has become indefeasibly vested in a beneficiary.

New Zealand residents who include in assessable income for any year their percentage interest in the income of a non-resident company or trust computed on a branch-equivalent basis will be entitled to a credit for their percentage interest in the foreign taxes paid by the non-resident company or trust in that year.

2.3 Comparative-Value Basis

Under the comparative-value basis, a New Zealand taxpayer must include in his or her assessable income each year any change in the market value of a direct or indirect interest in a non-resident company or trust. The market value of

an interest in a non-resident company must be determined by reference to the trading price of the interest if the price is available and reliable. If not, the market value must be determined in accordance with appropriate valuation methods based on shareholders' funds or net (after-tax) earnings. In certain circumstances, taxpayers will be required to compute the change in value of an interest by reference to an imputed rate of return of five percent in excess of the rate on five-year Government stock.

Where the proceeds of disposition or the market value of an interest in a non-resident company exceed the last reported value of the interest by more than 30 percent and the interest has not been valued by reference to trading prices, a post facto adjustment will be made to the taxpayer's tax liability for the preceding years to recoup any tax-deferral benefits resulting from the undervaluation, unless the taxpayer can demonstrate that earlier market values were accurate.

The market value of an interest in a non-resident trust will be the portion of the market value of the net assets of the trust represented by the settlor's percentage interest in the trust. If, however, the market value of the assets of the trust cannot be determined, the imputed return method must be used to value the interest.

2.4 Distributions from Non-Resident Companies and Trusts

Foreign portfolio dividends received by resident companies (ie dividends from a non-resident company in which a resident has less than 10 percent of the paid-up share capital) will be included in assessable income. A credit will be allowed for any foreign withholding taxes. Other dividends received by resident companies from non-resident companies will continue to be exempt from company tax. However, recipient companies will be required to collect a withholding payment on behalf of their shareholders. The withholding payment will be creditable to their resident shareholders (and refundable to

tax-exempt and non-resident shareholders) when dividends are paid by the resident company. Similarly, any New Zealand tax paid by resident companies under the branch-equivalent basis will be creditable to resident shareholders under the imputation scheme outlined in the accompanying consultative document.

Dividends received by individuals resident in New Zealand will remain assessable, with a credit allowed for any foreign withholding tax.

Distributions received by resident beneficiaries from non-resident trusts will be included in assessable income except to the extent that the distribution is made out of the corpus of the trust. A credit will be allowed for any foreign withholding taxes on the distributions.

2.5 Effective Dates

The various aspects of the reform proposals set out in this consultative document will come into effect as follows:

- for taxpayers electing to use the branch-equivalent basis, from 1 April 1988. Where a non-resident entity's accounting year straddles 1 April 1988, only the proportion of its income for the year attributable to the period after 1 April 1988 will be subject to tax under these measures;
- for taxpayers using the comparative-value basis, from 1 April 1988. Such taxpayers will be required to establish the market value on 1 April 1988 of their interest in non-resident companies and trusts. Thus, only increases and decreases in market value occurring after 1 April 1988 will be taken into account under these measures;
- for portfolio dividends received from non-resident companies, such dividends declared after the time of the Minister of Finance's statement on 17 December 1987. A dividend will be deemed to be received when it is declared by the payer company; and

- for distributions by non-resident trusts to resident beneficiaries, such distributions that become indefeasibly vested in a resident beneficiary after the time of the Minister of Finance's statement on 17 December 1987.

2.6 Disclosure and Administration

Taxpayers will be required to disclose their interests in non-resident companies and trusts and to provide all information necessary to compute foreign income in accordance with these measures. Taxpayers with interests in non-resident companies or trusts will be required to file a separate schedule for each such company or trust with their annual return. Schedules will deal with the calculation of the income from such interests. Penalties will apply for failure to disclose the necessary information.

A special unit of the Inland Revenue Department will be established to ensure the efficient and fair administration of the measures proposed in this document.

CHAPTER 3 - OBJECTIVES OF THE REFORM MEASURES

3.1 Introduction

The purpose of this chapter is to briefly outline the deficiencies in New Zealand's existing international tax provisions and their consequences; the objectives for the reform of those provisions; why the reform proposals set out in this consultative document have been adopted and why they are more comprehensive than those proposed in the June 1987 Budget; and to address issues relating to the likely impact of the reforms.

3.2 The Issues at a Glance

The taxation of income earned by residents through offshore entities is manifestly in need of reform. New Zealand's existing international tax provisions are unable to counter the deferral or outright avoidance of New Zealand tax. The following observations sum up the problems.

There is blatant erosion of the tax base. Many large companies and wealthy individuals resident in New Zealand are avoiding and deferring New Zealand tax through a variety of offshore transactions. Such practices have become easy and routine.

The cost to New Zealand of tax abuse is high and growing. As the level of deferral and avoidance has become more widespread and the techniques more sophisticated, the New Zealand tax base has been seriously eroded. Such erosion amounts annually to hundreds of millions of dollars in forgone tax revenue - which must be raised from other sources.

Offshore investment is taxed more favourably than domestic investment. The exploitation of opportunities to defer or avoid New Zealand tax has resulted in investment being directed offshore rather than to more productive uses in New Zealand. Tax considerations are driving investment decisions. Consequently, the best use is not being made of New Zealand's scarce resources.

The cost is pervasive and ultimately borne by other New Zealanders. The fiscal and economic cost of the deferral and avoidance of New Zealand tax reduces the economic and social well-being of the nation. In this sense, the tax system imposes a greater burden on the community than is necessary. The impact is adverse for jobs, growth and living standards.

International tax avoidance is unfair. The ability of some taxpayers to defer or avoid New Zealand tax undermines perceptions about fairness and puts at risk the voluntary compliance of taxpayers on which the integrity of the tax system rests.

Desirable domestic reform is obstructed. A tax system that is vulnerable to international tax deferral and avoidance reduces the prospects for domestic tax reform. In particular, lower and more uniform rates of income tax are possible only if all taxpayers bear their fair share of tax.

3.3 Deficiencies in Existing Law

The fundamental deficiency in the tax system, which is at the heart of the issues identified above, is the lack of neutrality. In principle, residents are subject to New Zealand tax on their income derived from all sources - that is, their worldwide income. In practice, however, foreign income derived by residents is often not subject to New Zealand tax. Whether it is depends on whether the income is realised directly or realised indirectly through the use of interposed entities such as companies or trusts, and on whether it is earned in a country that levies high or low income taxes.

For example, residents of New Zealand may conduct business outside New Zealand through branches or separately incorporated subsidiaries. Branches are not considered to be separate entities and income derived by a foreign branch is included in the resident taxpayer's assessable income as it is realised by the branch. However, because a company is considered to be a legal and taxable entity separate from its shareholders, income derived by a non-resident company does not constitute income of the New Zealand shareholders until they receive dividends. Thus, New Zealand resident individuals and companies can

defer New Zealand tax on foreign income simply by earning such income through a non-resident company. Moreover, resident companies may avoid New Zealand tax entirely because the dividends they receive from non-resident companies are exempt.

If the foreign taxes are lower than those in New Zealand, taxpayers can enjoy tax deferral advantages by realising income through a non-resident company or trust instead of directly. The income will not be taxed in New Zealand until repatriated and will not be taxed even then in the case of dividends received by a resident company.

The deferral or avoidance of New Zealand tax on foreign income earned through non-resident companies and trusts is unacceptable. It constitutes an incentive for foreign investment by New Zealand residents in countries with tax rates lower than those of New Zealand. It encourages the diversion of New Zealand income to non-resident companies and trusts. It benefits mainly large companies and wealthy individuals. More generally, it undermines the integrity of the tax system by permitting the New Zealand tax base to be easily eroded.

3.4 Objectives of Reform

The two major objectives guiding the Government's reform of the tax system are efficiency and equity. The best way to improve the efficiency and equity of New Zealand's tax system is to broaden the tax base and lower income tax rates. A comprehensive base with lower and more uniform rates will encourage investment decisions to be based on commercial rather than tax considerations. It will remove artificial incentives for taxpayers to invest offshore. Lower rates will serve to encourage all types of investment, business and income-earning activity. Lower tax rates are possible only if the tax base is broadened and avoidance is curtailed.

New Zealand's international tax regime should generally reflect the same principles of efficiency and equity embodied in the domestic tax system. In particular, the taxation of foreign income should reinforce the taxation of domestic-source income and prevent the erosion of the domestic tax base by international tax avoidance. Reform of New Zealand's international tax regime therefore requires measures which will ensure that all New Zealand residents are subject to tax on their worldwide income as it is earned.

More particularly, the objectives of the reform proposals contained in this consultative document are to ensure, as far as possible, that:

- a foreign income derived by New Zealand residents is subject to New Zealand tax as it is earned, whether earned directly or indirectly through a non-resident company or trust;
- b the bias in the existing tax system, which encourages foreign investment by New Zealand residents in countries with lower tax rates than those of New Zealand, is removed;
- c opportunities for international tax avoidance, which erode the New Zealand tax base and undermine the New Zealand tax system, are eliminated;
- d appropriate relief is provided for foreign taxes on foreign income earned by New Zealand residents;
- e the complexity of the tax law and the attendant compliance and administrative costs are kept to the minimum necessary to ensure the effectiveness of the measures; and
- f the reform proposals are compatible with the existing domestic tax system and with the thrust of future domestic reforms.

3.5 Context of Reform

The thrust of the reform proposals in this consultative document is the elimination of the avoidance and deferral of New Zealand tax on all foreign income derived by residents of New Zealand through non-resident companies and trusts. Consequently, these reforms differ in some important respects from those originally proposed.

The proposals outlined in the 18 June 1987 Budget were essentially anti-avoidance rules. They were directed primarily at the use of trusts and companies established in tax havens to earn passive investment income and limited types of business income. They applied only to non-resident companies controlled by, and trusts settled by, residents of New Zealand.

The proposals were modelled on anti-tax haven measures currently in effect in several capital-exporting countries. Such measures may be effective in limiting the use of tax haven companies and trusts to defer and avoid domestic tax, but they are narrow in scope, arbitrary and complex. They deal only with the worst forms of tax avoidance. They do not deal with the fundamental problem of the deferral of domestic tax on foreign income earned through non-resident companies and trusts.

The Government has decided a broadening of the tax base with respect to foreign income is required to permit cuts in the rates of income tax applicable to both individuals and companies. Accordingly, the task is to eliminate the avoidance and deferral of New Zealand tax on foreign income earned by residents of New Zealand through non-resident companies or trusts. Where a New Zealand resident has an interest in a non-resident company and can provide sufficient information about the company, the resident's share of the foreign income will be taxed as if it were derived from a foreign branch. Where the resident is unable to provide sufficient information, New Zealand tax will be levied annually on the change in value of the interest. A similar approach will be adopted with respect to non-resident trusts to which New

Zealand residents contribute property. Further, there will be several consequential changes to the tax treatment of dividends received by New Zealand residents from non-resident companies and distributions received by New Zealand resident beneficiaries from non-resident trusts.

