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International Tax Reform

Part 1

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Report of the

Consultative Committee

MARCH 1988

Office of the

**Consultative Committee on
Full Imputation and International Tax Reform**

PO Box 3724
WELLINGTON

23 March 1988

Hon R O Douglas

Minister of Finance

Parliament Buildings

Wellington.

Dear Mr Douglas,

On behalf of the Consultative Committee on Full Imputation and International Tax Reform, I enclose Part 1 of the Committee's report on the reform proposals outlined in the Consultative Document on International Tax Reform. The report outlines the Committee's recommendations on the main elements of the international tax regime. We will report separately on further details of our recommended regime and on the proposals in the Consultative Document on Full Imputation.

The Consultative Document proposed that the main taxing regimes, the branch equivalent and the comparative value regimes, take effect from 1 April 1988. We have therefore concentrated in this report on the matters which need to be decided before 1 April 1988 so that taxpayers will know with as much certainty as possible whether they are to be affected after that date. We believe that, once you have made your decisions, taxpayers will have a considerable degree of certainty.

A period of uncertainty is one of the costs of the consultative process. The trade off is that taxpayers have far more input into decision making than they had previously. We believe that the benefits of the consultative process outweigh the costs and that it would be impossible to implement tax reforms as complex as these without such a process.

If you accept our recommendations on transitional provisions, most existing foreign investments owned by New Zealand residents will not be affected by the branch equivalent regime until 1 April 1990. The need for legislative certainty from 1 April 1988 would therefore be reduced.

This report deals with the major building blocks of the international regime. Because of the substitutability of different legal entities, the building blocks need to be closely integrated. In addition, the international reforms are intimately linked with the full imputation proposals, the reforms to the taxation of superannuation funds and life insurance and also future tax reforms such as the introduction of a capital gains tax. We have considered our recommendations

in this context.

I would add that the recommendations in this report represent the unanimous views of Committee members .

The Committee has benefited from the input of officials of the Treasury and the Inland Revenue Department. In particular, we express our thanks to Messers Alex Duncan, Ken Heaton and David White of Treasury and Anthony Grace and Michael Rigby of the Inland Revenue Department.

Yours sincerely



Arthur Valabh

Chairman

25 March 1988

PRESS STATEMENT BY

Minister of Finance, Hon R O Douglas

Minister of Revenue, Hon T A de Cleene

This document is the first part of the report on the introduction of international tax measures by the Consultative Committee on Full Imputation and International Tax Reform. The report sets out the major building blocks of the regime recommended by the Committee following its review of the regime contained in the Consultative Document and the many public submissions received. So as to provide taxpayers with as much information as possible as soon as possible, this first part of the report is being released now.

The Committee broadly endorses the Government's objective of reducing the opportunities for the avoidance and deferral of New Zealand tax by residents through the use of offshore entities. It also recommends the introduction of a domestic capital gains tax as a matter of priority. It is partly in light of such future action on capital gains that the Committee has recommended a number of important changes to the international tax regime set out in the Consultative Document.

In brief, the major recommendation is that the branch-equivalent method of taxation should apply only where there is control and, where there is not control, the comparative-value method of taxation should apply but only to a limited range of investments (foreign investment funds). To streamline the operation of the branch-equivalent method and reduce compliance costs, an exemption is recommended for taxpayers having interests in entities which are in designated countries and which do not benefit from significant tax preferences. Transitional arrangements are also recommended by the Committee together with more comprehensive disclosure provisions.

The regime recommended by the Committee, although less comprehensive than that in the Consultative Document, is one which substantially meets the objectives of reform which were set by the Government. The Committee has developed the regime in accordance with clear principles and at the same time has given due recognition to the real practical constraints. It has also had regard to the Government's broader programme of taxation reform.

Accordingly, we agree with the recommendations in the Committee's report which constitute the basic framework of the regime. At this stage there are only three main areas in which the Government reserves its position. The first concerns the foreign investment fund provisions (recommendation (g), page 63). Their effect is to exclude from the regime all residents with non-controlling interests in 'active' tax haven entities. The Committee has suggested that coverage of this area should await the introduction of a domestic capital gains tax, or evidence that the regime is not catching the majority of opportunities for avoidance and deferral, or evidence that taxpayers are abusing the exemption. This is an area the Government intends to monitor closely in the initial stages of the operation of the regime. If necessary, such provisions will be reviewed and strengthened prior to the introduction of a capital gains tax.

The second area in which the Government reserves its position is the treatment of capital profits earned by trusts subject to the settlor regime, and by testamentary trusts, after 31 March 1989, that is after the end of the transitional period. The Committee has recommended that, on distribution, capital profits be allowed to pass through to beneficiaries tax free (recommendation (o), page 65 and recommendation (t)(i), page 66). The Government wishes to consider these recommendations further in the context of the imputation and superannuation reforms.

The third area concerns the taxation of resident trusts as defined under the new regime, settled on or before 17 December 1987, in the period from 1 April 1989. The Committee recommends that the settlor regime apply to any such trusts which are newly settled or which have new settlements made to them after 17 December 1987, or which have elected with the settlor's agreement to come under that regime; other trusts could remain outside the settlor regime, but distributions of income (including accumulated income) and capital profits to New Zealand resident beneficiaries would be taxed to the beneficiary with an interest charge calculated from 1 April 1988 to recoup deferred tax (recommendations (r), page 65 and (s), pages 65-66). At this stage, the Government considers that from 1 April 1989 resident trusts should be taxed according to the settlor regime, except where the settlor can demonstrate that there is manifest good reason for such an exception and it can be shown that either the trust is subject to tax in a high tax jurisdiction or the imposition of the settlor regime would cause undue hardship to the settlor. For these excepted trusts, as for testamentary trusts, the beneficiary regime recommended by the Committee would apply (recommendation (s), pages 65-66 and recommendation (t) (ii), page 66).

Subject to these reservations it is agreed that work on the further detailed measures and the draft legislation, to be developed for the Government's final approval, proceed on the basis of the Committee's report.

A summary of the changes and the key elements of the new regime are to be set out in a separate press release. Further information on the detailed technical issues relating to the operation of the regime will follow in the second part of the Committee's report.

The Committee is chaired by Mr Arthur Valabh and its members comprise Dr Robin Congreve, Mr Stuart Hutchinson, Dr Susan Lojkine, Professor John Prebble and Mr Tim Robinson. The Committee has faced a formidable task. Its professionalism is reflected in the excellence of the report.

We thank Mr Valabh and his Committee for their significant contribution to the reform of taxation in this area. Our appreciation extends also to those who took the time to make submissions and provide constructive comment. This has facilitated the Committee's work and will result in improvements to the policies finally enacted.

We look forward to the second part of the Committee's report on the international tax measures and its report on full imputation; both will be accompanied by draft legislation. After the subsequent introduction of the Bill to Parliament, it will be referred to a Select Committee. Interested parties will therefore have a further opportunity to make submissions.

 

Roger Douglas Trevor de Cleene

Minister of Finance Minister of Revenue

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**Report on
International Tax Reform**

**Part 1**

**\_\_\_\_\_\_**

**Consultative Committee on
Full Imputation and International Tax Reform**

# CHAPTER 1 – INTRODUCTION

## 1.1 Purpose of This Report

1.1.1 This is Part 1 of the Report of the Consultative Committee on Full Imputation and International Tax Reform. It deals with the Committee's recommendations on the main elements of the international tax reforms. Our aim in presenting this report is to enable you to give taxpayers as much certainty as possible before 1 April 1988, the implementation date proposed in the Consultative Document on International Tax Reform (the "CD") for the regimes to apply to undistributed income.

1.1.2 To this end, the report concentrates on the Committee's recommendations on the main building blocks of the international tax reforms and, in particular, the boundaries of the regime and the transitional provisions. In this way, we hope that, once you have considered our recommendations, taxpayers will know with as much certainty as is practicable at this stage whether they are affected by the regime and, if so, when it will first affect them and broadly how it will do so. Where we have not finalised our views, we say so or refrain from commenting.

1.1.3 A number of details are still to be considered. We will address these in Part 2 of our report which will accompany the draft legislation. A separate report will also be prepared on full imputation and the corresponding draft legislation.

1.1.4 Given the Committee's reporting deadline of 31 March 1988, we began meeting on 22 December 1987 in an endeavour to identify the major issues. We have met regularly, usually several times a week, since then. Since our brief includes the preparation of draft legislation, we have engaged three legal draftsmen to assist with this task. As a result, the draft legislation is well advanced, though considerable detail has still to be decided.

## 1.2 Submissions

1.2.1 A total of 209 submissions were received by the Committee. Of these, 108 dealt only with the international tax reforms, 49 dealt only with imputation and 47 commented on both. Given our reporting deadline, we have been able to hear only a small number of oral submissions. Committee members have, however, discussed the CD proposals widely with tax practitioners and business people. In addition, Committee members attended the Institute of Policy Studies seminar on the reforms, which was held in Wellington on 2 February 1988, and the annual conference of the New Zealand branch of the International Fiscal Association, held at Wairakei on 26-27 February 1988, which was focussed entirely on the international reforms and imputation. These were helpful in providing feedback on the CD proposals and alternatives advocated by practitioners.

## 1.3 Context of the Reforms

1.3.1 The international tax reforms are part of a wider package of reforms which includes substantial reductions in statutory tax rates and removal of tax concessions for superannuation and life insurance. The Committee recognises that

the Government regards an effective international regime as part of the trade off for lower tax rates and, indeed, a prerequisite for the latter. In addition, the reforms should be mutually consistent and should reinforce one another as far as possible. For example, the effectiveness of the superannuation fund tax reforms depends in part on the international tax regime covering offshore vehicles which could substitute for domestic superannuation funds. The Committee has kept these linkages in mind in considering the present proposals.

1.3.2 The reforms must also be seen in the context of future tax reforms, particularly the possible introduction of a capital gains tax and interjurisdictional allocation rules (such as transfer pricing and expense allocation provisions). The latter are necessary to ensure that New Zealand collects the appropriate amount of revenue from domestic investments owned by non-residents. This objective is not addressed in the current international proposals, which are aimed at taxing New Zealand residents on income diverted from New Zealand and foreign-source income derived through offshore companies and trusts.

## 1.4 Criteria for Evaluation of Proposals

1.4.1 There are a number of criteria which are conventionally used to evaluate tax reforms. These have formed the basis of the Committee's framework for considering the CD proposals and possible alternatives. In brief, we believe the reforms should be:

a equitable. The effectiveness of the reforms will depend to a large extent on voluntary compliance by taxpayers. This is much more likely to occur if they are perceived to be fair;

b efficient, in the sense of minimising additional administrative and compliance costs and the impact of the tax system on business decision-making; and

c as far as possible, simple to implement and certain in their impact.