This approach has several advantages over the more limited anti-avoidance approach adopted by some countries. For example, under the measures proposed in this document it will be unnecessary to determine when a non-resident company is controlled by New Zealand residents; to distinguish between tainted and other income; or to determine whether a non-resident company is resident in a tax haven.

The new approach will significantly limit opportunities for international tax avoidance and protect the domestic tax base. Since the foreign income of non-resident companies will be subject to New Zealand tax currently, there will be little reason for New Zealand residents to divert income (whether in the form of transfer pricing, fees for services, royalties or interest) from New Zealand to a non-resident company.

Under the reform proposals, if a New Zealand resident has an interest in a non-resident company or trust, in many cases that interest will be treated, in effect, as if it were a foreign branch. Since the tax treatment of foreign branches is relatively straightforward, the reform proposals are simple in concept and should not involve undue legislative complexity. The alternative basis for taxing foreign income, the comparative-value basis, will require such interests to be valued each year.

The Government recognises that no other country has to date eliminated the deferral of domestic tax on foreign income earned through non-resident companies and trusts as completely as these measures propose. Nevertheless, they are fully justifiable as part of the Government's broad tax reform initiatives to expand the tax base and lower income tax rates.

3.6 Impact of the Measures

In developing the proposed reforms, the Government has considered their effect on new investment, on New Zealand firms operating offshore, on foreign countries, and on the existing investment of residents.

3.6.1 New Investment

The key impact of the proposed measures on new investment will be to remove artificial incentives for taxpayers to invest in low-tax jurisdictions, and to restore incentives for investment to flow to areas where it will provide the greatest returns for the nation as a whole. This is consistent with directing New Zealand's resources to their most profitable uses.

At present, however, some offshore investment by residents has a lower pre-tax return than alternative investment in New Zealand. Such investment is made because it has a higher post-tax return as a result of the avoidance or deferral of New Zealand tax. This is clearly an undesirable effect of the current law which the proposed measures will remedy. A likely consequence is more productive investment by New Zealand residents, both domestically and offshore, and a relative increase in domestic investment by residents.

3.6.2 New Zealand Business Offshore

It is sometimes contended that New Zealand businesses offshore should not be required to pay as much tax as they would in New Zealand to enable them to compete more readily in foreign markets. This contention carries little weight. A resident taxpayer should not pay less New Zealand tax simply as a result of investing offshore in a particular legal form (ie a non-resident company or trust).

The implicit subsidy in the existing tax system for foreign investment in countries with tax rates lower than those of New Zealand is inefficient and inequitable. The proposed reforms will eliminate this aspect of our tax system.

Much offshore investment is not primarily tax-motivated. New Zealand companies are attracted to invest offshore for such reasons as proximity to markets, availability of natural resources, access to particular goods and services, and the like. The proposed measures will have little impact on these investments where they yield high pre-tax returns. The measures will, however, adversely affect offshore investments that have been made primarily for tax reasons.

3.6.3 Other Countries

Some countries may be adversely affected by New Zealand's moves to counter the avoidance and deferral of domestic tax by its residents. For example, if a foreign country provides significant corporate tax concessions in order to attract investment, those concessions may be less effective in eliciting investment from New Zealand as a result of the proposed reforms. Where foreign taxes are very low, reductions in the foreign tax of a company owned by New Zealand residents will simply be replaced by the domestic tax payable on such income according to the rules proposed in this document.

However, there will be some benefits for foreign countries arising from New Zealand's tax reforms. For example, the lowering of the New Zealand company tax rate will mean that the return which non-residents can obtain from investment in New Zealand will increase. The anti-avoidance measures will also make it more difficult for non-residents to enter into tax avoidance arrangements via New Zealand to exploit the tax systems of their own or other foreign countries.

3.6.4 Existing Investment

The effective date of the reform proposals for undistributed income is 1 April 1988, which provides taxpayers with a reasonable opportunity to reorganise their affairs if necessary. Although there may be costs for some investors who have entered into arrangements which cannot be altered, the Government has decided that no special relief can be justified. All tax policy changes

create winners and losers, as do economic policy changes in general. New Zealand is currently undergoing a period of substantial and necessary economic adjustment. The long-term benefits of economic reform will be shared by all New Zealanders.

3.7 Conclusion

Significant reform of New Zealand's international tax provisions is urgently required. Such reform is a key element in the Government's overall programme of tax reform. In particular, the ability of the tax system to afford lower rates of income tax depends in large measure on a comprehensive tax base, and international tax reform is essential to ensure that all New Zealand residents pay tax on their worldwide income.

The measures proposed in this consultative document will strengthen New Zealand's international tax regime against widespread tax avoidance techniques and arrest the erosion of the domestic tax base. At the same time, the new measures will reduce the bias in the tax system in favour of foreign investment by New Zealand residents. The nature of the problems involved suggests, however, that results will not be achieved through any single set of initiatives. Rather, results will depend on a continuing reform of tax provisions on a broad front. The overriding concern must be to ensure that New Zealand's tax system adjusts as necessary, so that the nation secures the maximum benefit possible from international investment and income flows. The measures proposed in this document are compatible with this longer-term direction.

CHAPTER 4 - INCOME SUBJECT TO THE REFORM MEASURES**4.1 Scope of Reform**

The purpose of these reforms is to tax New Zealand residents on income as it accrues to their benefit through their direct interest in a non-resident company or trust and through their interest held indirectly through that non-resident entity in other non-resident entities. Two requirements must therefore be met before income will be subject to the rules:

- a the income must be earned through a company or trust resident outside New Zealand; and
- b a New Zealand resident must have an interest in the company or trust.

Once these requirements have been met, a New Zealand resident will be required to include in assessable income his or her percentage interest in the income of the non-resident company or trust. Whether a person is a New Zealand resident for the purposes of these measures will be determined according to the normal tax residence provisions in section 241 of the Income Tax Act. However, there will be one special rule. An individual who has been resident in New Zealand for a cumulative period of less than 24 months in the immediately preceding 15 years will not be a resident for the purposes of these measures. Thus, individuals who work in New Zealand on a temporary basis will not be taxed on their interest in non-resident companies or trusts.

The new regime will apply only to income earned through non-resident companies or trusts. These are separate taxable entities under New Zealand law and may be used to avoid or defer New Zealand tax. Income derived by New Zealand

residents through foreign branches or partnerships, which are not separate taxable entities under New Zealand tax law, will not be affected since such income is already subject to current taxation in New Zealand. Income derived directly by New Zealand residents from foreign property, whether tangible (such as land) or intangible (such as debt instruments), is also excluded since it is already subject to taxation in New Zealand as it is earned.

This chapter elaborates on the types of non-resident entities that will be subject to the rules. It deals first with companies and then with trusts.

4.2 Non-Resident Companies

The forthcoming legislation will apply to income earned through the following "non-resident companies":

- a a non-resident entity which is comparable to a company under New Zealand law or to an entity which is deemed to be a company under New Zealand tax law (eg a unit trust); and
- b a company or deemed company which is a resident of New Zealand and any other country and which is not subject to tax in New Zealand on its foreign income.

The existing residence rules in the Income Tax Act will apply to determine the residence of companies. For the guidance of taxpayers, a list of common non-resident entities that will be treated as companies for the purpose of this legislation will be issued by the Commissioner of Inland Revenue.

4.2.1 Percentage Interest in a Non-Resident Company

This regime will require the measurement of a New Zealand resident's true economic stake in a non-resident company. This is best measured by the ability of a resident to extract income from the company. As proposed in the consultative document on full imputation, the definition of dividends for

income tax purposes is to be widened to include all types of distributions, with the exception of certain returns of paid-up share capital. Thus, a New Zealand resident's interest in a non-resident company will be defined in terms of his or her expected return of dividends from the company. It is clearly not feasible to give the Commissioner of Inland Revenue a discretion to decide what is a resident's ability to extract dividends from a non-resident company on a case by case basis. The rule should ideally be clear and objective so that taxpayers know in advance the tax consequences of investing in non-resident companies. Furthermore, it is not sufficient to define an interest in a non-resident company only in terms of current rights, or future entitlements, to dividends. In order to prevent avoidance, it is also necessary to measure a resident's current and future entitlement to voting rights in relation to the distribution policy of the non-resident company.

Therefore, a taxpayer's "percentage interest" in a non-resident company will be defined as the greatest of:

- a the proportion of rights to dividends to which the resident is entitled;
- b the proportion of rights to dividends which the resident is entitled to acquire;
- c the proportion of voting rights, in relation to distributions and changes to the company's constitutional rules, to which the resident is entitled;
- d the proportion of voting rights, in relation to distributions and changes to the company's constitutional rules, which the resident is entitled to acquire.

A taxpayer's percentage interest will be determined at the end of the non-resident company's accounting year.

An interest in a non-resident company will include an interest held indirectly through interests in other non-resident companies or trusts. A taxpayer's percentage interest in a lower-tier non-resident company will be determined by multiplying the taxpayer's interest in the first-tier non-resident company by that company's percentage interest in the lower-tier company. This determination must be made for all levels in a chain of ownership of non-resident companies (see sections 5.2.1 and 5.2.2 and Appendices 5.1 and 5.2 for further details).

Many capital structures are designed to take advantage of tax provisions. It is not unreasonable to expect that these structures will be altered to reflect the new tax provisions. However, the adoption of the rule outlined above may cause difficulties for some taxpayers who currently hold certain classes of shares in non-resident companies. A period of adjustment will therefore be provided before the regime comes into effect. In this period, taxpayers may wish to reconsider their interests in companies with complicated capital structures or, if they control the non-resident company, to adjust the way in which they invest in the company so that they obtain the desired level of risk, return and control, taking into account the definition of "percentage interest" in this regime.

The following are examples of instruments to which the rights taken into account in determining a taxpayer's percentage interest in a non-resident company may attach:

- a shares in a non-resident company;
- b units in a non-resident unit trust;
- c debentures of a non-resident company without a fixed interest rate and debentures issued in substitution for shares of a non-resident company as defined in sections 192 and 195 of the Income Tax Act;

- d options, or other rights to acquire, interests in a non-resident company or a non-resident unit trust that can be exercised directly or indirectly by the holder of the option, and put options which are in substance callable options;
- e convertible debt of a non-resident company, including instruments similar in nature to convertible notes defined in section 196 of the Income Tax Act; and
- f any interest in non-resident companies owned by a non-resident company or trust in which the taxpayer has an interest as described in (a) to (e) above, including any interest in non-resident companies and trusts held through a chain of ownership.