1.4.2 We would add that taxpayer perceptions of the reforms will be enhanced if they are consistent with existing income tax principles and give adequate recognition to the need for transitional measures.

## 1.5 Objectives of International Tax Reform

1.5.1 The CD has two main objectives: 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."

(CD, page 1)

1.5.2 There is no sharp distinction between tax avoidance and tax deferral since the latter amounts to a permanent reduction in the present value of the tax collected by New Zealand. The avoidance problem which the CD identifies and which was the target of the controlled foreign company ("CFC") measures announced in Annex 4 of the 1987 Budget is essentially the use of controlled tax haven vehicles, whether companies or trusts, to avoid New Zealand tax by the diversion of New Zealand-source income. There is widespread agreement amongst parties making submissions that the Government is fully justified in addressing this problem. The Committee certainly endorses this view. There is also general, though less solid, support for a regime which taxes the accumulation of foreign-source income in tax haven entities.

1.5.3 The anti-deferral objective is much more contentious and there is considerable opposition in submissions to a comprehensive anti-deferral regime. The CD regards the deferral problem broadly as the absence of taxation on an accrual basis of residents on income they earn through non-resident companies and trusts. At present, New Zealand tax is collected on income derived by foreign companies owned by New Zealand residents only when it is distributed to non-corporate resident taxpayers. In the case of trusts, New Zealand tax is collected, if at all, only when distributions are made to resident beneficiaries.

1.5.4 The CD proposals pursue the anti-deferral objective primarily by aiming to tax residents on the undistributed income of non-resident companies and trusts in which they have an interest or a connection as a settlor. This objective is also behind the introduction of a withholding payment to apply to foreign-source non-portfolio dividends received by resident companies, as announced in the Government Economic Statement of 17 December 1987.

1.5.5 Thus, the thrust of the reforms is to tax all residents, including companies, on the income that they actually receive from foreign entities (i.e. non-resident companies and trusts) and on certain undistributed income. The taxation of income on receipt is well within the current concepts of the income tax system (though other considerations may suggest that dividends received by companies should be taxed differently from dividends received by individuals). As commercial transactions have become more sophisticated, both the accounting and the income tax concepts of income have of necessity been extended in many areas to include not only income received but income which can be said with reasonable certainty to have accrued. It is fully consistent with this extended definition of income to tax residents on the undistributed income of non-resident entities that can reasonably be assumed to have accrued to them. This does not require that they have legal title to the income. It is sufficient that they possess the power to give themselves legal title. We therefore do not regard it as offensive to income tax principles that residents are taxed on income over which they have power of disposition, even if they have not received it. We would, however, go no further than this. It is not reasonable to tax residents on income that they may never receive.

1.5.6 One of the Committee's main reservations about the CD proposals is that they pursue the anti-deferral objective to its extreme limits without giving enough attention to conventional income tax principles or to the administration and compliance problems which arise. In some cases, taxation would be levied on amounts that were well beyond the income to which a taxpayer had any reasonable chance of access. Moreover, at some point, the administration and compliance costs would be excessive relative to the revenue that could be expected.

1.5.7 The CD supports the anti-deferral objective on the basis that "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" (CD, page 15). This is seen as the primary justification for the comparative value ("CV") regime (under which residents would be taxed on the annual change in the market value of their interests in foreign companies), though it has also been advanced on other grounds which will be discussed below. The Committee strongly supports the objective of broadening the tax base and lowering income tax rates. We believe that this objective also has widespread support amongst the business community. There is, however, strenuous opposition to pursuing it through what is in effect an accrual nominal capital gains tax, i.e. the CV method. The CV method is not defended in the CD as a capital gains tax. There is no discussion of the fundamental design issues associated with such a tax, such as whether it should tax only real or nominal gains and whether it should apply on an accrual or realisation basis. Given the complete novelty of the CV proposal, its lack of any international precedent, its valuation problems, its cash-flow consequences and the absence of a convincing justification for it in the CD, it is not surprising that the proposal found no support amongst those who made submissions.

1.5.8 This raises the Committee's other main concern. The CD gives too little weight to the importance, in a tax system based on voluntary compliance, of acknowledging taxpayer perceptions of "fairness". If the CV regime were implemented as proposed, it would encourage evasion and stretch the limits of avoidance because taxpayers would regard it as very unfair. The objective of retaining taxpayer goodwill should be kept in mind.

1.5.9 The second objective referred to in paragraph 1.5.1, of reducing the extent to which the tax system encourages offshore investment, is intimately linked with the first objective. To the extent that tax payable on foreign investment is avoided or deferred relative to the tax that would be payable in New Zealand, the tax system will influence decisions to invest in New Zealand or overseas. Most decisions to invest offshore are not tax driven though, as an important business cost, taxes must obviously be taken into account and will influence decisions to repatriate or reinvest income. The CD objective refers to the impact of taxes on the marginal investment decision, that is, where other factors are in balance, tax considerations might tip the scales in favour of investing offshore rather than in New Zealand.

1.5.10 This objective can be addressed in terms of the criteria of "capital export neutrality" (which holds when foreign- and domestic-source income are taxed in the same way so that residents are indifferent on tax considerations between investing offshore or domestically) and "capital import neutrality" (which holds when the tax treatment of foreign investments is determined solely by the rules applying in the country in which the investment is located). Many submissions explicitly or implicitly advocated the latter approach in order that New Zealand firms could compete with foreign firms. It was pointed out that no other country has a regime comparable to that proposed in the CD.

1.5.11 To a large extent, the international competitiveness argument advanced in submissions reflects the immediate and potentially adverse impact the CD proposals would have on existing investment. The Committee considers that these concerns can be addressed by providing adequate transitional arrangements. As to the future, we recognise that tax is only one factor

affecting competitiveness. In the long run, New Zealand as a whole is best served by an efficient tax system: that is, one which is neutral between domestic and foreign investment. The Committee therefore supports the second objective of the CD, though there are major constraints on the extent to which it can be achieved. We comment further on this issue in section 2.3.

1.5.12 Wherever there is cross-border investment, there are at least two tax jurisdictions involved: the country in which the investment is sourced and the country in which the investors are resident. The interests of the respective revenue authorities are to some extent in conflict because the residence country typically allows a tax credit, within limits, for the tax levied by the source country. Tax treaties resolve the conflicting interests to some extent but unilateral tax changes can affect the balance. For example, Australian companies have an incentive to minimise the New Zealand tax they pay, even if this means increasing their Australian tax, since the Australian imputation scheme allows credits for Australian but not foreign company tax. Thus, another general objective of reform of New Zealand's international tax regime should be to ensure that New Zealand collects its share of tax, especially on income that has a New Zealand source. This is the objective of allocation rules which we referred to in section 1.5.

## 1.6 Regimes Proposed in the Consultative Document

1.6.1 The scope and nature of the international tax regime should be determined in the light of the above objectives and the criteria for evaluation outlined in section 1.4. The CD proposes two broad options for taxing on an accrual basis income derived by residents through offshore entities. The first is to tax residents each year on "their share" of the underlying income of

the offshore entity. This is the approach taken under the branch-equivalent ("BE") method. The second approach is to tax residents on the distributions they receive from the offshore entity and the capital gain or loss that accrues to them each year. This is the all-embracing approach of the CV method.

1.6.2 These two approaches differ because taxable income may be less than comprehensive but, given a reasonably broad tax base, the primary difference is that the BE method taxes what may be termed systematic gains (which are due primarily to the accumulation of assets within companies as a result of retained earnings), whereas the CV method taxes both systematic and non-systematic or unanticipated gains. From the point of view of the efficiency of the tax system, it is not necessary to tax unanticipated or windfall gains and losses. Because such gains cannot be anticipated, they cannot influence investment decisions. Thus, the case for taxing them must rest on some notion of fairness.

1.6.3 Another way of viewing the difference between the two methods is that BE income is taxable income as currently defined whereas CV income is the much less conventional economic concept of income. The Committee prefers the approach, wherever feasible, of taxing residents on the underlying income of foreign entities since this focuses on systematic or planned gains and is consistent with the principles of the current tax system.

1.6.4 Where this approach (i.e. the BE method) is not feasible, the CD falls back on the CV method. Some of the Committee's concerns about the CV approach were referred to above. An accrual alternative to the CV method would be to tax residents each year on their share of the reported income of foreign companies based on the companies' audited accounts. In

order to avoid taxing residents on the undistributed income of foreign companies which they never receive, it would be desirable to have a post facto wash up on disposal of shares. This post facto adjustment would determine the actual gain or loss derived by a taxpayer on a foreign investment by calculating the distributions received and the capital gain or loss. Thus, a realisation-based capital gains tax is an inherent part of this approach.

1.6.5 The Committee do not advocate the adoption of this approach now. We mention it mainly to suggest that there are alternatives to the CV method that would meet the Government's objectives and in some respects are preferable to the CV method. The option outlined would be best examined in the context of the current investigation of capital gains taxes and should be introduced only as part of a general capital gains tax.

1.6.6 The CV method does, however, have a role as part of the current reforms where there are systematic or expected gains resulting from the accumulation of income in an offshore entity, such as may be the case for some unit trusts and mutual funds. We comment further on this in chapter 3.

## 1.7 Summary: Main Building Blocks

1.7.1 The Committee's proposals are developed in the following chapters. The main elements are:

a the BE regime to apply to non-minor shareholders of controlled companies which are either:

i resident outside of the United States, the United Kingdom, West Germany, Canada, France, Japan or Australia; or

ii if resident in one of those countries, fail the grey list test outlined in section 7 concerning the effect of significant tax preferences in those countries;

b a foreign investment fund regime to apply to residents with interests in certain investment vehicles domiciled in low tax countries;

c the settlor regime to apply to resident trusts (i.e. those with a resident settlor);

d transitional arrangements under which taxpayers would be exempt from:

i the BE regime until 1 April 1990 in respect of interests acquired on or before 17 December 1987 in companies which are not resident in low tax jurisdictions specified in a transitional list;

ii the BE regime until 1 April 1989 in respect of interests acquired after 17 December 1987 in companies resident in a country listed in (a)(i);

iii the settlor regime in respect of settlements made on or before 17 December 1987 where the settlor so elects, in which case an alternative regime would apply to distributions to beneficiaries and to the settlor where he or she had a debt, guarantee or other form of financial assistance outstanding to the trustee;

e strict disclosure requirements and penalties for non-compliance;

f eventually, but we would hope within a relatively short time, the extension of the income tax base to include capital gains on both domestic and offshore investments, including offshore investments not covered by the present proposals; and

g also as a matter of priority, the introduction of interjurisdictional allocation rules to ensure that New Zealand collects the appropriate amount of revenue, particularly in relation to New Zealand-source income.

# CHAPTER 2 – BRANCH EQUIVALENT REGIME FOR CONTROLLED FOREIGN COMPANIES

## 2.1 Control Test

2.1.1 The BE method would tax New Zealand shareholders on their proportionate shares of the undistributed income of foreign companies measured according to New Zealand tax rules. Thus, the method requires taxpayers to have all of the information necessary to recompute the taxable income of offshore companies. In practice, this information will generally not be available unless the resident(s) control the offshore company. In addition, as we have argued in section 1.5, it is unreasonable to tax residents on the undistributed income of offshore companies which they may never receive, unless they at least have access to it, that is, they have the power to require distribution if they wish. For these two reasons, the Committee recommends that the BE regime apply only where residents control an offshore company.

2.1.2 This would be in line with practice overseas, where BE-type regimes apply only where there is a controlled foreign company. Submissions were strongly in favour of a control test. This would not be a significant departure from the CD proposals since, in practice, the BE regime could be applied only where there is control.

2.1.3 A number of companies making submissions noted that their ability to repatriate profits from non-resident subsidiaries may be restricted because of exchange controls, governmental foreign investment requirements, or agreements made with co-venturers. Since businesses do not consciously make bad investment decisions, we would expect that the return generated

from foreign subsidiaries in these circumstances will be higher than otherwise to reflect the constraints imposed. Thus, the New Zealand parent will generally expect to be able to gain access to the foreign subsidiary profits at some stage, though not necessarily to repatriate them, and be compensated for any impediments and time delays. Even if this were not the case, it would be impracticable to give relief from the BE regime merely because profit access restrictions exist because taxpayers could voluntarily enter into such arrangements to suspend the effect of the regime. It might also encourage foreign governments to impose repatriation controls on New Zealand investment. Where such restrictions currently apply to foreign subsidiaries, some relief will be provided by the transitional provisions recommended by the Committee.

2.1.4 The Committee has considered the appropriate control test after looking at several overseas models. Any test must of necessity be somewhat arbitrary since, in practice, there are no clearly defined criteria for control. We recommend defining control as the ownership of 50 percent or more of the shares (or rights to income, distributions on wind up, votes, etc) of a company by 5 or fewer residents. This is similar to the Canadian test and that proposed in Annex 4 of the 1987 Budget. It would be necessary to have a constructive ownership rule so that interests held in nominees and associated parties would be aggregated. In addition, we propose an anti-avoidance provision aimed at arrangements, such as voting trusts and understandings, which have the effect of defeating the intent and application of the control test. We would also add a de facto control test to cover situations such as where a shareholder has a right to require a distribution or the wind up of a company.

2.1.5 Where a non-resident company falls within the control test, all of its New Zealand shareholders or only the controlling ones could be subject to the regime. The Committee favour the latter approach because only controlling shareholders have access to the necessary information and the undistributed income of the company. Since there may be more than one group of 5 residents which satisfies the control test, we recommend that all resident shareholders of controlled companies with interests of 10 percent or more (hereafter referred to as "non-minor" shareholders) be subject to the BE regime. An exception should apply where control exists by virtue of the proposed anti-avoidance or de facto control provisions. In those cases, the residents deemed to have control should be subject to the regime in accordance with their proportionate interests.

2.1.6 Further details of the control provisions proposed by the Committee are contained in Annex 1.

### Recommendation

2.1.7 The Committee therefore recommends that, in relation to foreign companies:

a the BE regime apply only where New Zealand residents have control of a company;

b control be defined as the ownership by 5 or fewer residents of 50 percent or more of the shares (or votes, rights to dividends or distributions on wind up) of a company, subject to:

i a constructive ownership test to include interests held through associated persons, nominees and other controlled companies;

ii a de facto control provision to include within the regime persons who have the power to require a distribution or the wind-up of a non-resident company; and

iii an anti-avoidance provision to deter arrangements which have the effect of defeating the intent and application of the control test; and

c resident shareholders who directly or indirectly hold a 10 percent or greater interest in a controlled company and residents who are deemed to have control by virtue of the de facto control and anti-avoidance provisions be subject to the BE regime, but other resident shareholders of controlled companies be exempt from it.

## 2.2. White List

2.2.1 One of the criticisms of the BE regime is that it would involve heavy compliance costs for possibly little revenue when it applied to companies in "high tax" countries, such as the United States and the United Kingdom. The compliance costs would be most acute for New Zealand's large internationally diversified companies, some of which have hundreds of offshore subsidiaries. In addition, the administrative costs of the regime would be high.

2.2.2 The United Kingdom, West Germany and France address this problem by having a so-called "white list" of countries. If a company is resident in a white list country and the large bulk of its income is sourced and subject to tax in such countries, it is exempt from the CFC regime.

2.2.3 In principle, it is desirable to minimise compliance costs where the revenue at stake is not material. The practical difficulty in this case is that the revenue loss relative to the compliance cost savings resulting from some form of list cannot readily be quantified. Nevertheless, the Committee recommends the adoption of a restricted list as a reasonable pragmatic compromise. We recognise that no list can be watertight and that there will be costs in compiling and updating it. These problems must be weighed against the need to reduce the compliance costs of the regime where it is unlikely that revenue would be collected.

2.2.4 Accordingly, the Committee favours a list, qualified by tax preferences as set out below, of countries which have comprehensive international tax rules including CFC regimes. At present, there are six - the United Kingdom, the United States, West Germany, France, Canada and Japan. We understand that Australia is currently considering the introduction of a CFC regime and, given our proposed transitional provisions (discussed in chapter 7), we recommend that Australia be included on the list. The existence or otherwise of a CFC regime gives the list an objective basis.

2.2.5 The United Kingdom white list is qualified by an income source rule to the effect that, to be exempt from the CFC regime under the white list provisions, controlled companies must derive at least 90 percent of their income in the (white list) country in which they are resident. This rule aims to ensure that, to qualify for exemption, the large bulk of the income of a controlled company must be subject to tax in a white list country. An alternative approach is to "look through" companies resident in white list countries to controlled companies beneath them. These lower tier controlled companies would be exempt only if they also satisfied the qualified white list test. The Committee favours this approach rather than an income source test, In addition, it would be necessary to list as a significant preference the exemption of foreign-source income where a listed country excluded it from its tax base. This is presently the case with France. We discuss the issue of foreign tax preferences in the next subsection.

## 2.3 Tax Preferences

2.3.1 In addition to having a white list, the United Kingdom has a qualified (or "grey") list which provides for exemption from the CFC regime only if the foreign company does not benefit from certain listed tax preferences. Many submissions argued that foreign tax preferences should be recognised under the BE regime to preserve the competitiveness of foreign subsidiaries of New Zealand companies. We commented briefly on the international competitiveness argument in section 1.5. The arguments against recognising foreign preferences are that:

a it would be inconsistent with domestic tax policy, which is generally to remove tax preferences. This policy would make no sense at all if foreign tax preferences

 were recognised under the BE regime since it would merely encourage New Zealand residents to invest offshore. If tax incentives were to be allowed as a matter of tax policy, it would be better to provide them domestically;

b tax preferences are only one form of investment subsidy. Other types of assistance that may be provided in other countries include grants, subsidised input costs, output bounties, tariff protection, concessional loans and provision of free services such as research. All of these would have the effect of increasing the profitability of foreign investments owned by New Zealand residents but the benefit of them would to some extent be clawed back under the BE regime. It would be impractical to preserve the effect of all types of assistance under the regime and we see no reason to preserve tax preferences in particular; and

c tax preferences are similar in effect to low or zero rates of tax. If the BE regime is to apply to controlled companies in low tax countries ("tax havens”), it should also apply to such companies in high tax countries where effective tax rates are low, not because of a low statutory tax rate, but because of tax preferences.

2.3.2 In addition, the trend amongst OECD countries is to phase out or remove tax preferences. This is certainly the case in the United States, the United Kingdom and Canada. As tax preferences are removed, effective tax rates in other countries will rise so that, since New Zealand's statutory tax rates will be amongst the lowest, if not the lowest, in the OECD, our

effective tax rates should be comparable to those in the countries where most of New Zealand's offshore investment is located. The impact of the BE regime on the competitiveness of New Zealand-owned foreign companies will therefore diminish as the trend away from preferences continues.

2.3.3 In the Committee's view, the arguments against recognising foreign tax preferences under the BE regime outweigh the counter arguments. We therefore favour the qualification of the proposed white list by the identification of significant tax preferences in each country. As noted above, this qualified list is referred to as a grey list. Taxpayers would be required to adjust the taxable income of a CFC resident in a listed country, measured according to that country's tax rules, for any identified significant preferences that the CFC has utilised. If the foreign tax paid as a proportion of the adjusted taxable income equals or exceeds the New Zealand company tax rate, the taxpayer would be exempt from the regime in respect of that CFC. In our view, the reduction in the New Zealand statutory company tax rate removes the need to base this effective tax rate comparison on two-thirds of the statutory rate, as proposed in Annex 4 of the 1987 Budget.

2.3.4 The comprehensiveness of the list of preferences is largely a matter of tax policy. New Zealand tax policy has been to eliminate explicit preferences. This may suggest a relatively extensive list, though materiality and compliance costs must be taken into account.

2.3.5 A number of submissions argue that the claw back of foreign tax preferences would be inconsistent with a number of New Zealand's tax treaties which include tax sparing provisions. These provisions generally apply only to branches of New Zealand

companies in the tax treaty country and, since foreign branches are not affected by the present reforms, tax sparing would not be withdrawn or diminished. We are satisfied that the BE regime does not breach a tax treaty obligation. The tax sparing provisions were, however, entered into before the introduction of the present proposals and may now appear to be inconsistent with the thrust of the reforms.

### Recommendation

2.3.6 The Committee therefore recommends that:

a residents be exempt from the BE regime in respect of interests in companies which are:

i resident for tax purposes in certain listed countries with comprehensive international tax regimes including CFC regimes (i.e.the United States, the United Kingdom, West Germany, Canada, France and Japan) or Australia; and

b ii do not benefit from specified significant tax preferences in those countries such as accelerated capital write-offs or the exemption of certain foreign-source income. Where a company did utilise a specified preference, it would be required to adjust its taxable income, determined according to the country of residence tax rules, for the effect of the tax preference(s). If its foreign tax paid as a ratio of its adjusted taxable income equals or exceeds the New Zealand company tax rate, the BE regime would not apply; and

c non-minor shareholders (and other shareholders deemed to have control) in a controlled company who have interests which are held indirectly through other foreign companies be subject to the regime unless the controlled company satisfies the exemption outlined in recommendation (a).