Convertible debt in a non-resident company is debt which converts automatically, or at the option of the holder or issuer of the debt, into equity in the company. Convertible debt instruments have the characteristics of both equity and debt. Any change in the market value of convertible debt reflects changes in market yields on debt and changes in the market value of the potential equity rights represented by the instrument. The debt portion of such instruments is currently taxable under the provisions of section 64B to 64M of the Income Tax Act. The forthcoming legislation will ensure that a taxpayer is not taxed twice on income derived from convertible debt instruments.

Where a nominee of a resident holds an interest in a non-resident company, the interest shall be deemed to be held by the resident. The existing definitions of "nominee" in the Income Tax Act will be reviewed to ensure that they are satisfactory for the purposes of this regime.

4.2.2 De Minimis Rule

Where the market value of an individual's aggregate direct interests in non-resident companies, at all times in the individual's income year, does not exceed \$10,000, the individual will be exempt from reporting his or her income from those non-resident companies under the branch-equivalent or comparative-value basis. Market value will be determined according to the valuation rules set out in section 6.1.2.

4.3 Non-Resident Trusts

The measures will also apply to non-resident trusts. To eliminate any possible ambiguity in the present law, a trust will be deemed to be resident in New Zealand for tax purposes if any trustee of the trust is resident in New Zealand at the end of the accounting year of the trust. The existing residence rules in section 241 of the Income Tax Act will apply to determine the residence of a trustee. A non-resident trust will thus be a trust that does not have any trustee resident in New Zealand at the end of the accounting year of the trust. The measures will apply to inter vivos and testamentary trusts, irrespective of whether they are specified or non-specified trusts pursuant to the Income Tax Act.

4.3.1 Interest in a Non-Resident Trust

Non-resident trusts may be used to avoid New Zealand tax where the non-resident trustee or trustees accumulate trustee income and it is not also derived by New Zealand resident beneficiaries entitled, or deemed to be entitled, in possession to the receipt of it (this is the definition of beneficiaries' income in section 227 of the Income Tax Act). In many cases it will not be possible to ascertain, at the end of a trust's accounting year, whether there are any resident beneficiaries, or, if there are, their respective shares of the trust income. Consequently, it is often not feasible to tax resident beneficiaries on their share of the trust income of non-resident trusts.

In order to achieve the objectives of these reform measures with regard to non-resident trusts, any person resident in New Zealand (referred to as a "resident settlor") who has contributed property by way of gift, including a transfer of property for inadequate consideration, to a non-resident trust will be considered to have an interest in the non-resident trust until such time as:

- a a resident settlor who is a natural person dies and his or her estate is wound up; or
- b a resident settlor which is a company or another trust is wound up.

The value of a contribution to a non-resident trust will be the difference between the market value of the property transferred to the trust and the market value of any consideration given by the trust. Special rules will be necessary in relation to any financial assistance given to non-resident trusts, whether given directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise. The definition of a "resident settlor" will include residents who make indirect contributions to non-resident trusts through resident or non-resident interposed entities such as trusts, companies or financial institutions, or through non-resident individuals. A resident will also be considered to have an interest in any non-resident trust to which a non-resident trust or a non-resident company in which the taxpayer has an interest contributes property. This determination must be made for all levels of entities in a chain of ownership irrespective of whether the income of the higher-tier entity is being reported on a branch-equivalent or comparative-value basis. A resident settlor with an interest in a non-resident trust will also be deemed to have an interest in any non-resident company in which that trust has an interest.

4.3.2 Percentage Interest in a Non-Resident Trust

The rules for determining a resident settlor's percentage interest in a non-resident trust are set out in section 5.3.2.

4.3.3 De Minimis Rule

An individual will be exempt from the proposed resident settlor rules if the market value of all contributions made by him or her to non-resident trusts at any time is less than \$500. For this purpose, the market value of each contribution must be determined at the time of the contribution.

4.3.4 Beneficiaries

New Zealand-resident beneficiaries of non-resident trusts must include in their assessable income trust income distributed to them or which becomes vested indefeasibly in them in accordance with the rules set out in section 7.3.1.

New Zealand residents who purchase a beneficial interest in a discretionary non-resident trust will be taxed on such an interest on the comparative-value basis (see section 6.3).

4.4 Bases for Reporting Income

Once it is determined that a New Zealand resident has an interest in a non-resident company or trust, then the amount of the entity's income that has accrued to the benefit of the New Zealand resident must be calculated in accordance with the "branch-equivalent" basis or the "comparative-value" basis.

The next two chapters explain in more detail the branch-equivalent and the comparative-value bases of determining income to which the reform measures outlined in this document apply.

CHAPTER 5 - REPORTING INCOME ON A BRANCH-EQUIVALENT BASIS**5.1 Overview**

New Zealand residents who elect to have the income they derive through a non-resident company or trust taxed on a branch-equivalent basis will be taxed on their percentage interest in the entity at the end of the entity's accounting year multiplied by the income of the entity. The branch-equivalent basis operates in almost the same manner as the present treatment of foreign branches. It commences with a calculation of the non-resident entity's income as measured by New Zealand tax rules. The New Zealand resident's percentage interest in such income is then included in the resident's assessable income. A non-resident company's losses attributed to a New Zealand taxpayer may be offset only against the taxpayer's branch-equivalent or comparative-value income from other non-resident companies. Losses attributable to a settlor's interest in a non-resident trust must be carried forward to be offset against future income from the settlor's interest in that trust.

The tax liability resulting from the taxation of branch-equivalent basis income is reduced by the taxpayer's percentage interest in foreign taxes paid by the non-resident entity deriving the income. Where distributions to New Zealand residents from the non-resident entity are taxable in New Zealand, relief for previous New Zealand taxes paid is provided by permitting such distributions to be deducted from branch-equivalent income to the extent of the branch-equivalent income reported in the year of distribution. The New Zealand tax liability will be reduced by any foreign withholding taxes levied on the distributed income. Branch-equivalent income will be reported in New Zealand dollars using a close-of-trading spot exchange rate on the last day of the relevant accounting year of the non-resident entity.

5.2 Non-Resident Companies

5.2.1 Measurement of Branch-Equivalent Basis Income

New Zealand taxpayers reporting income from a non-resident company on a branch-equivalent basis will include in assessable income their percentage in the company's income at the end of the company's accounting year. This applies to non-resident companies in which a New Zealand taxpayer has a direct or an indirect interest. The income of each such company will be calculated according to New Zealand tax rules with one exception. Where dividends are paid by a non-resident company whose income is being reported by the taxpayer on a comparative-value basis to another non-resident company, they shall be included in the assessable income of the recipient company. It is necessary to include the latter dividends in the net income of the recipient company because their payment will reduce the market value of the taxpayer's interest in the dividend-paying company (for an illustration of this point, see Appendix 5.2 where the income of Company E is reported on a comparative-value basis).

When computing his or her share of branch-equivalent income, a taxpayer may deduct dividends received (gross of foreign withholding taxes) from the non-resident company. Such dividends are deductible against the income of the non-resident company in the accounting year in which they are paid, to the extent of the branch-equivalent income earned in that year. This ensures that income from which dividends are paid is not subject to New Zealand tax twice. Should the deduction of dividends result in a branch-equivalent loss being computed, such a loss may be offset against branch-equivalent or comparative-value income earned through other non-resident companies, whether in a current or future income year of a taxpayer.

5.2.2 Calculating a Taxpayer's Percentage Interest in the Income of a Non-Resident Company

The portion of a non-resident company's income included in the income of a resident New Zealand taxpayer will be the amount of such income multiplied by the taxpayer's percentage interest in the non-resident company at the end of company's accounting year (see section 4.2.1 for a description of how to calculate a percentage interest in a company). Similarly, where a taxpayer elects to report on a branch-equivalent basis the income of a non-resident company in which he or she has an indirect interest, the portion of that company's income to be included in the taxpayer's income is the company's income multiplied by the taxpayer's percentage interest in the company. In this situation, the taxpayer's percentage interest will be determined by multiplying the taxpayer's percentage interest in the first-tier non-resident company by that company's percentage interest in the lower-tier non-resident entity, and so on.

There is an exception to the income allocation rules, however, where a taxpayer can establish that 100 percent of the income of a non-resident company is included in the income of New Zealand taxpayers. (It should be noted that tax-exempt entities are not taxpayers.) The purpose of this exception is to prevent more than 100 percent of the branch-equivalent basis income of a non-resident company being taxed where there is no prospect of avoidance or deferral. It is possible for more than 100 percent of the income of a non-resident company to be taxable under these rules because the determination of a taxpayer's percentage interest is based on the greatest of the taxpayer's entitlement, or entitlement to acquire, rights to dividends and voting rights in relation to distributions and changes to the company's constitutional rules. To qualify for the exception, any one New Zealand resident with an interest in the non-resident company must provide the Inland Revenue Department (IRD) with the following information: the branch-equivalent basis income of the non-resident company, the names and IRD tax numbers of all of the resident taxpayers with interests in the company, and the allocation of

100 percent of the branch-equivalent income. If this exception applies, the resident shareholders may allocate the branch-equivalent income among themselves on any reasonable basis.

Taxpayers who acquire an interest in a non-resident company during the company's accounting year will be required to include in their assessable income their percentage interest in the pro-rata portion of the company's income attributable to the period after acquisition. Taxpayers who dispose of their interests during the company's accounting year will be required to include in their assessable income the pro-rata portion of the company's income attributable to the period before disposition. If the taxpayer lacks sufficient information to pro-rate the company's income in this way, tax will be levied on a comparative-value basis for the part-year from the beginning of the company's accounting year to the time of disposition. The valuation rules set out in chapter 6 will be used to determine the comparative-value income to be taxed.

A New Zealand resident's share of the income of a non-resident company for a particular year will be included in the resident's assessable income for his or her income year in which the non-resident company's accounting year ends. For example, if a company has a balance date of 30 September and a New Zealand resident a balance date of 31 March, the New Zealand resident will report his or her share of the non-resident company's income for the year ended 30 September on his or her return for the year ended 31 March of the following year.

A non-resident company's losses attributed to a New Zealand taxpayer may be used to offset the taxpayer's branch-equivalent or comparative-value income from other non-resident companies. Where the taxpayer is a company within a group of companies (as defined in section 191 of the Income Tax Act), these losses may be transferred to other companies in the group for offset against comparative-value or branch-equivalent income.