## 2.4 Submissions

2.4.1 Most submissions were in favour of a CFC regime along the lines of those applying in other countries. The two main differences between the regime proposed by the Committee and CFC regimes elsewhere are that:

a other CFC regimes generally make a distinction between so-called "active" and "passive" income. The latter is generally regarded as internationally "mobile" income such as interest, dividends, royalties and related party sales and service income;

b in some cases, the CFC regimes are to some extent targeted on tax haven CFCs. The United States and Canada do not, however, target tax havens in this way.

2.4.2 The artificiality of the distinction between active and passive income is best illustrated in the case of shares. A share portfolio of, say, one percent stakes in 100 companies is regarded as a passive investment even though each company may itself be an active business. Conversely, a 100 percent holding

in a single company is regarded as a direct or active investment. In the first case, an interest is held in 100 active businesses. In the second case, an interest is held in one active business. In both cases, the income of the shareholder consists of dividends and capital gain on the shares. Though these investments may differ in other respects, both are ultimately investments in active businesses. Thus, there are boundary problems in distinguishing between active and passive investments.

2.4.3 Another problem with the active/passive income distinction arises with certain classes of income. For example, interest income is regarded as active business income when it is earned by a financial institution but passive income when derived by other businesses. If the regime employed this distinction, banks could shelter interest income while other businesses would reorganise themselves in an attempt to resemble banks or they would establish finance subsidiaries which were difficult to distinguish from banks. This problem has forced the United States to include within its definition of CFC (i.e, subpart F) income dividends, interest and realised gains from the disposition of shares and other securities, regardless of the nature of the business deriving them. For similar reasons, subpart F income now includes income from the insurance of risks outside the insurer's country of incorporation.

2.4.4 Finally, the advantages of low tax rates and tax preferences are the same whether they apply to active or to passive income. In view of these considerations, the Committee considers that there is no merit in distinguishing between different classes of income.

2.4.5 The argument for targeting the BE regime on tax haven CFCs is that these are the major avoidance vehicles. There are, however, several problems with this approach. The first is that there are definitional problems. A country which is normally regarded as a high tax country may in practice be a tax haven for certain types of investment. An example was the United Kingdom in respect of manufacturing activity before it commenced to phase out immediate capital write-offs in 1984. The effect of the capital write-offs was generally to eliminate the tax liabilities of manufacturing businesses in the United Kingdom. If this had been achieved by abolishing income tax on manufacturing, the United Kingdom would have been regarded as a tax haven for this type of business. Thus, the existence of tax preferences removes any clear distinction between a tax haven and a non-tax haven.

2.4.6 The more general argument is that, from an anti-deferral perspective, there is no difference between these two types of jurisdiction. Offshore income derived by resident companies that is ultimately taxable in New Zealand is foreign income net of foreign taxes. (Where foreign income is earned directly by an individual, a credit is given for foreign taxes). It does not matter whether the income is sourced in a low- or high-tax jurisdiction, the deferral benefit is the same. The CD does not, however, propose the complete elimination of tax deferral by permitting companies only a deduction for foreign tax in the calculation of a their tax liability on BE regime. Instead, a credit will be given, though this is clawed back when the income is distributed. Thus, in the context of the CD proposals, New Zealand tax liabilities under the BE regime will depend on whether the foreign company is resident in a high- or low-tax jurisdiction. For this reason, the Committee advocates the adoption of a grey list as outlined in section 2.3.

2.4.7 On a practical level, there would be obvious difficulties with the alternative approach of targeting the regime on companies resident in listed tax havens. The list would never be up to date and would probably exclude apparently high tax countries which nevertheless had significant tax preferences. For this reason, no country except Japan bases its CFC regime on a formerly published tax haven list. (The Committee does propose a distinction between tax havens and other countries as part of its recommended transitional provisions but in this case, a need for exhaustive coverage and updating does not arise.)

## 2.5 Dividends Received by a Controlled Company, Losses and Foreign Tax Credits

2.5.1 BE income will be calculated according to New Zealand tax law. A number of special rules will, however, be required in respect of dividends received by a controlled company, BE losses and the calculation of the amount of foreign tax to be credited against the New Zealand tax liability on BE income. The Committee has had time to give only preliminary consideration to these issues but we set out below our current thinking.

2.5.2 The tax treatment of dividends received by a controlled foreign company needs to mirror their treatment in the hands of its resident shareholders. If this were not the case, it would be easy to avoid the domestic rules by trapping dividends in a non-resident vehicle. There would then be little point in changing the domestic rules. Thus, portfolio dividends received by a controlled non-resident company should be assessable to both corporate and non-corporate resident non-minor shareholders.

Non-portfolio dividends received by the controlled company should also be assessable to a non-corporate non-minor shareholder but a corporate non-minor shareholder would be subject to the proposed withholding payment system if the proposed domestic tax rules applied to the calculation of the BE income. In order to avoid the multiple levying of tax on dividends, it would be necessary in the case of both corporate and non-corporate non-minor shareholders to exclude dividends received by a controlled company from another company in relation to which the taxpayer is also a non-minor shareholder.

2.5.3 This treatment would, however, be simplified if all dividends received by a controlled company, other than those received from another company in respect of which the taxpayer is a non-minor shareholder, were made assessable. It would then not be necessary for a corporate shareholder to keep separate account of portfolio and non-portfolio dividends.

2.5.4 The BE regime itself and the proposed changes to the treatment of dividends received by companies have implications for the deductibility of interest on money borrowed by a company to acquire shares in non-resident companies. The deductibility of interest expense relating to foreign investments would also be affected by interjurisdictional allocation rules. It would therefore be desirable to review the current provisions relating to interest deductibility in the context of the consideration of allocation rules.

2.5.6 The treatment of BE losses was one of the most contentious issues raised in submissions. The CD proposed that BE losses (which would be computed according to New Zealand tax rules) be "ring-fenced" to the BE regime. That is, losses would be able to be offset against any BE income of a taxpayer, but not

against non-BE taxable income (i.e New Zealand- and foreign-source income taxable under current law). Any excess BE loss not able to be offset against BE income in the current year would be carried forward for offset against BE income in future income years.

2.5.7 Submissions were opposed to any ring-fencing of BE losses and generally called for unrestricted pooling of losses with a taxpayer's other taxable income. The unrestricted offset of BE losses would, however, lead to a decidedly asymmetric result as far as the New Zealand tax base was concerned. When a taxpayer derived a BE profit but the foreign tax paid by the controlled company was at least equal to the New Zealand tax liability on the BE income, no New Zealand tax would be collected. If, once the controlled company made a loss, the loss could be offset against other New Zealand taxable income, the overall result would be to diminish the New Zealand tax base. Similar problems arise now with actual branches. There is no point in implementing a regime which would further erode the present tax base.

2.5.8 Another problem would arise if taxpayers could acquire BE tax losses (by obtaining an interest in non-resident companies which were in tax loss under New Zealand rules) to shelter BE income in low tax jurisdictions. Anti-avoidance rules could cope with this to some extent but such rules have their own deficencies.

2.5.9 Considerations such as these suggest that the CD proposals will need to be tightened rather than relaxed. At one extreme, BE losses could be ring-fenced to the offshore entity for each taxpayer. This may, however, be impracticable since, where control exists, taxpayers will generally have some

discretion to shift taxable income between different controlled companies, particularly where they are resident in the same country. Thus, a further possibility would be to allow the grouping of profits and losses among entities within the same tax jurisdiction. The Committee will report further on this issue.

2.5.10 The rules for crediting foreign taxes need to be integrated with those applying to losses. The CD proposed that credits be limited on an entity by entity and a source of income basis. We have yet to discuss the appropriate rules for foreign tax credits.

2.5.11 Some further discussion of various aspects of the BE regime is contained in Annex 2.

# CHAPTER 3 – FOREIGN INVESTMENT FUNDS

## 3.1. Avoidance Problems: Need for an Alternative Regime

3.1.1 If, as recommended by the Committee, the BE regime applied only to the non-minor shareholders of controlled foreign companies, the types of offshore investment outside the regime would be:

a minor or non-controlling shareholdings in companies resident in high tax jurisdictions;

b minor or non-controlling shareholdings in companies resident in low tax jurisdictions ("tax havens"); and

c interests in investment companies,unit trusts, mutual funds and similar entities, which collectively may be referred to as "foreign funds".

3.1.2 The CD proposes that the CV regime should apply to all of these types of investment. In the light of the concerns about the CV regime outlined in chapter 1, the Committee considers that it could be justified now only where there is a serious avoidance problem that exists or can reasonably be expected to develop. Outside that area and CFCs, the taxation of the gains, other than dividends, that residents derive from offshore investments should await the introduction of a general capital gains tax.

3.1.3 In the Committee's view, minor or non-controlling shareholdings in companies resident outside tax havens clearly fall in the category of investments that are best taxed under a capital gains tax. These companies cannot be used by the investor to erode the New Zealand tax base and the most important

of them, publicly listed companies, generally distribute a substantial proportion of their income as dividends which are already taxed or will suffer a similar impost under the Government's new proposals.

3.1.4 Minor or non-controlling shareholdings in tax haven companies are a possible source of concern. The majority of problem cases will, however, be passive investment vehicles which would fall into the foreign investment fund regime discussed in section 3.3.

3.1.5 Offshore funds, especially those located in tax havens, are clearly the biggest avoidance problem. The Committee therefore favours the introduction of a foreign investment fund regime targeted at investment vehicles which confer significant tax benefits, such as unit trusts based in tax havens.

## 3.2 Coverage of the Regime

3.2.1 In summary, the two building blocks of the Committee's proposals for companies would be:

a the BE regime to apply to controlled foreign companies which do not meet the grey list test outlined in chapter 2; and

b a foreign investment fund regime to apply to investment vehicles.

3.2.2 Between these two types of investment, no regime would apply. Three arguments have been advanced for a regime which applies to all foreign investments. The first is that complete coverage is needed to catch taxpayers who have control of an

foreign company but manage to avoid the control test. The response in other countries to vehicles which side step the control test has been to introduce an offshore fund regime. We would similarly expect that many of these non-controlled vehicles would fall into the foreign investment fund regime proposed by the Committee. With a comprehensive definition of control and a wide foreign investment fund definition, the remainder of the problem does not justify the administration and compliance costs of a fully comprehensive regime. We would also note that most companies find real minority interests disadvantagous. Minority interests will be all the more unattractive as a result of these reforms since a substantial though minority shareholder in a non-resident company could be tipped into the BE regime by the purchase of a possibly small interest in the company by another New Zealand resident.

3.2.3 The second argument for comprehensive coverage is that a CV or comparable regime is needed to discourage resident companies from "going offshore", by penalising their New Zealand resident shareholders. By going offshore it is meant that a New Zealand company would establish a non-resident holding company which would own its New Zealand and foreign subsidiaries. No New Zealand company would then own foreign assets. Thus, the corporate group would avoid the international regime. Under the CD proposals, however, the resident shareholders in the foreign company would fall into the relatively draconian CV regime, thereby discouraging such restucturing.

3.2.4 It is obvious that this restructuring does not result in a shift of physical assets out of New Zealand. In addition, the resident shareholders end up in no better position than residents who own shares in what are now non-resident companies. Furthermore, the tax advantages are not one-sided since the restructured company would lose the ability to pass imputation

credits for New Zealand tax paid through to its resident shareholders. In addition, non-resident dividend withholding tax on dividends paid out of New Zealand and dividend withholding payment on incoming dividends might also be incurred. Moreover, there are commercial constraints on this process since, at the end of the day, New Zealand companies are dependent on New Zealand shareholders for their equity base and need to maintain good relationships with them. The Committee therefore considers that the second argument is not sufficient to warrant a fully comprehensive regime at this stage.

3.2.5 The third argument is that a comprehensive regime would extend the tax base and permit a further reduction in tax rates. If revenue were the objective, however, it would be necessary to evaluate alternative sources which might better meet the efficiency, equity and simplicity objectives of tax reform. As argued elsewhere, the Committee considers that the taxation of foreign equity investments outside tax havens is best left to a capital gains tax regime and could not be advanced now without a real cost in taxpayer attitudes towards voluntary compliance.

3.2.6 The Committee therefore concludes that there is insufficient justification for a fully comprehensive regime at this stage. If a problem emerges, additional measures could be considered. In order to monitor developments and encourage compliance, it is desirable to have comprehensive disclosure requirements. For example, all taxpayers could be required to disclose offshore interests that fall outside the BE and foreign fund investment regimes. This would enable the Inland Revenue Department to request further information where necessary and hence keep abreast of responses to the new measures. We consider that the approach of aiming to define the extent of the problem, if any, resulting from incomplete coverage is preferable to implementing an across-the-board regime now.

### Recommendation

3.2.7 The Committee therefore recommends that the CV regime apply only to interests in foreign investment funds, as discussed in section 3.3.

## 3.3 Foreign Investment Fund Regime

3.3.1 The definition of a foreign investment fund can potentially be very wide. The regime should be targeted at non-resident entities which provide significant tax advantages compared with comparable entities in New Zealand. This is the case when the income of the entity is untaxed or only lightly taxed compared with the tax that would be levied on such income in New Zealand. For example, a unit trust based in a tax haven which invests in debt securities would offer significant tax advantages to New Zealand investors compared with an identical unit trust in New Zealand. A unit trust investing exclusively in shares, however, offers tax advantages only to the extent that it permits dividend income to be converted into capital gain. A diversified foreign investment fund will, however, typically own non-controlling interests in companies, debt instruments and other investments.

3.3.2 The other targets of the foreign fund regime are entities which slip outside the BE regime because they provide tax benefits which do not depend on control. This will generally be feasible among non-associated persons only when there are well-defined means of purchasing and disposing of interests and regularly quoted prices for them so that members can monitor fund performance. Thus, such funds will typically be listed on a stock exchange or have redemption arrangements under which

investors can sell their interests to the fund manager at a price based on the net assets of the fund.

3.3.3 In order to address the tax advantages offered by these types of fund, the Committee favours a regime based on the Canadian one. According to Canadian tax practitioners, this has largely eliminated the marketing of tax haven funds in Canada. The key criteria for the application of the regime would be that:

a the fund (which would include any legal entity) derives its income or value primarily or substantially from holding or trading in portfolio investments in shares, investments in debt instruments, real property, commodities, royalty agreements, etc; and

b the effect of the residence of the entity for tax purposes and its distribution policy is to reduce the tax payable on the income of the entity below what it would be had the income been taxed in New Zealand as it was derived.

3.3.4 We would define a "portfolio investment" as a non-controlling interest where the investor has no significant influence over the investee. The term is incorporated in the foreign investment fund definition not because we believe that there are particular tax advantages in holding shares in foreign funds (apart from the deferral or avoidance of tax on dividends) but because such investments are characteristic of the type of fund we have in mind.

3.3.5 An effect test such as that outlined in (b) is to some extent subjective but it is necessary to target the regime on entities in low tax countries. Taxpayer compliance would be encouraged by comprehensive disclosure requirements.

3.3.6 Canada taxes residents on the basis of a prescribed rate of interest applied to the amount of their investment in such funds. Because there will usually be a quoted price for interests in such funds which reflects the underlying income they accumulate, the Committee considers that the CV regime could apply to such investments. Thus, the investor would be taxed on the difference between the market price of the interest at the end of the income year and the equivalent value at the beginning of the year, plus any distributions received during the year. Where a taxpayer was subject to both the BE and offshore fund regimes, the former should apply.

3.3.7 It may be necessary to include an anti-avoidance rule aimed at entities which are in substance foreign investment funds but which are structured to avoid the regime. Further comment on the Committee's recommended regime for foreign investment funds is provided in Annex 3.

### Recommendation

3.3.8 The Committee therefore recommends that:

a in addition to the BE regime, there be a foreign investment fund regime to apply to interests in entities which:

i derive their income or value primarily or substantially from holding or trading portfolio investments in shares, investments in debt instruments, real property, commodities, etc; and

ii the effect of the residence of the entity for tax purposes and its distribution policy is to reduce the tax payable on the income of the entity below what it would be had the income been taxed in New Zealand as if it were derived by the investor;

b the taxable income derived by a resident from an interest in a foreign investment fund be calculated as the increase in the market value of the interest over the income year, plus any distributions receivable; and

c where an interest in a non-resident entity falls within both the BE and foreign investment fund regimes, the BE regime apply.

# CHAPTER 4 – TREATMENT OF DIVIDENDS

## 4.1 Corporate Recipient

4.1.1 The CD distinguishes between "portfolio" and "non-portfolio" dividends received by a resident company from a non-resident company. Portfolio dividends are defined to be dividends received by a resident company from a non-resident company in which the resident owns less than 10 percent of the paid-up share capital. All other foreign dividends received by a resident company are defined to be non-portfolio dividends.

4.1.2 The CD proposes that portfolio dividends be assessable to companies in accordance with general international practice. Non-portfolio dividends are to be subject to a withholding payment system, as outlined in the Government Economic Statement of 17 December 1987. The withholding payment system does not come directly within the Committee's terms of reference but it is necessary to consider it in order to integrate the taxation of dividends with the taxation of undistributed income under the BE regime. The treatment of dividends received by a controlled company for the purposes of calculating BE income was discussed in section 2.5.

4.1.3 A number of submissions called for the retention of the existing dividend exemption for companies. Other submissions took the view that dividends should be assessable to a company only if credit were given for both foreign withholding tax and the underlying foreign company tax. A number of other countries have such a system in respect of non-portfolio dividends, including the United States, the United Kingdom and Australia.

While credit for foreign taxes may be allowed at the corporate level, no country passes credits for foreign taxes through to non-corporate or individual shareholders. In this respect, the proposal to allow credits for non-resident dividend withholding tax to pass through to individuals under the New Zealand imputation system goes further, as far as we are aware, than any other country. Thus, all countries ultimately claw back credits given to companies for underlying foreign company tax. This is not surprising since the revenue consequences of permitting credits to flow through to individual shareholders could be substantial.

4.1.4 If credits for foreign taxes do not pass through to individual shareholders, they are allowed to them in effect as a deduction from assessable income. Under the proposed withholding payment system, the conversion to a deduction system will be advanced from the ultimate individual recipient to the first corporate recipient of a foreign dividend. This is very much the objective of the withholding payment system and it would be incompatible with it to allow the corporate dividend recipient a credit for underlying foreign company tax. Foreign tax credit systems are also extremely complex, as the United States and Canadian systems illustrate, and inherently arbitrary because of the practical difficulty of tracing foreign dividends through time and among different companies. The Committee therefore considers that it would not be feasible from a compliance or administrative point of view to introduce a foreign tax credit system for intercorporate dividends, at least in the current context.

4.1.5 Submissions also questioned the need for a separate withholding payment system for non-portfolio dividends. It would undoubtedly be simpler to make all foreign dividends assessable

to a corporate recipient but this would not be consistent with a number of New Zealand's tax treaty obligations.

4.1.6 One of the differences between taxing such dividends and the proposed withholding payment system is that a company in tax loss receiving foreign dividends would not incur any tax liability if the dividends were assessable but would incur the withholding payment. This problem could be overcome by allowing a company in tax loss to offset the dividend against its loss. Thus, the loss would reduce by the amount of the gross dividend (i.e. the dividend received plus any foreign withholding tax), thereby extinguishing the withholding payment liability.

4.1.7 In order to avoid taxing foreign-source income twice, once as BE income and again on receipt, the CD proposes that, in calculating BE income, taxpayers be able to deduct any dividends received from the foreign company concerned. We consider that there are serious problems with this deduction system. For example, a company which had a BE loss in the year it received a dividend would obtain no relief from double taxation. There are potentially many timing differences between New Zealand's and other countries' tax rules which could lead to this result.

4.1.8 In order to avoid these problems, in principle a separate account needs to be kept of tax paid on BE income. When a resident receives a dividend from a controlled company, the tax (or withholding payment) liability on the dividend would be offset in whole or in part according to the balance of the tax paid in the special account. In practice, for resident companies, the Imputation Credit Account ("ICA") proposed for the imputation system can perform just this function so that a separate account is not necessary.

4.1.9 The Committee propose to detail its recommendations on the integration of the international, imputation and withholding payment regimes in Part 2 of this report and in our report on the imputation proposals.

## 4.2 Non-Corporate Recipient

4.2.1 For the same purpose of avoiding the double taxation of offshore income, it would be necessary to require individual and other non-corporate non-minor shareholders to keep the equivalent of an ICA. We will also report further on this aspect in Part 2 of this report and our report on full imputation.

# CHAPTER 5 – TRUSTS

## 5.1 Introduction

5.1.1 In this chapter we comment on the future regime for trusts (which also has implications for existing trusts). By existing trusts, we mean settlements made before 17 December 1987. The treatment of these trusts, and the transition to the proposed new regime, is dealt with in chapter 7.