5.2.3 Credit for Foreign Taxes

A taxpayer's tax liability arising from income reported on a branch-equivalent basis will be reduced by his or her percentage interest in the foreign taxes paid by the non-resident company deriving the income. A taxpayer's percentage interest in foreign taxes paid by a non-resident company will be the foreign taxes paid by the company multiplied by the taxpayer's percentage interest in the company. This calculation is subject to the exception described in section 5.2.2 where 100 percent of the income of a non-resident company is included in the income of New Zealand taxpayers. If a taxpayer's percentage interest in the branch-equivalent income of a non-resident company is reduced pursuant to that exception, then the taxpayer's percentage interest of the foreign taxes paid by the company must be reduced correspondingly.

The conditions and limitations that apply to foreign tax credits in Part VIII of the Income Tax Act will be amended to ensure that they are appropriate for these measures. Foreign tax credits will be limited to the amount of New Zealand tax payable on the income of each non-resident entity. Foreign tax credits will also be limited to the amount of New Zealand tax which would have been payable on the income sourced in each jurisdiction. Carry-back and carry-forward for foreign taxes that cannot be used in the current year will be allowed to the extent permitted under current law to deal with timing differences between foreign and New Zealand tax law. Foreign taxes which will qualify for the foreign tax credit regime are income and company taxes which are of substantially the same nature as New Zealand income tax whether levied by the federal, state or provincial government in any foreign jurisdiction on the income of the non-resident entity. A credit will also be permitted for New Zealand taxes paid by a non-resident company on New Zealand-source income. Foreign withholding taxes levied on distributed income will also be creditable.

Taxes paid by non-resident companies in which a New Zealand resident has an indirect interest will also be creditable. The same formula used to determine a taxpayer's percentage interest in an entity's income will be used to calculate the taxpayer's percentage interest in the foreign taxes paid by the entity.

The operation of the rules for calculating a taxpayer's entitlement to foreign taxes paid by non-resident companies is illustrated in Appendix 5.2.

5.3 Non-Resident Trusts

As explained in section 4.3, a resident settlor will be assessed on income attributable to his or her interest in a non-resident trust. The branch-equivalent reporting system applies to settlors with interests in non-resident trusts in much the same manner as it applies to resident shareholders with interests in non-resident companies.

5.3.1 Measurement of Branch-Equivalent Basis Income

On the branch-equivalent basis, the income of a non-resident trust must be measured in accordance with New Zealand tax rules, in the same way as the income of a non-resident company (see section 5.2.1). Where, however, a non-resident trust receives dividends from a non-resident company whose income is reported on a branch-equivalent basis by the resident settlor of the trust, such dividends will be excluded from the trust's income. Where a non-resident trust receives dividends from a non-resident company whose income is reported on a comparative-value basis by the resident settlor of the trust, the dividends will be included in the trust's income in accordance with New Zealand law.

Trustee income of a non-resident trust will be defined as the net assessable income of the trust, computed in accordance with New Zealand tax law as modified above, less distributions to the extent of the branch-equivalent income reported in the year of distribution, and less amounts that have vested indefeasibly in beneficiaries (except beneficiaries which are non-resident trusts and companies). Under current law, trustee income excludes only income that is also derived by a beneficiary entitled, or deemed to be

entitled, in possession to the receipt thereof. That definition will be amended in relation to non-resident trusts to make it clear that income in which a beneficiary has an indefeasibly vested interest will be deducted from the net assessable trustee income, whether or not the beneficiary is entitled to enforce immediate payment of the income. Whether trustee income vests indefeasibly in a beneficiary will be determined in accordance with New Zealand law. For example, if, under foreign law, income is deemed to vest in the registrar of trusts or some other government official until it is distributed by trustees, the income will nevertheless be considered trustee income for New Zealand income tax purposes.

5.3.2 Calculating a Taxpayer's Percentage Interest in the Income of a Non-Resident Trust

Resident settlors will include in their assessable income the portion of the trustee income of a non-resident trust equal to the trustee income multiplied by their percentage interest in the trust. The percentage interest of a resident settlor in a non-resident trust will be calculated as the percentage that the market value of the property contributed to the trust by the settlor, determined at the time of the contribution, is of the market value of the trust's net assets, also determined at the time of the settlor's contribution. Once the interest is established, it will remain constant until another contribution is made to the trust. Thus, for example, if A and B each contribute \$100 to a trust each will have a 50 percent interest in the trust. If the trust assets double in value from \$200 to \$400, at which time C contributes \$400 to the trust, A and B will each have a 25 percent interest in the trust while C will have a 50 percent interest in the trust. The recalculation of settlors' respective interests in a trust will be made only at the end of a trust's accounting year and will apply to attribute income to settlors for the next trust accounting year.

Where a non-resident trust in which a New Zealand taxpayer has an interest contributes property to another non-resident trust, the taxpayer's percentage interest in the second trust will be determined by multiplying his or her

percentage interest in the first trust by that trust's percentage interest in the other non-resident trust, and so on. Resident settlors will be taxed on their share of the income of each non-resident trust separately from their other New Zealand income. This is consistent with the way trustee income is taxed in the hands of New Zealand resident trustees.

Trust losses attributable to a settlor's interest in a non-resident trust must be carried forward to be offset against future income from the settlor's interest in that trust. Since beneficiaries will never have an interest in trust losses, the entire amount of a loss will, in effect, be treated as a trustee loss. Without a carry-forward rule, the attribution system would be open to abuse, since trustees could ensure that beneficiaries had indefeasibly vested interests in any trust income while passing losses on to the settlor for tax purposes.

5.3.3 Credit for Foreign and New Zealand Taxes

If a non-resident trustee provides a resident settlor with information about foreign taxes paid on trustee income (or New Zealand taxes on New Zealand-source income), the settlor will be entitled to claim a tax credit equal to the taxes paid on trustee income multiplied by the settlor's percentage interest in the trust. The calculation and attribution of tax credits available to resident settlors who report income attributed to their interests in non-resident trusts on a branch-equivalent basis is made by reference to the same rules applicable to shareholders in non-resident companies who report income on a branch-equivalent basis.

5.4 Election to Report on Branch-Equivalent Basis

Taxpayers who qualify to report income from a non-resident entity on a branch-equivalent basis must file an election with the IRD office to which they send their annual tax returns. A copy will be sent by IRD to the special IRD tax unit. A separate election must be made in respect of each

non-resident entity which the taxpayer wishes to report on a branch-equivalent basis. Thus, the taxpayer may choose to report the income of one non-resident entity on a branch-equivalent basis and another on a comparative-value basis.

The taxpayer will be required to inform the Commissioner of Inland Revenue of the accounting year used by the non-resident entity. Any subsequent change in the entity's balance date must be communicated to the Commissioner and approved by him as a basis for continuing to use the branch-equivalent method. If the Commissioner does not give his consent, the taxpayer will be required to report income from the entity using the comparative-value basis. The mechanics of changing the basis of reporting income are described in section 5.5.

Elections to use the branch-equivalent basis reporting system filed before 1 April 1988 will be effective from 1 April 1988. Elections filed after 1 April 1988 will be effective from the first accounting year of the non-resident entity commencing after the date on which the election is filed.

Branch-equivalent taxpayers must be able to provide the Commissioner with information similar to that which taxpayers reporting on an actual branch basis are required to provide. The Inland Revenue Department will make available details of the information required for filing and auditing purposes. A special requirement for taxpayers reporting income on a branch-equivalent basis will be that they must be able to provide the Commissioner, on request, with a copy of the financial accounts of the non-resident company or trust and a copy of its foreign tax returns. Any information in a foreign language must be accompanied by an English translation (see the discussion of the disclosure requirements in chapter 8).

5.5 Changing from Branch-Equivalent to Comparative-Value Basis

Taxpayers may change the basis of reporting income from a non-resident entity if they notify the Commissioner of Inland Revenue at least one month before the beginning of the next accounting year of the entity. The change in the

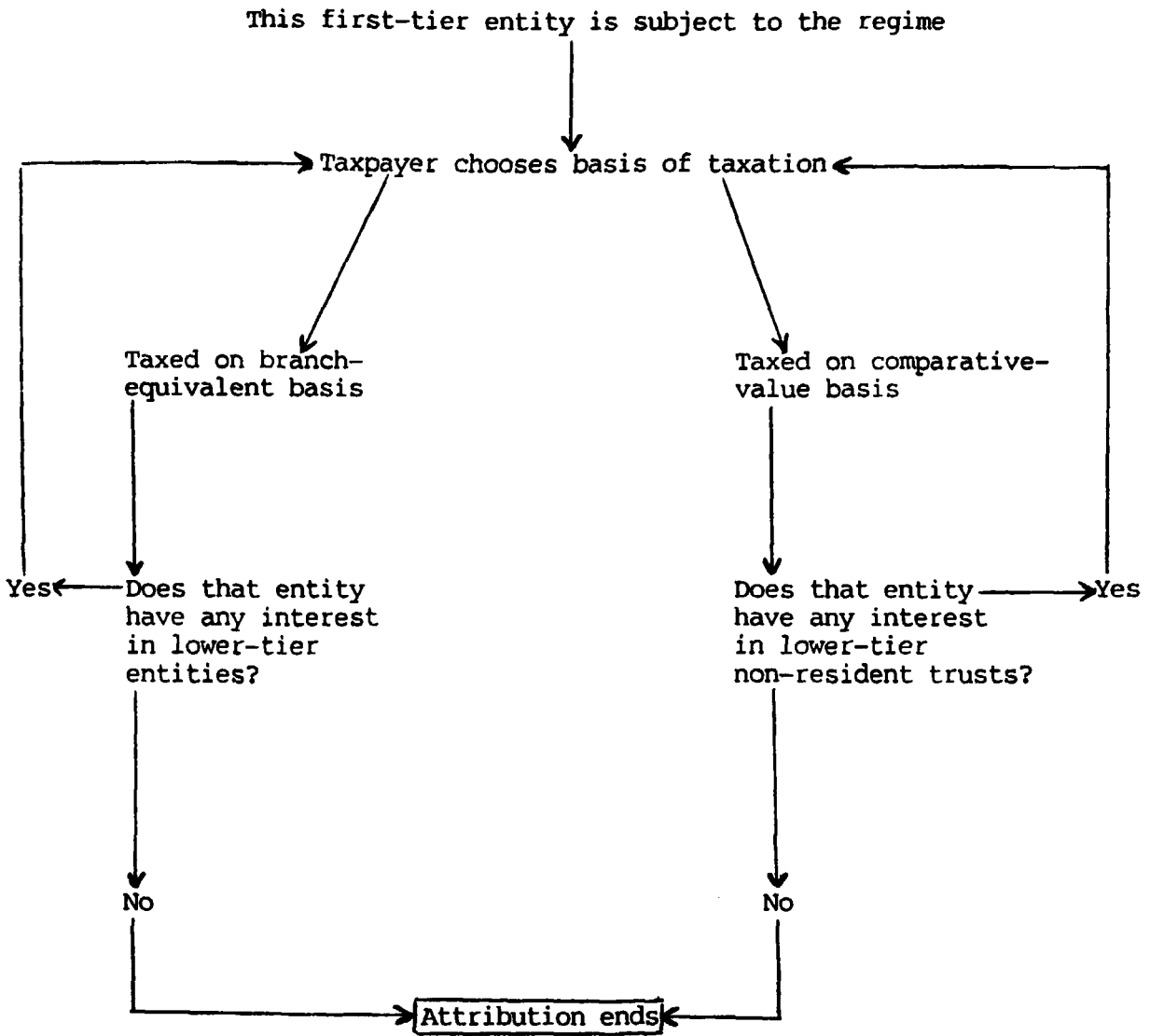
basis of reporting will become effective from the beginning of the next accounting year of the entity.