## 5.2. Trust Income

5.2.1 The international tax reforms cannot be fully effective unless there is a regime to apply to trusts since, in many cases, a trust can substitute for a company. The CD treats "foreign trusts" (i.e. those with non-resident trustees) in a similar manner to foreign companies. Since there is no resident trustee and the beneficiaries may not be identified, the CD proposes that resident settlors be liable for tax on trustee's income. This approach ignores the legal relationships between a settlor and a trustee since the former has no right to the income of the trust. Indeed, the whole point of a trust is to ensure that property and the income it produces is legally divested by a settlor. In reality, however, a settlor often has substantial influence over the trustee, usually on an informal basis though there may be specific provision in the trust deed and, in practice if not in law, may be able to wind up the trust and take back the property. Thus, the economic substance of a trust may differ from its legal appearance.

5.2.2 In order to meet the objectives of the international reforms, trust income derived by non-resident trustees of trusts settled by New Zealand residents must be taxed each year as it is earned. Ignoring enforcement problems, the best course would be to tax the income in the hands of the trustee as if he or she were a resident. Where the trustee did not comply, there would be little alternative but to tax the resident settlor since there may be no identifiable resident beneficiaries. In the first instance, however, the legal liability for the tax should be placed on the trustee. This could be achieved by defining trusts with resident settlors to be New Zealand residents for tax purposes. The trust would then be liable for New Zealand tax on its foreign- and New Zealand- source income in the same way as other residents. Where a non-resident trustee defaulted on the liability, the resident settlor would be liable as the agent of the trustee. It would be necessary to define a trust settlement widely to include settlements made indirectly through nominees or associates and all dispositions of property to a trust made for less than full consideration.

5.2.3 The Committee therefore supports the basic approach of the CD. This closely follows the grantor trust provisions in the United States. This regime would, however, be unjustifiably severe if it applied to all existing trusts since settlors will usually be unable to alter their settlor status and, furthermore, distribution requirements and trustees' powers are comparatively inflexible. Hence, we recommend more generous transitional provisions for trusts than for companies.

5.2.4 The concept of the residence of a trust could also apply to existing trusts. As with future trusts, residence would be determined by the residence of the settlor. Where there was:

a a resident settlor and a resident trustee, the trustee would be liable for tax on trust income, whether sourced in New Zealand or elsewhere, as at present;

b a resident settlor and a non-resident trustee, the trustee would be liable for tax on trust income, as in (a), but in the event of default, the settlor would be liable;

c no resident settlor but a resident trustee, the trustee would be liable for tax on the trust's New Zealand-source income as would be the case with any other non-resident. If, however, the trust had no New Zealand-source income, the trustee would have no New Zealand tax liability.

5.2.5 One consequence of this approach would be that New Zealand would not tax the foreign-source trust income of a resident who was the trustee of a trust with a non-resident settlor. In our view, this is the appropriate treatment since such income has no definite connection with New Zealand apart from the existence here of the trust administrator (who will, however, have no beneficial interest in the income). Beneficiaries may be resident here, but their interests do not materialise until there is a distribution or vesting. This makes it infeasible to tax beneficiaries on trust income. Resident beneficiaries should, however, be taxed on any trust income which is distributed to or vested in them, as discussed in the next subsection. This leaves only the resident trustee to tax but, if that were done, he or she would of course resign in favour of a non-resident trustee. Thus, we believe there is little to be gained from attempting to tax foreign-source income derived by resident trustees of non-resident trusts.

5.2.6 The adoption of this trust residence rule would remove some ambiguities in the taxation of existing trusts. There may be other consequential changes to the current treatment of trusts that will need to be addressed when the Committee considers the draft legislation dealing with trusts.

## 5.3 Distributions From Resident Trusts

5.3.1 Distributions to beneficiaries from resident trusts (as defined in the previous section) made out of trust income (i.e. income which has been taxed as assessable income in the hands of the trustee or the resident settlor) should be exempt from tax since they will have already borne the appropriate amount of New Zealand tax.

5.3.2 Where a distribution from a resident trust is not made out of trust income, it should continue to be assessable or exempt to the beneficiary as under the present rules, except in the situation dealt with in paragraph 7.2.4.

## 5.4 Distributions From Non-Resident Trusts

5.4.1 There are deficiencies in the present tax treatment of trust distributions received by resident beneficiaries from non-resident trusts (i.e those with no resident settlor). Case law supports the view that if trust income has been taxed in the hands of the non-resident trustee, it is not assessable a second time in the hands of the beneficiary. If, however, the trustee has not paid tax on that income, the treatment of the distribution in the hands of the beneficiary is unclear.

5.4.2 This unsatisfactory ambiguity should be resolved by amending the law to make it clear that resident beneficiaries will be assessable on all income distributions received from non-resident trusts. A credit should be given for any foreign or New Zealand tax paid by the trustee on the income out of which the distribution is made. This would necessitate the trustee keeping records of the income of the trust and the tax paid, but the onus for establishing that a credit should be given can be placed on the beneficiary.

5.4.3 The trust regime should mirror the taxation of individuals since individuals are ultimately the beneficiaries of trust income. Since capital gains will normally be exempt in the hands of resident individuals, capital profits, as defined in New Zealand tax terms, distributed to beneficiaries should also be exempt in their hands. Similarly, a distribution of the corpus (i.e. the original capital settled plus all additional settlements) of the trust should not be assessable to a beneficiary.

5.4.4 Further elaboration of the Committee's views on trusts is contained in Annex 4. Our recommendations on transitional provisions relating to existing trusts are outlined in chapter 7.

### Recommendation

5.4.5 The Committee recommends that, in respect of future trust settlements:

a a settlor be widely defined as any person who directly or indirectly provides money, goods, services or other benefits to a trust for inadequate consideration;

b a trust be treated as a resident of New Zealand for income tax purposes if the settlor of the trust is a New Zealand resident;

c the trustee of a resident trust be primarily liable for tax on trust income but, in the event of the trustee defaulting on such a liability, the settlor be liable as agent of the trustee;

d distributions of trust income (i.e. income which has been taxed in the hands of the trustee or the resident settlor) to a beneficiary from a resident trust be exempt from tax in the beneficiary's hands;

e all distributions of income to a beneficiary from a non-resident trust be taxable in the hands of the beneficiary, but the beneficiary be allowed a credit for any foreign or New Zealand tax paid by the trustee; and

f distributions of capital profits as defined in New Zealand tax terms or the corpus to a resident beneficiary from a non-resident trust be exempt from tax in the hands of the beneficiary.

# CHAPTER 6 – DISCLOSURE REQUIREMENTS AND PENALTIES

## 6.1 Disclosure Requirements and Penalties

6.1.1 The objective of information disclosure is twofold. First, it provides the Inland Revenue Department with the base data necessary to administer the tax system. Secondly, it encourages taxpayers to comply with the law since they commit an offence if they fail to provide the information requested. New Zealand requires a much lower level of disclosure than countries such as Australia, the United States and the United Kingdom. Furthermore, our penalties for non-compliance are generally lighter than those applying in these countries. A combination of minimal disclosure and low penalties reduces compliance and makes enforcement more difficult.

6.1.2 Both of these matters need to be addressed in the context of the international tax reforms. The Department will be dependent in the first instance on the information provided by taxpayers. The objective of disclosure is not to obtain exhaustive information from every taxpayer. That would merely swamp the Department and impose unnecessary compliance costs on taxpayers. Rather, at the first level of disclosure, a small number of key questions should be asked of all taxpayers. This enables the Department to identify those taxpayers who should then be required to provide fuller disclosure.

6.1.3 The Committee will comment further on disclosure requirements and penalties in the context of the present reforms in Part 2 of its report.

# CHAPTER 7 – TRANSITIONAL PROVISIONS

## 7.1 Branch Equivalent Regime

7.1.1 The CD proposes no transitional arrangements apart from the deferral of the implementation date of the BE and CV regimes until 1 April 1988. A number of submissions argue for complete exemption of investments entered into before the announcement of the regime and you will be aware of the general arguments made against retrospective tax changes. The Committee considers that complete "grandfathering" can seldom be justified since commercial decisions do not assume that the tax system applying when they are made will continue indefinitely. Nevertheless, we consider that a reasonable period of adjustment is necessary in order to give taxpayers time to restructure their affairs and gear up to comply with the regime. There has, however, been fair warning of the Government's intention to address tax haven avoidance.

7.1.2 To this end, we recommend that residents be exempt from the BE regime until 1 April 1990 in respect of interests acquired on or before 17 December 1987 in companies that are not resident in low tax jurisdictions specified in a transitional list. An illustrative transitional list is shown in Annex 5. Shareholders with controlling interests in tax haven companies will generally have known since at least the date of the 1987 Budget that they were to be subject to a CFC regime. We therefore consider that a 1 April 1988 implementation date is appropriate in these cases.

7.1.3 We also recommend that residents be exempt from the BE regime until 1 April 1989 in respect of interests acquired after 17 December 1987 in companies which are resident in the listed

countries (though the exemption of any underlying controlled companies would depend on whether they also were resident in a listed country). After that date, a continued exemption would apply only if the company met the grey list test outlined in section 2.3. Taxpayers in this position would therefore not have to adjust the taxable income of the controlled company for significant preferences in the first year. It would in any case be difficult to compile lists of significant preferences in time for a 1 April 1988 start date.

7.1.4 For the purposes of determining whether a non-resident company is controlled, a resident's total interest in the company, whether acquired before or after 17 December 1987, would be considered. Similarly, a resident's total shareholding would be considered for the purposes of determining whether the 10 percent interest threshold for attribution of income was triggered. Attribution of income during the transitional period would, however, be based on that part of a resident's total interest that was acquired after 17 December 1987. An example illustrating these transitional provisions is shown in Annex 2.

## 7.2 Resident Trusts

7.2.1 As mentioned above, we consider that a more generous transition is justified for existing resident trusts (as defined in chapter 5) with non-resident trustees. In some cases, settlors will be able to wind up a trust and remove themselves from the new regime but this will often not be possible. Thus, some settlors of such resident trusts would be unable to alter their settlor status and could suffer a considerable additional tax liability that could not have been anticipated. The regime

should not, however, protect existing settlors forever where they are able, through their influence over the trustee, to effect a wind up of a trust since a decision not to do so represents in effect a new settlement. Where a wind up is not feasible, the settlor should not be subject to the new regime. Since the trustee is offshore, the only other party, if any, with a connection with New Zealand will be resident beneficiaries. We do not consider that it is feasible to tax beneficiaries on undistributed trust income each year, but the benefit of deferral of tax that they enjoy can to some extent be addressed once a distribution (or vesting) is made.