A taxpayer changing from branch-equivalent to comparative-value reporting will be required to compute the value of his or her interest in the entity on the date the change becomes effective (referred to as the "effective date"). The value of an interest will be computed on this date in accordance with the rules set out in chapter 6.

The value of the interest computed on the effective date will be deemed as the opening value of the interest at the beginning of the taxpayer's income year. This value will be compared with the value of the interest at the end of the taxpayer's income year for the purposes of computing income using the comparative-value basis. The taxpayer will be required to report income from the entity for the accounting year up to the effective date on a branch-equivalent basis.

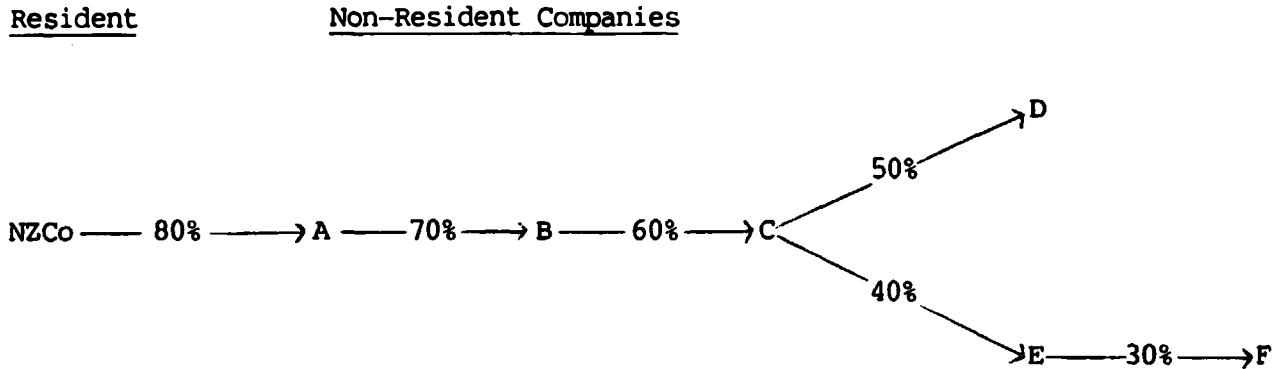
Where a taxpayer has elected to report income on a branch-equivalent basis and it is not possible for whatever reason to compute branch-equivalent income up to the effective date, income from the beginning to the end of the entity's accounting year must be calculated using an imputed return method. For the purposes of applying an imputed return method, the value of the interest on the first day of the non-resident entity's accounting year will be computed as the market value of the taxpayer's interest on the last day of the entity's accounting year discounted by the annual imputed return rate on a straight-line basis. This rule will apply where taxpayers cannot compute branch-equivalent income in any accounting year of a non-resident company and where they have not given prior notice of their intention to compute income on a comparative-value basis.

SCHEMATIC OUTLINE OF THE INCOME ATTRIBUTION RULES



APPENDIX 5.2

EXAMPLE OF ATTRIBUTION RULES IN OPERATION



Company	Income (1)	Foreign Taxes	NZCo's Interest (2)	Attributed to NZCo	
				Income (3)	Tax Credit (4)
	(\$)	(\$)	(%)	(\$)	(\$)
A	300	50	80	240	40
B	-400	NIL	56	-224 (5)	NIL
C	500 (6)	100	34	170	34
D	600	200	17	102	31 (7)
E	700 (8)	150	13	91	N/A (9)
F	N/A (10)	N/A	N/A	N/A	N/A

(Figures rounded; amounts in New Zealand dollars)

Notes

- 1 A, B, C and D's income, measured according to New Zealand tax rules, is reported on a branch-equivalent basis.
- 2 Each interest is multiplicative, eg NZCo's interest in C = .8 x .7 x .6.
- 3 Income attributed to NZCo is its interest in each company's income.
- 4 Tax credit attributed to NZCo is its interest in foreign taxes paid.
- 5 Loss may be offset (or carried forward for offset) only against other branch-equivalent of comparative-value income.
- 6 Includes dividend received from E since E's income is reported on a comparative-value basis.
- 7 Foreign taxes paid by D exceed the New Zealand tax (say, 30%) on such income. Thus, the credit is limited to NZCo's interest in 30% of D's income.
- 8 Reported on a comparative-value basis.
- 9 No credit available as comparative-value income is net of foreign taxes.
- 10 As E's income has been reported on a comparative-value basis, F's income is ignored.

CHAPTER 6 - REPORTING INCOME ON A COMPARATIVE-VALUE BASIS**6.1 Non-Resident Companies****6.1.1 Overview**

Under the comparative-value basis, a taxpayer includes in his or her income for a year any change in the market value of an interest in a non-resident company. The change in value will be calculated by comparing the market value of the taxpayer's interest in a company at the end of the taxpayer's income year and the value of that interest at the beginning of the year. Where market values cannot be determined by reference to the traded price of an interest, the market value of a taxpayer's interest in a non-resident company will be determined at the end of the company's accounting year.

Subject to provisions to prevent avoidance, where an interest in a non-resident company is acquired during a year, the amount included in assessable income will be the difference between the cost of the interest and its market value at the end of the year. Similarly, where an interest is disposed of during a year, the amount included in assessable income will be the difference between the market value at the beginning of the year and the proceeds of disposition.

In general, taxpayers will be required to value interests in non-resident companies by reference to the traded prices of the interests, if such prices are available and provide a reliable indication of market value. Otherwise, taxpayers will be required to compute the market value of their interests in accordance with appropriate valuation techniques. Where the traded price of an interest is unavailable or unreliable and the compliance costs of establishing market values by any other methods are excessive, the taxpayer

may use an imputed rate of return method of valuation to determine the value of the interest. Where the Commissioner of Inland Revenue is not satisfied that the values reported by a taxpayer accurately reflect market values, he may use the imputed-return method to determine the market value of the taxpayer's interest.

Where the market value of an interest has not been determined by reference to the traded price of the interest, and the market value of an interest at the end of a taxpayer's income year or the proceeds of disposition exceed the last-reported value by more than 30 percent, a post facto adjustment will be made to recoup any tax-deferral benefits which the taxpayer has enjoyed, unless the taxpayer is able to demonstrate the accuracy of the previously reported market value.

The method for computing foreign income under the comparative-value basis is summarised in the following formula:

$$Y = (E + S) - (B + P)$$

where:

Y = annual accrued gain or loss in respect of an interest in a non-resident company.

E = market value of the interest at the end of the taxpayer's income year.

S = proceeds from the disposition of all or part of the interest in the non-resident company during the taxpayer's income year.

B = market value of the interest at the beginning of the taxpayer's income year (this will be the market value of the interest at the end of the immediately preceding year).

P = the cost of any interest acquired by the taxpayer in the non-resident company during the income year.

All amounts must be calculated in New Zealand dollars in accordance with the rules for converting foreign currency denominated values contained in section 6.1.2.

The annual accrued gain or loss from interests in non-resident companies must be calculated separately for each non-resident company in which a taxpayer has an interest. Any losses so calculated may be used to offset branch-equivalent or comparative-value income in respect of interests in other non-resident companies in the current year or may be carried forward to offset such income in future years. Such losses may not be used to offset a taxpayer's other assessable income. However, where the taxpayer is a company within a group of companies (as defined in section 191 of the Income Tax Act), these losses may be transferred to other companies in the group for offset against branch-equivalent or comparative-value income.

6.1.2 Market Value of an Interest in a Non-Resident Company

The market value of an interest in a non-resident company is the highest price obtainable for the interest in a transaction between non-associated persons who are under no compulsion to buy or sell and who have full knowledge of all the relevant facts.

Methods that may be used to determine the market value of an interest in a non-resident company are outlined below.

a Valuation by Reference to Traded Price

The best indication of the market value of an interest in a non-resident company will be the observable traded price of the interest. Where an interest is traded on a public exchange, its market value will be determined by reference to the reported traded price of the interest computed on the following basis:

- where buy and sell offers are recorded on the exchange for the five working days prior to the end of the taxpayer's income year (referred to as the taxpayer's balance date), market value is the average of the close-of-trading prices recorded during that period;
- where for any day within the five day period no transactions in the interest are recorded, the market value shall be the mid-point of the close-of-trading buy and sell offers reported; and
- where neither buy nor sell offers are recorded during the last five trading days prior to the taxpayer's balance date, market value is the average of the mid-point of buy and sell offers reported in the most recent three days of the 30 working days immediately preceding the taxpayer's balance date.

Interests in unit trusts that are not traded but are redeemable at call or upon notice by the unit holder at prices set by the trust fund managers may be valued by reference to the most recently quoted redemption price in the 30 days immediately preceding a taxpayer's balance date. The redemption price may be a daily, weekly, or monthly price quoted in accordance with procedures adopted by the managers of the unit trust.

The market value of an interest in a non-resident company determined on the basis of its traded price or redemption price must be computed in New Zealand dollars using the close-of-trading spot exchange rate on the balance date of the taxpayer. Taxpayers will be required to disclose the name of the public exchange and the dates of the traded prices used to establish the market value of their interest (disclosure requirements are discussed further in Chapter 8).

b Other Valuation Methods

Where traded prices are not available, or do not provide a reliable indication of the market value of a taxpayer's interest in a non-resident company, the market value of the interest must be determined in accordance with other valuation methods provided that they conform to commercially acceptable valuation methods.

Under these valuation methods, the market value of an interest in a non-resident company will reflect:

- i the shareholders' funds of the non-resident company, provided that all assets and liabilities of the company are included in the company's balance sheet at their market values; and/or
- ii the net (after-tax) earnings of the non-resident company. One common method used to determine market value is based on the present value of future cash flows of a company. Alternatively, a value may be obtained by multiplying current or projected annual earnings by a price/earnings ratio. The discount rate or the price/earnings ratio should take account of the risk and returns typical of the industry in which the non-resident company operates.

Other valuation methods or variants of the above methods may be employed provided that they conform with commercially acceptable valuation methods.

Where interests in a non-resident company are not traded on a public exchange, but that company's assets can be valued by reference to traded prices, the market value of an interest in the first company should be determined by reference to the traded prices of its assets.

If the market value of an interest can be determined by reference to traded prices, it will be valued at the end of the taxpayer's income year. If the market value of an interest is determined on some basis other than the traded price of the interest, it will be computed at the end of the non-resident company's accounting year. The market value of the interest at the end of the taxpayer's income year will be considered to be the value computed on the last day of the non-resident company's previous accounting year. However, if the last day of the non-resident company's accounting year is before 1 April 1988, taxpayers will be required to value their interest as at 1 April 1988.

The market value of an interest in a non-resident company determined at the end of the company's accounting year must be converted to New Zealand dollars using the close-of-trading spot exchange rate on the last day of the company's accounting year.

c Valuation by Reference to an Imputed Return

Where the traded price of an interest is unavailable or unreliable and the compliance costs of establishing market values by any other methods are excessive, the taxpayer may compute the value of the interest at the end of an income year by an imputed return method. This will be based on a rate of return equal to a yield of 5 percent above the yield on five-year New Zealand Government stock. The annual imputed rate applicable to this method will be published each year by the Inland Revenue Department.

A taxpayer will compute the value of an end-of-year interest on an imputed-return basis by multiplying the opening value of the interest by the appropriate imputed rate and adding the result to the opening value. The same calculation is done for interests acquired during the taxpayer's income year except that the imputed return is pro-rated to reflect the portion of the taxpayer's income year during which the asset is owned.

When a taxpayer uses the imputed return method for calculating comparative-value income, he or she may deduct from the value of the interest at the end of the income year any dividend received from the non-resident company during the income year. This provision for dividends paid is only necessary where an end-of-year value is determined using the imputed-return method. The market value of an interest computed on any other basis will reflect any dividends paid by a non-resident company.

Once taxpayers have an end-of-year interest in a non-resident company computed on an imputed-return basis they will not be able to alter the basis upon which the interest can be valued for a further period of four income years. This

provision is necessary so that taxpayers cannot choose the method of valuation each year depending on whether income computed by reference to the actual market value of the interest or the imputed-return method results in lower assessable income.

At the end of a five-year period, if the taxpayer wishes to continue to use the imputed return method, he or she will be required to compute the market value of his or her interest on the basis of the rules set out in section 6.1.2(a) or (b) above. When a taxpayer changes at the end of a five-year period from the imputed-return method to any other method of valuing an interest, the market value of the interest at the beginning of the year must be equal to its market value under the imputed-return method at the end of the previous income year. Where a taxpayer changes from another method of valuation to an imputed-return method, the imputed-return method will be applied to the market value of the interest at the beginning of the taxpayer's income year. In the case of valuations which are not based on traded prices, the value of an interest at the beginning of a taxpayer's income year is deemed to be the market value at the end of the last accounting year of the non-resident company. The imputed return will be pro-rated to reflect the portion of the taxpayer's income year represented by the period between the end of the non-resident company's accounting year and the taxpayer's balance date.

d Market Value of an Interest on the Date of Commencement of these Rules

The date of the implementation of these rules is 1 April 1988. The market value of an interest in a non-resident company at the beginning of the first income year this regime applies will be the market value of the interest on that date. This ensures that only accrued gains and losses derived after 1 April 1988 will be included in the assessable income of a taxpayer.

6.1.3 Proceeds of Disposition of an Interest in a Non-Resident Company

When a taxpayer disposes of an interest in a non-resident company, the taxpayer must include in his or her assessable income the difference between the market value of the interest at the beginning of the year and the proceeds of disposition. The determination of the time of disposition of an interest is dealt with in section 6.1.6.

A special rule is necessary where a taxpayer has valued his or her interest at the end of a non-resident company's accounting year pursuant to the rules set out in section 6.1.2(b) and the interest is disposed of after the end of the non-resident company's accounting year. The amount included in the taxpayer's income will be the difference between the proceeds of disposition and the deemed market value of the interest at the beginning of the taxpayer's income year.

a Arm's-Length Dispositions

Proceeds of disposition will be defined to include all amounts received or receivable in consideration for the interest. Proceeds will be valued in New Zealand dollars using the close-of-trading spot exchange rate applicable on the date of disposition of the interest.

b Dispositions Not at Market Value

A taxpayer who disposes of an interest in a non-resident company by way of testamentary or inter vivos gift, or for less than its market value, will be deemed to have received proceeds of disposition equal to the market value of the interest at the time of the disposition. As a result of this deemed disposition at market value, the taxpayer will be required to include in assessable income any change in the market value of the interest from the last time it was valued for the purposes of these rules.

6.1.4 Acquisition of an Interest in a Non-Resident Company

When a taxpayer acquires an interest in a non-resident company, the market value of the interest is added to the market value of the taxpayer's interest in that company, if any, at the beginning of the income year for purposes of computing his or her annual accrued gain or loss pursuant to the formula set out in section 6.1.1 above. An interest acquired during a taxpayer's income year may be taken into account in this manner provided it is acquired on or before the actual date when the value of the interest at the end of the taxpayer's income year is determined.

For example, if the market value of the taxpayer's interest at the end of the year is determined by reference to the traded price of the interest, any interests acquired during the taxpayer's income year will be taken into account (the value of an interest computed by reference to traded prices being determined at the end of the taxpayer's income year). This includes interests acquired during an income year when the taxpayer switches from a method of valuation based on the accounting year of the non-resident company to a method based on the traded price of the interest. If the market value is determined at the end of the non-resident company's accounting year, only those interests acquired by the taxpayer prior to the end of the non-resident company's accounting year (on which date the interest is valued) may be taken into account. Interests acquired after the end of the non-resident company's accounting year will be taken into account in determining the value of the interest in the taxpayer's next income year.

a Arm's Length Acquisitions

The market value of an interest acquired by a taxpayer in an arm's length transaction will be the cost of the interest to the taxpayer.

b Acquisitions Not at Market Value

Taxpayers who acquire an interest in a non-resident company by way of

testamentary or inter vivos gift or for more than market value, will be deemed to have acquired the interest at a cost equal to its market value at the time of the acquisition.

This provision will ensure that the value of a gift is not subject to income tax under these rules. However, any subsequent increase in the market value of the interest will be taxable. This deeming provision complements a similar provision described in section 6.1.3(b) which deems the donor of an interest in a non-resident company to have disposed of the interest for its market value at the time of the gift.

The rules for computing the market value of interests in non-resident companies acquired by gift or for excessive consideration will be identical to those set out in section 6.1.2. The determination of the time of acquisition of an interest is dealt with in section 6.1.6.

The cost of acquisitions in a non-resident company will also be defined to include disguised acquisitions. For example, property transferred to, or services performed for a company directly or indirectly by a taxpayer or an associated person of the taxpayer will be deemed to be an acquisition of an interest in the company by the taxpayer. The cost of the interest acquired would be the difference between the market value of the property transferred or service performed and the market value of the consideration received in respect of the service or property.

6.1.5 The Post Facto Adjustment

The post facto adjustment is an adjustment to a taxpayer's tax liability on income computed on a comparative-value basis where the annual accrued gain for the preceding year has been significantly under-estimated. The adjustment is designed to counteract taxpayers gaining an advantage from the deferral of New Zealand tax by under-reporting the market value of an interest. By removing the advantage of deferral, this adjustment will also encourage taxpayers to value interests in non-resident companies as accurately as possible.

A post facto adjustment will be required when the proceeds of disposition of an interest in a non-resident company or the market value of the interest at the end of the taxpayer's income year plus any dividends received exceeds the market value of the interest at the end of the immediately-preceding income year by more than 30 percent. However, such an adjustment will not be required if the taxpayer has valued his or her interest at the end of the immediately-preceding income year by reference to traded prices, or can demonstrate the accuracy of the previously reported value, or can demonstrate the accuracy of the previously reported value.

The taxpayer (or the Inland Revenue Department where it has undertaken a revaluation of a taxpayer's interest) will determine an adjusted tax liability in accordance with the following steps:

Step 1: compute the amount which determines whether the post facto adjustment is triggered:

$$a + b - c - d$$

where:

a = proceeds of disposition and/or on the market value at the end of the taxpayer's income year; and

b = dividends paid by the non-resident company in the income year in respect of which the post facto adjustment applies and received by the taxpayer or by a non-resident company or trust in respect of which the taxpayer reports income on a branch-equivalent basis;

c = reported market value at the end of the immediately preceding income year; and

d = the cost of an interest acquired by the taxpayer during the income year.

Step 2: if the amount computed in step 1 is greater than 30 percent of the reported market value at the end of the immediately preceding income year, the post facto adjustment must be undertaken. The amount subject to adjustment is that computed in step 1, less an amount equal to 30 percent of the reported market value at the end of the immediately preceding income year. This amount is referred to as the post facto adjustment balance (PFAB).

Step 3: if the taxpayer is a resident individual or a company portfolio investor with less than 10 percent of the paid up capital of the non-resident company, the dividends and gains in the value of the interest are both assessable. A single post facto adjustment calculation will suffice. If, on the other hand, the taxpayer is a resident company which is not a portfolio investor, the dividends are exempt but the company will be required to collect a withholding payment at a rate equal to the personal tax rate. The taxpayer will therefore need to apportion the PFAB between that part attributable to the gain in the value of the interest and that part attributable to dividends. The portion of the PFAB attributable to the gain in the value of the interest is referred to as the income adjustment balance (IAB) and the remainder is referred to as the dividend adjustment balance (DAB). The PFAB will be allocated first to the IAB with any remainder being allocated to the DAB. A separate post facto adjustment will be required for each balance. The adjustment to the IAB will be taxed at the company tax rate. The adjustment to the DAB will be subject to a withholding payment at the personal tax rate.

Step 4: spread the amount subject to the post facto adjustment computed in step 3 evenly across the lesser of:

- the period over which the interest was held subsequent to 1 April 1988; or

- the period since the market value of the interest was last valued by reference to traded prices.

The shortfall will be spread on the basis of each complete month of the relevant period.