7.2.2 The Committee therefore favours a trust transition which encourages settlors and trustees to wind up existing resident trusts with non-resident trustees if they can. If they are not able to, an interest element should be incorporated into the determination of the assessable income of a beneficiary resulting from a trust distribution. The latter approach is adopted in the United States in respect of distributions to United States beneficiaries from trusts settled by non-residents.

7.2.3 In order to encourage dissolution of a trust where it is feasible, we propose that distributions of income made on or before 31 March 1989 from existing trusts with non-resident trustees be subject to a final tax levied at a rate of 10 percent, provided that either the trust is wound up before 1 April 1989 or the settlor elects to be subject to the new settlor regime from that date. Distributions of capital profits and the corpus of such a trust made on or before 31 March 1989 should be exempt from tax in beneficiaries' hands. Our proposed rate of 10 percent reflects a compromise between the rate of tax which would have been payable had the distribution been unambiguously taxable under current law and the rate needed to encourage dissolution.

7.2.4 Where these alternatives are not availed of, we recommend that the non-resident trustee and the resident settlor not be subject to the settlor regime, but that all distributions, whether of income or capital (other than of the corpus of the trust), should be assessable in the hands of a resident beneficiary with an interest charge to reduce the advantage of deferral. The interest should be calculated from 1 April 1988, the implementation date of the settlor regime. A credit should be given for any foreign tax paid by the trustee. In addition, where a settlor has a loan, guarantee or other form of financial assistance outstanding to the trustee, he or she should be assessed on imputed interest at a prescribed rate (less any interest actually received by the settlor or paid by the trustee, as the case may be) computed on the amount of the loan, guarantee or other assistance.

7.2.5 A less stringent transition is justified for resident testamentary trusts with non-resident trustees since these are not used for avoidance purposes. Where such trusts are wound up on or before 31 March 1989, the provisions outlined in paragraph 7.2.3 should apply. We propose that distributions of capital profits from this category of testamentary trusts made after 31 March 1989 be exempt in the hands of beneficiaries. Distributions of income should, however, be assessable with the interest charge since the beneficiaries of testamentary trusts may enjoy the advantages of tax deferral to the same extent as beneficiaries of other trusts.

7.2.6 Where a settlement is made after 17 December 1987 to an existing resident trust, the whole of the trust income could be subject to the new regime or only that part attributable to post-17 December 1987 settlements. It would, however, be difficult to arrive at workable apportionment rules because of the need to

trace and compare settlements made at different times in the past and in various forms. We therefore favour the approach of bringing all trust income within the regime where a new settlement is made to an existing trust. This would have little practical impact, since future settlements could be made to a new trust on the same terms as an existing trust, but would avoid the need for apportionment rules.

7.2.7 In order to implement this transition, resident settlors should be required to disclose all settlements, as widely defined, on non-resident trustees existing on 1 April 1988. Settlors should also notify the Inland Revenue Department of the transition they have elected.

7.2.8 Settlements of trusts made by residents after 17 December 1987 and distributions of income or capital from such trusts would be subject to the new regime proposed in chapter 5.

## 7.3 Non-Resident Trusts

7.3.1 Non-resident trusts (i.e those which are not settled by a New Zealand resident) are not affected by the settlor regime, irrespective of when they were settled. The treatment of distributions from such trusts to resident beneficiaries is, however, to be clarified as part of the present reforms. The Committee's recommended treatment was outlined in chapter 5. The Government's intention to clarify the law in this area was included in the CD. We therefore propose that our recommended regime apply to distributions from non-resident trusts made after 17 December 1987.

## 7.4 Foreign Investment Funds

7.4.1 The foreign investment fund regime is targeted at tax haven entities. The Government signalled its concern about the use of tax havens in 1986 and again in the 1987 Budget. In addition, taxpayers will usually be readily able to dispose of the interests that would be affected by the regime. Thus, the Committee supports the implementation of the foreign investment fund regime from 1 April 1988.

## 7.5 Recommendations

7.5.1 The Committee recommends that:

a taxpayers be exempt from the BE regime for a two year period (i.e. until 1 April 1990) in respect of interests acquired on or before 17 December 1987 in companies which are not resident in a transitional list of specified tax havens;

b taxpayers be exempt from the BE regime for a one year period (i.e. until 1 April 1989) with respect to interests which were acquired after 17 December 1987 in companies which are resident in the list of countries specified in recommendation (a) of paragraph 7.17;

c distributions of income made on or before 31 March 1989 from existing trusts with non-resident trustees, be subject to a final tax levied at a rate of 10 percent, provided that either the trust is wound up by 1 April 1989 or the settlor elects to be subject to the new settlor regime from that date. Where either of these options applies, distributions of capital profits

 and the corpus of the trust made on or before 31 March 1989 should be exempt from tax in beneficiaries' hands;

d where neither option outlined in (c) applies in respect of existing trusts with non-resident trustees, other than testamentary settlements:

i all distributions, whether of income or capital (other than of the corpus of the trust), should be assessable in the hands of a resident beneficiary subject to an interest charge calculated from 1 April 1988, with the beneficiary receiving a credit for any foreign tax paid by the trustee; and

ii where a settlor has a loan, guarantee or other form of financial assistance outstanding to the trustee, he or she should be assessed on imputed interest at a prescribed rate (less any interest actually received by the settlor or paid by the trustee, as the case may be) computed on the amount of the loan, guarantee or other assistance outstanding;

e in the case of testamentary trusts in existence on 17 December 1987 where the deceased person was a resident and which do not wind up pursuant to recommendation (c):

i distributions of capital profits made after 31 March 1989 continue to be

exempt in the hands of beneficiaries; and

ii distributions of income be assessable subject to an interest charge calculated from 1 April 1988;

f where a resident makes a settlement after 17 December 1987 to a trust in existence on that date, all of the trust settlements be deemed to have been made after 17 December 1987;

g taxpayers be required to make full disclosure of all settlements, as widely defined, to trusts with non-resident trustees existing on 1 April 1988;

h the implementation date for the proposed changes to the treatment of distributions from non-resident trusts be 17 December 1987; and

i the implementation date for the foreign investment fund regime be 1 April 1988.

# CHAPTER 8 – FURTHER MEASURES

## 8.1 Role of a Capital Gains Tax

8.1.1 We have commented already on the possible role of a capital gains tax in the context of the present reforms. In many cases, the income that residents derive through offshore investments (apart from distributions) is best characterised as capital gain and, short of violating accepted income tax principles, is most appropriately taxed under a capital gains tax.

8.1.2 The lack of the comprehensive taxation of capital gains in New Zealand is the last outstanding gap in our tax system. The reforms that the Government has implemented over the last few years have gone a long way to broadening the tax base and addressing sources of avoidance. The first major base broadening measure was the introduction of GST. Within the income tax system, the next step was the removal of explicit tax concessions such as export incentives and accelerated depreciation provisions. The removal of such incentives in return for a reduction in tax rates is very much the central theme of current tax reform programmes in OECD countries.

8.1.3 The third set of reforms was the adoption of comprehensive accrual rules. These were aimed at countering tax planning based on the deferral of financial arrangement income or the advancing of tax deductions. The fourth and present set of reforms address the avoidance and deferral opportunities which

arise in the international context. The Government has also moved simultaneously to reduce the avoidance problems which arise with the exemption of the superannuation funds and other entities.

8.1.4 The last major tax base problem is the general exclusion of capital gains from the definition of assessable income. There is widespread support amongst tax practitioners for the taxation of capital gains. The Committee endorses this view. Many of the remaining deficiencies in the tax system have their origin in or are compounded by the lack of a capital gains tax. The next step in the Government's tax reform programme should be to extend the tax base to include capital gains as soon as it is feasible to do so with the objective of facilitating a further reduction in tax rates.

8.1.5 New Zealand is the only country in the OECD which still has no general capital gains tax. Countries such as the United States, the United Kingdom, West Germany, France and Japan have all taxed capital gains for some time, while Australia introduced a capital gains tax in 1985.

## 8.2 Interjurisdictional Allocation Rules

8.2.1 In addition, we reaffirm our view that priority should also be given to the introduction of interjurisdictional allocation rules to ensure that New Zealand collects its share of tax. Along with the taxation of capital gains, such rules form one of the basic building blocks of the tax systems of countries such as the United States and the United Kingdom.

## 8.3 Recommendation

8.3.1 The Committee therefore recommends that, in addition to giving priority to the extension of the income tax base to include capital gains, the Government give priority to the introduction of interjurisdictional allocation rules, such as expense allocation rules and more effective transfer pricing provisions.

# CHAPTER 9 – SUMMARY AND CONCLUSION

## 9.1 Summary of Recommendations

9.1.1 In summary, the Committee's recommendations are that:

### BE Method

a the BE regime apply only where New Zealand residents have control of a company;

b control be defined as the ownership by 5 or fewer residents of 50 percent or more of the shares (or votes, rights to dividends or distributions on wind up) of a company, subject to:

i a constructive ownership test to include interests held through associated persons, nominees and other controlled companies;

ii a de facto control provision to include within the regime persons who have the power to require a distribution or the wind-up of a non-resident company; and

iii an anti-avoidance provision to deter arrangements which have the effect of defeating the intent and application of the control test; and

c resident shareholders who directly or indirectly hold a 10 percent or greater interest in a controlled company and residents who are deemed to have control by virtue of the de facto control and anti-avoidance provisions be subject to the BE regime, but other resident shareholders of controlled companies be exempt from it;

d residents be exempt from the BE regime in respect of interests in companies which are:

i resident for tax purposes in certain listed countries with comprehensive international tax regimes including CFC regimes (i.e.the United States, the United Kingdom, West Germany, Canada, France and Japan) or Australia; and

ii do not benefit from specified significant tax preferences in those countries such as accelerated capital write-offs or the exemption of certain foreign-source income. Where a company did utilise a specified preference, it would be required to adjust its taxable income, determined according to the country of residence tax rules, for the effect of the tax preference(s). If its foreign tax paid as a ratio of its adjusted taxable income equals or exceeds the New Zealand company tax rate, the BE regime would not apply;

e non-minor shareholders (and other shareholders deemed to have control) in a controlled company who have interests which are held indirectly through other foreign

 companies be subject to the regime unless the controlled company satisfies the exemption outlined in recommendation (d);

### CV Method

f the CV regime apply only to interests in foreign investment funds, as outlined in recommendation g;