- Step 5: calculate the increased annual tax liability (or the adjusted withholding payment) for each income year the interest was held during the relevant period described in step 4;
- Step 6: determine the total adjusted tax liability or withholding payment amount. This will be the cumulative amount of increased tax or withholding payment recomputed for previous income years calculated on a year-on-year compounding basis using interest rates for each year published by the Inland Revenue Department applicable to tax in dispute. The interest levied to adjust tax payable or withholding payments to current values will not be deductible.
- Step 7: where the post facto adjustment applies to the income adjustment balance (the IAB) compute net tax to pay on total assessable income by adding the tax payable on income that has been subject to the post facto adjustment to tax payable on other income (that is, tax on other assessable income excluding the amount subject to the post facto adjustment). Where the post facto adjustment applies to the dividend adjustment balance (DAB), compute the withholding payment due by adding the withholding payment on dividends that have been subject to the post facto adjustment to withholding payments due on other dividends received (that is, payments due on dividends received excluding the dividends subject to the post facto adjustment).

EXAMPLE:

A corporate taxpayer X sells a 20 percent interest in non-resident company Y for \$435,000 on 30 September 1990. The reported value of the interest at the end of the taxpayer's previous income year (31 March 1990) was \$360,000. During the income year to 31 March 1991, the taxpayer received \$73,000 in dividends from company Y. The taxpayer originally purchased the interest in company Y on 1 June 1985.

Step 1: Compute the amount which determines whether the post facto adjustment is triggered:

= proceeds of disposition + dividends received - reported value at end of previous year.

= \$435,000 + \$73,000 - \$360,000

= \$148,000

Step 2: Compare the amount computed in step 1 to the reported market value at the end of the previous income year:

= $\frac{\$148,000}{\$360,000} = 41\%$

Therefore post facto adjustment is activated.

Compute the amount subject to the post facto adjustment:

= \$148,000 minus an amount equal to 30 percent of reported market value at end of previous income year.

= \$148,000 - \$108,000

= \$40,000

In this example, the PFAB (ie \$40,000) is less than the gain in the value of the interest in the company, \$75,000 (ie \$435,000 minus \$360,000). Thus, the PFAB is only allocated to the IAB. The DAB is zero. If, on the other hand, the PFAB were \$85,000 which exceeded the gain in the value of the interest in the company (viz \$75,000), the remainder (ie \$10,000) would be allocated to the DAB.

Step 4: Spread the IAB subject to the post facto adjustment across the period the interest was held from 1 April 1988.

	<u>Complete Months</u>
2 complete income years 1988-89 to 1989-90	24
6 months in 1990-91 income year	6
	<hr/>
Total	30
	<hr/>

$$\begin{aligned} \text{Shortfall per month} &= \frac{\$40,000}{30} \\ &= \$1,333,33 \end{aligned}$$

Step 5: Recomputation of tax liability

Year	Adjusted End Annual 31/3 Income	Adjusted Annual Tax @ 30% (say)	Annual Tax Int. Rate (say)	Adjusted Tax at Start of year	Adjusted by Int. Rate	Plus Adjusted Tax for Year	Equals Year- End Tax Liability
	\$	\$	%	\$	\$	\$	\$
1989	16,000	4,800	15	0	0	4,800	4,800(1)
1990	16,000	4,800	13	4,800	5,424(2)	4,800	10,224(3)
1991	8,000	2,400	10	10,224	10,724(4)	2,400	13,124
	(6 months)						

Notes

- (1) This figure is the underpaid tax for the 1989 income year.
- (2) This is the underpaid tax for 1989 compounded up by the tax in dispute rate for the 1990 income year.
- (3) This is equal to \$5,424 plus the underpaid tax for the 1990 income year (ie \$4,800).
- (4) For six months @ 10% p.a.

Figures rounded to nearest dollar for illustrative purposes.

Step 6: Adjusted Tax Liability on the income adjustment balance (IAB) subject to post facto adjustment = \$13,124

6.1.6 Time of Acquisition or Disposition of an Interest in a Non-Resident Company

In general, a taxpayer will be considered to have acquired an interest in a non-resident company when the taxpayer acquires legal title in the interest from the seller. Similarly, a taxpayer will be considered to have disposed of an interest in a non-resident company when title in the interest passes to the purchaser.

6.2 Non-Resident Trusts

6.2.1 Overview

The comparative-value basis of reporting foreign income will apply to resident settlors who are deemed to hold an interest in a non-resident trust pursuant to the rules set out in section 4.3.1 and who do not qualify for, or choose not to use, the branch-equivalent basis (see section 5.3).

The measurement of the annual accrued gain or loss in an interest in a non-resident trust will be similar to the measurement of the annual accrued gain or loss in an interest in a non-resident company. The annual accrued gain or loss in respect of a taxpayer's interest in a non-resident trust is the difference between the market value of the interest at the end of the taxpayer's income year and its market value at the beginning of the income year.

The method for computing annual accrued gains or losses is summarised in the following formula:

$$Y = E - (B + P)$$

where:

Y = annual accrued gain or loss in respect of an interest held by a New Zealand resident settlor in a non-resident trust.

E = market value of a settlor's interest in a non-resident trust at the end of the settlor's income year. This will be deemed to be the market value at the end of the non-resident trust's accounting year.

B = market value of a settlor's interest in a non-resident trust at the beginning of the settlor's income year.

P = market value of contributions to the non-resident trust by the settlor during the trust's accounting year.

All amounts must be calculated in New Zealand dollars in accordance with the procedures set out in section 6.2.2(b).

Losses from an interest in a non-resident trust must be carried forward and will offset only comparative-value or branch-equivalent income from the trust in future years.

6.2.2 Valuation of a Settlor's Interest in a Non-Resident Trust

a Market Value of an Interest at the End of a Taxpayer's Income Year

The market value of an interest in a non-resident trust will be determined at the end of the trust's accounting year and that amount will be the market

value of the interest at the end of the taxpayer's income year (the taxpayer's balance date). The market value of an interest at the beginning of any income year will be the market value of the interest reported on the last day of the taxpayer's immediately preceding income year.

The market value of an interest in a non-resident trust will be computed by multiplying the market value of the net assets of the trust (being assets of the trust that are not indefeasibly vested in beneficiaries, less the trust's liabilities) as at the end of the trust's accounting year by the settlor's interest in the trust, determined in accordance with the rules in section 5.3.2. The market value of an interest must be reported in New Zealand dollars converted at the close-of-trading spot exchange rate on the last day of the non-resident trust's accounting year.

b Valuing an Interest Using the Imputed Return Method

If a resident settlor has insufficient access to the financial information of a non-resident trust to compute the market value of an interest in the trust by reference to the net assets of the trust, the market value will be the market value of the interest at the beginning of the settlor's income year in New Zealand dollars adjusted by an imputed return. As for valuing interests in non-resident companies, the imputed rate of return will be equal to a rate 5 percent above the yield on five-year New Zealand Government stock. The annual imputed rate applicable will be the same as that applying to the valuation of interests in non-resident companies. The same calculation will be made for contributions to a non-resident trust during the taxpayer's income year except that the imputed return will be pro-rated.

Once the market value of a settlor's interest in a non-resident trust has been determined on an imputed-return basis, it must continue to be valued on that basis for a further period of four income years. When taxpayers move from the imputed-return method to the net assets method of valuing an interest, the market value of their interest at the beginning of the year must be equal to its market value under the imputed-return method. When taxpayers move from the net assets method of valuation to the imputed return method, the imputed-return method will be applied to the market value of the interest at the end of the last accounting year of the non-resident trust.

c Market Value of an Interest in a Non-Resident Trust on the Date of Commencement of These Rules

Settlors of non-resident trusts who adopt the comparative-value method of reporting income will be required to value their interests as at 1 April 1988, the date of implementation of the regime.

Where a taxpayer is unable to compute the market value of an interest in a non-resident trust by reference to the market value of the net assets of the trust, the market value of the interest will be computed as the market value, at the time of the contribution, of all property contributed to the trust to 31 March 1988 adjusted on a year-on-year compounding basis by the annual interest rate published for each income year by the Inland Revenue Department.

6.2.3 Valuation of Property Contributed to a Non-Resident Trust

Property contributed to a non-resident trust by a resident settlor during an income year must be valued at market value. Procedures for valuing gifts and transfers for inadequate consideration will be the same as those set out in section 6.1.4(b).

Whenever additional property is contributed to a trust, it will be necessary to recompute the settlor's interest in the trust pursuant to the rules set out in section 5.3.2.

Where the value of a settlor's interest at the end of his or her income year is computed by reference to the net assets of the non-resident trust, only contributions made prior to the end of the trust's accounting year (on which date the interest is valued) may be taken into account. Otherwise, gifted property contributed during a taxpayer's income year may be taken into account in determining the market value of an interest at the beginning and end of the taxpayer's income year.

6.2.4 Post Facto Adjustment

A post facto adjustment to a settlor's tax liability for prior income years will be triggered where the market value of a settlor's interest in a non-resident trust at the end of any income year exceeds the reported value of the interest at the end of the immediately preceding income year by more than 30 percent. A post facto adjustment may be triggered by the taxpayer or as a result of a revaluation of the settlor's interest by the Inland Revenue Department.

The post facto adjustment will be identical to that in respect of interest in non-resident companies. The post facto adjustment is described in greater detail in section 6.1.5.

6.3 Beneficial Interests in Discretionary Non-Resident Trusts

Taxpayers who acquire through purchase a beneficial interest in a discretionary non-resident trust will be taxed on such an interest on the same basis as any interest held by resident settlors described in section 6.2. The opening value of an interest in the non-resident trust will be the cost of the interest or market value if this is greater.

6.4 Changing from Comparative-Value to Branch-Equivalent Basis Reporting.

A taxpayer may only change the basis of reporting income earned through a non-resident company or trust from the comparative-value basis to the branch-equivalent basis from the beginning of a non-resident entity's accounting year. The taxpayer must notify the Commissioner of Inland Revenue of the change before the beginning of the accounting year in respect of which the change is to be effective. The Commissioner may require taxpayers to continue to use the comparative-value basis where their access to the financial information of the foreign entity is insufficient to permit branch-equivalent basis reporting.

CHAPTER 7 - THE TAXATION OF DISTRIBUTIONS

7.1 Introduction

To this point, this consultative document has outlined the treatment of foreign income earned by residents through non-resident companies and trusts that will be taxable on a current basis in New Zealand. This chapter outlines the proposed treatment of distributed income in residents' hands, whether in the form of dividends from non-resident companies or distributions from non-resident trusts.

7.2 Foreign Dividends

7.2.1 Dividends Received by Companies

All foreign dividends received by resident companies will continue to be exempt from tax with the exception of portfolio dividends. However, companies receiving non-portfolio dividends will be required to collect a withholding payment on behalf of shareholders.

Foreign portfolio dividends received by companies resident in New Zealand after the time of the Minister of Finance's Statement on 17 December 1987 will be included in assessable income. A credit will be allowed for foreign withholding taxes paid in respect of such dividends. Portfolio dividends will be defined as dividends received from a non-resident company in which the recipient company owns less than 10 percent of the paid-up share capital at the time that the dividends are received. A dividend will be deemed to be received when it is declared by the payer company.

7.2.2 Dividends Received by Individuals

Foreign dividends received by individuals who are residents of New Zealand will continue to be included in assessable income. Foreign withholding taxes levied on such dividends will continue to be creditable against a resident's New Zealand tax liability.

7.3 Assessable Distributions from Trusts

It is necessary to amend existing income tax rules with respect to distributions by non-resident trusts to beneficiaries who are residents of New Zealand. These amendments will make it clear that all distributions will be taxable in the hands of beneficiaries resident in New Zealand with the exception of distributions made from the capital of the trust.

7.3.1 Definition of a Distribution

In order to minimise opportunities for deferral of New Zealand tax, beneficiaries' income in respect of distributions received from non-resident trusts will be defined to include any amount which vests indefeasibly in a beneficiary, whether or not the beneficiary is entitled to enforce immediate payment of the amount. This definition of beneficiaries' income is consistent with the definition of trustee income of a non-resident trust set out in section 5.3.2 which excludes any income that vests indefeasibly in beneficiaries of the trust. This definition will be restricted to distributions from non-resident trusts. However, the extension of the definition to distributions from resident trusts will be considered in due course.

Distributions out of the capital of the trust will not be included in assessable income. For the purpose of these rules, distributions will be deemed to be made out of trust income unless the beneficiary can show that it represents distributions of the capital of the trust.

These rules will apply to distributions received and amounts that vest indefeasibly in beneficiaries after the time of the Minister of Finance's Statement on 17 December 1987.

7.3.2 Non-Resident Trusts That Become Resident Trusts

An opportunity to avoid New Zealand tax on distributions exists when a non-resident trust with accumulated funds appoints a resident trustee, thereby becoming a resident trust. Distributions from the accumulated funds of the trust to beneficiaries in New Zealand would not be subject to New Zealand tax.

Therefore, when a non-resident trust becomes a resident trust, the resident trustee will be assessable on the market value of the trust assets reduced by the value of the capital of the trust, being the original capital and any subsequent contributions, at historical cost.

7.4 Relief for Branch-Equivalent Taxes

As noted in section 5.2.1, relief for New Zealand tax is available for dividends or distributions paid from income that has been reported by a taxpayer on a branch-equivalent basis. This is provided by permitting a deduction for dividends or distributions to the extent that branch-equivalent income is earned in the year of distribution.

There will be no provision for relief from New Zealand tax for dividends or distributions from income that has been reported by a taxpayer on a comparative-value basis. This is because the payment of such dividends or distributions will reduce the value of a resident's interest in the non-resident company, thereby reducing the resident's income measured on a comparative-value basis.

7.5 Foreign Tax Credit

7.5.1 Dividends from Non-Resident Companies

Tax credits will be provided for foreign withholding taxes paid on portfolio dividends received by resident companies and dividends received by resident individuals in accordance with the provisions in Part VIII of the Income Tax Act.

Foreign non-portfolio dividends, while exempt in the hands of resident companies, will be assessable when distributed to individual shareholders. Certain foreign withholding taxes on dividends received by a resident company will be added to the company's imputation credit account and thereby flow through to individual shareholders. This is explained in greater detail in the consultative document on full imputation.

7.5.2 Distributions from Non-Resident Trusts

Foreign withholding taxes paid on assessable distributions received by resident beneficiaries from non-resident trusts will be creditable against New Zealand tax payable on such distributions.

Section 293 of the Income Tax Act currently permits a credit to be claimed against New Zealand tax payable by a beneficiary for foreign income taxes and withholding taxes paid in respect of the beneficiaries' income. This section will be amended to provide a tax credit for foreign withholding taxes only.

The credit for foreign withholding taxes paid on distributions to resident beneficiaries will be subject to conditions and limitations similar to those under the provisions of Part VIII of the Income Tax Act.

Where both exempt and assessable distributions are received, foreign withholding tax must be apportioned between them on a pro-rata basis.

7.6 Disguised Distributions

Dividends from non-resident companies or distributions from non-resident trusts received by a resident will be broadly defined to include benefits received directly or indirectly by the resident. Such benefits must be reported at market value.

Examples of benefits considered to be distributions or dividends include those enjoyed pursuant to loans to a resident shareholder or beneficiary at non-market interest rates, or property transferred or services performed for consideration that differs from market value. The value of the benefit in such circumstances will be the difference between market value of the arrangement and the actual value of any consideration paid or received by the resident shareholder or beneficiary to or from the non-resident entity.

CHAPTER 8 - DISCLOSURE AND ADMINISTRATION**8.1 Introduction**

Taxpayers will be required to disclose their interests in non-resident companies and trusts and to provide all information necessary to compute foreign income in accordance with these measures. Taxpayers with interests in such entities will be required to file a separate schedule for each entity with their annual income tax return. Penalties will apply for failure to disclose the necessary information. To assist in the efficient and fair administration of the new measures, a special unit of the Inland Revenue Department will be established.

8.2 Disclosure

Each income year taxpayers will be required to disclose whether they:

- had an interest, as defined in section 4.2.1 of this document, in a non-resident company;
- had an interest, as defined in section 4.3.1 of this document, in a non-resident trust;
- received a dividend from a non-resident company; and
- received a distribution from a non-resident trust or whether income in such a trust became vested indefeasibly in them.

A separate schedule for each non-resident company or non-resident trust in which the taxpayer has an interest must be filed with the annual income tax return. Individuals will not be required to complete such schedules where the total value of all interests in non-resident companies does not exceed \$10,000 at all times in the income year or where the total value of all contributions to non-resident trusts does not exceed \$500 at all times in the income year.

The information to be disclosed on the schedule will include:

- the name, address and other basic details of the entity;
- the taxpayer's percentage interest in the entity;
- a return of income computed on either a branch-equivalent or comparative-value basis;
- the computation of New Zealand tax liability on dividends or distributions;
- recomputed tax liability where the post facto adjustment is triggered; and
- any change in the balance date of the entity during the income year.

A taxpayer reporting income on a branch-equivalent basis will be required to include with the return the annual balance sheet and profit and loss statement for the non-resident trust or company. In addition, the taxpayer must have available in New Zealand, for inspection by Inland Revenue Department on request, a copy of the entity's financial accounts (audited if available) and of its tax return filed with the foreign tax authorities.

A taxpayer reporting income on the comparative-value basis must provide sufficient information to support the basis of valuation used and the change in value reported. Where relevant, this will include such details as the name of the exchange on which the interest is traded, the dates on which traded prices have been used to value the interest, and the volume of shares traded.

All information required to be disclosed by taxpayers under these measures must be in English or be accompanied by an English translation.

Substantial penalties will apply for non-disclosure or inadequate disclosure.

8.3 Administration

Taxpayers will continue to file their income tax returns at IRD district offices. The processing of disclosure returns will be centralised in a special unit of the Department. The unit will be staffed by personnel specialising in the monitoring of income earned by residents under this regime.

Such centralisation will facilitate investigation and the cross-checking of returns and hence their consistent treatment. Comprehensive auditing will also be possible.

The Government will ensure that the necessary resources are committed to enable the international tax regime to be effectively monitored and enforced.

GLOSSARY OF TERMS

Accounting year - the 12-month period ending with the taxpayer's balance date.

Associated persons - individuals and companies associated within the meaning of section 8 of the Income Tax Act.

Branch-equivalent basis - the method for determining a taxpayer's income from an interest in a non-resident company or trust where the taxpayer has sufficient information to calculate the income of the company or trust in accordance with New Zealand tax rules.

Comparative-value basis - the method for determining the annual increase or decrease in the market value of an interest in a non-resident company or trust.

Dividend Adjustment Balance (DAB) - the amount of non-portfolio dividends that will be subject to the post facto adjustment.

Distribution from a non-resident trust - any amount which vests indefeasibly in a beneficiary.

Imputation Credit Account - an account to be established by companies to record the amount of imputation credits available for allocation to shareholders.

Imputed return method - the determination of the market value of an interest in a non-resident company or trust assuming that the value grew at a rate equal to a prescribed interest rate.

Income Adjustment Balance (IAB) - that part of the accrued gain in the value of an interest that will be subject to the post facto adjustment.

Income year - the year ending 31 March. For example, the year ending 31 March 1988 is referred to as the 1988 income year. Income year is defined in section 2 of the Income Tax Act 1976.

Interest in a non-resident trust - the proportion of the market value of the net assets of the trust attributable to a resident settlor's contribution.

Interest in a non-resident company - an entitlement to, or entitlement to acquire, rights to dividends or voting power in relation to distributions and changes to a company's constitutional rules.

Market value - the highest price obtainable in a transaction between non-associated persons who are under no compulsion to buy or sell and who have knowledge of the relevant facts.

Non-Resident company - a company this is not subject to tax in New Zealand on its foreign income.

Non-resident entity - a company or trust resident outside New Zealand.

Non-resident trust - a trust which has no trustees resident in New Zealand at the end of its accounting year.

Proceeds of disposition - all amounts received or receivable on the disposition of an interest in a non-resident company or trust.

Portfolio dividends - dividends received by a company from another company in which the first company owns less than 10 percent of the paid-up share capital.

Post facto adjustment - an adjustment to a taxpayer's tax for previous years during which an interest in a non-resident company was owned where the proceeds of disposition of the interest or its market value significantly exceeded the last reported value of the interest.

Post Facto Adjustment Balance (PFAB) - the amount of accrued gain in the value of an interest in a non-resident entity and the amount of non-portfolio dividends that will be subject to the post facto adjustment. (The post facto adjustment balance is the sum of the dividend adjustment balance and the income adjustment balance.)

Resident settlor - any person resident in New Zealand who has contributed property, directly or indirectly, to a non-resident trust.

Tax avoidance - the minimisation of tax liability by legal means. The term describes practices which are contrary to the intent of, and exploit loopholes in, the tax law.

Tax base - the base on which tax is levied, which in New Zealand includes income and expenditure.

Tax deferral - the practice of delaying the payment of tax without penalty. For example, where income is taxed as received and not as it accrues, deferral is possible. A tax system which allows deferral provides certain taxpayers, in effect, with an interest-free loan.

Tax haven - a country which imposes little or no tax, or is otherwise attractive for tax reasons, relative to another country.