### Foreign Fund Regime

g in addition to the BE regime, there be a foreign investment fund regime to apply to interests in entities which:

i derive their income or value primarily or substantially from holding or trading portfolio investments in shares, investments in debt instruments, real property, commodities, etc; and

ii the effect of the residence of the entity for tax purposes and its distribution policy is to reduce the tax payable on the income of the entity below what it would be had the income been taxed in New Zealand as if it were derived by the investor;

h the taxable income derived by a resident from an interest in a foreign investment fund be calculated as the increase in the market value of the interest over the income year, plus any distributions receivable;

i where an interest in a non-resident entity falls within both the BE and foreign investment fund regimes, the BE regime apply;

### Trusts

j a settlor be widely defined as any person who directly or indirectly provides money, goods, services or other benefits to a trust for inadequate consideration;

k a trust be treated as a resident of New Zealand for income tax purposes if the settlor of the trust is a New Zealand resident;

l the trustee of a resident trust be primarily liable for tax on trust income but, in the event of the trustee defaulting on such a liability, the settlor be liable as agent of the trustee;

m distributions of trust income (i.e. income which has been taxed in the hands of the trustee or the resident settlor) to a beneficiary from a resident trust be exempt from tax in the beneficiary's hands;

n all distributions of income to a beneficiary from a non-resident trust be taxable in the hands of the beneficiary, but the beneficiary be allowed a credit for any foreign or New Zealand tax paid by the trustee;

o distributions of capital profits or the corpus to a resident beneficiary from a non-resident trust be exempt from tax in the hands of the beneficiary;

### Transition

p taxpayers be exempt from the BE regime for a two year period (i.e. until 1 April 1990) in respect of interests acquired on or before 17 December 1987 in companies which are not resident in a transitional list of specified low tax jurisdictions;

q taxpayers be exempt from the BE regime for a one year period (i.e. until 1 April 1989) with respect to interests which were acquired after 17 December 1987 in companies which are resident in the list of countries specified in recommendation (d)(i);

r distributions of income made on or before 31 March 1989 from settlements by residents, on non-resident trustees, in existence on 17 December 1987 be subject to a final tax levied at a rate of 10 percent, provided that either the trust is wound up on or before that date or the settlor elects to be subject to the new settlor regime from that date. Where either of these options applies, distributions of capital profits and the corpus of the trust made on or before 31 March 1989 should be exempt from tax in beneficiaries' hands;

s where neither option outlined in (r) applies in respect of settlements in existence on 17 December 1987 made by residents, other than testamentary settlements:

i all distributions, whether of income or capital (other than of the corpus of the trust), should be assessable in the hands of a resident beneficiary subject to an interest charge calculated from 1 April 1988, with the beneficiary receiving a credit for any foreign tax paid by the trustee; and

ii where a settlor has a loan, guarantee or other form of financial assistance outstanding to the trustee, he or she should be assessed on imputed interest at a prescribed rate (less any interest actually received by the settlor or paid by the trustee, as the case may be) computed on the amount of the loan, guarantee or other assistance outstanding;

t in the case of testamentary trusts in existence on 17 December 1987 where the deceased person was a resident and which do not wind up pursuant to recommendation (r):

i distributions of capital profits made after 31 March 1989 continue to be exempt in the hands of beneficiaries; and

ii distributions of income be assessable subject to an interest charge calculated from 1 April 1988;

u where a resident makes a settlement after 17 December 1987 to a trust in existence on that date, all of the trust settlements be deemed to have been made after 17 December 1987;

v taxpayers be required to make full disclosure of all settlements to trusts with non-resident trustees existing on 1 April 1988;

w the implementation date for the proposed changes to the treatment of distributions from non-resident trusts be 17 December 1987;

x the implementation date for the foreign investment fund regime be 1 April 1988;

### Other Reforms

y in addition to giving priority to the extension of the income tax base to include capital gains, the Government give priority to the introduction of interjurisdictional allocation rules, such as expense allocation rules and more effective transfer pricing provisions.

## 9.2 Conclusion

9.2.1 We believe that the regime we have outlined goes as far as is practicable towards achieving the Government's objectives within the boundaries of existing income tax principles, given the constraints imposed by compliance and administrative costs. It differs from the CD proposals primarily by introducing a control test and a grey list exemption to the BE regime,

curtailing the scope of the CV regime and giving more transitional relief. While our regime is more limited in scope than that in the CD, we have sought to make it effective in its area of application.

9.2.2 Once we have your response to our recommendations, we will consider the more detailed design issues and advance the draft legislation. There are many subsidiary issues to consider. We will report further on these, along with our proposed draft legislation.

# ANNEX 1 – CONTROL INTERESTS OF RESIDENTS IN CONTROLLED FOREIGN COMPANIES.

## 1 Introduction

1.1 Under the branch equivalent ("BE") regime, the income of controlled foreign companies would be assessed to their New Zealand resident shareholders in proportion to the interest held by each shareholder.

1.2 In order to determine whether income will be assessed in New Zealand on the basis of an interest held in a foreign company, a taxpayer will be required to establish:

a first, whether the interest held is within the ambit of the regime; and

b second, if so, whether the interest held directly or indirectly, by the taxpayer, either individually or combined with the interests held by other residents, is sufficient for the rules for attributing the income of the foreign company to apply.

## 2 Interests to which the Regime Applies

2.1 As outlined in the Consultative Document ("CD"), the regime will apply to interests in companies that are not resident in New Zealand or that are resident in New Zealand but, by virtue of the provisions of a double tax agreement, are not subject to tax in respect of foreign source income. The definition of a company will include entities that have a legal personality and existence distinct from that of their members.

2.2 The BE regime should apply to residents in respect of their interests in foreign companies. The control test advocated by the Committee would determine that a foreign company would be a controlled foreign company if five or fewer New Zealand residents owned 50 percent or more of its equity. This test requires taxpayers to determine their respective proportions of the equity of a foreign company.

2.4 The proportion so calculated for each resident is termed the resident's control interest. For this purpose, the Committee favours no minimum shareholding threshold for a resident's control interest to be taken into account when determining whether a company is a controlled foreign company. However, as explained in Chapter 2, taxpayers with interests in a controlled foreign company below a minimum threshold would not be required to include any part of that controlled foreign company's income in their assessable income.

2.5 A foreign company would be a controlled foreign company if, at any time in the foreign company's accounting year, the sum of the control interests held by five or fewer New Zealand residents is greater than or equal to 50 percent. The Committee favours applying the test to determine control at any time in

the year to prevent taxpayers 'de-controlling' by disposing of interests in controlled foreign companies through permanent sale to non-residents before the end of each accounting year of a foreign company. By disposing of interests in this manner taxpayers could accumulate income in the non-resident company and sell their interest for a tax free capital gain. Other countries with CFC regimes tend to apply the control test to interests held at the end of a foreign company's accounting year. However, this test does not provide an avoidance opportunity because, unlike the position in New Zealand, capital gains taxes in these countries ensure that a taxpayer is taxed on any gains realised on the disposal of interests in foreign companies during an accounting year.

## 3 Measurement of a Control Interest

3.1 A control interest measures the proportion of a foreign company's equity or profits over which a resident is considered to have control. This includes control interests held through nominees of the taxpayer and control interests held indirectly by the resident through other controlled foreign companies. Taxpayers could avoid the 50 percent control by five or fewer residents test by fragmenting shareholding or by exercising de facto control of a foreign company. The control test would therefore need to be supported by constructive ownership rules to include, in the control interest of a resident, control interests held by persons associated with the resident. In addition, de facto control rules will be needed to deal with situations where taxpayers can exercise control over the distribution of a foreign company's income or capital but do not fall within the formal control tests.

3.2 To prevent avoidance of the control test, determination of a control interest in a foreign company needs to take account of interests held by a taxpayer in a number of ways. For the purpose of determining whether a company is a controlled foreign company, the Committee considers that the control interest attributable to a taxpayer should include:

a any interest in the foreign company held directly by the taxpayer;

b any interest in the foreign company held indirectly by way of another foreign company in which the taxpayer has an interest;

c an interest held directly or indirectly by a nominee of the taxpayer; and

d an interest in the foreign company held directly or indirectly by associated persons of the taxpayer.

3.3 The Committee favours an approach for measuring a control interest based on that set out in section 191 of the Income Tax Act 1976 for measuring a "prescribed proportion" of the equity of two or more companies. We propose that the control interest in a company held by a resident be the proportion of:

a paid-up capital;

b nominal value of the allotted shares;

c entitlement to profits (including the entitlement to distributions on winding-up, whether from the capital or from the profits of the company); or

d the voting power;

e where appropriate, combinations of the above whichever is the highest.

3.4 The taxpayer would be required to take into account all classes of shares held when determining a control interest as well as rights to acquire equity in the foreign company whether in the form of options, convertible debt or other contingent interests.

## 4 Nominees and Trustees

4.1 Interests in companies in the names of trustees and nominees are a particular form of beneficial ownership. Interests held by nominees or by bare trustees would therefore be attributable to their beneficial owners. Nominee rules would also attribute a control interest to a shareholder who has an arrangement with another person to resume ownership of shares at a subsequent date (through so called "warehousing" of shares).

4.2 The Committee's general approach to the taxation of trusts is that their tax treatment should be determined by reference to the residence of settlors (see Annex 4). In accordance with this preferred approach, the Committee considers that a control interest in a controlled foreign company held by trustees of discretionary trusts should be attributed to any New Zealand resident who has settled property on the trust. In this context, the trustees of the discretionary trust settled by the resident would be considered to be nominees of the resident. A settlement of a trust is defined in Annex 4.

## 5 Indirect Control Rules

5.1 To determine accurately the level of a taxpayer's control interest in a foreign company, control interests held in the foreign company indirectly by a taxpayer through another controlled foreign company would need to be combined with control interests held directly by the taxpayer.

5.2 Indirect control interests held through a chain of controlled foreign companies would be determined by multiplying the taxpayer's control interest in the top tier controlled foreign company by the top tier company's control interest in the second tier controlled foreign company and so on. The indirect control test would 'look through' each controlled foreign company in a corporate tier in this manner until the combined control interest of the taxpayer and four other residents in the foreign company is less than 50 percent (i.e. the lowest tier foreign company is not a controlled foreign company).

5.3 For the purposes of tracing control down a corporate tier, a resident with a direct control interest in a first tier controlled foreign company of more than 50 percent would be deemed to hold a 100 percent control interest in the foreign company. Similarly, where a higher tier controlled foreign company in which a taxpayer has an interest controls a lower tier foreign company (i.e. its control interest is 50% or more) the higher tier company would be deemed to hold a 100 percent control interest in the lower tier company. This rule is necessary to prevent taxpayers avoiding the 50 percent control threshold in respect of an interest in a particular foreign company by interposing between themselves and the company in question a series of controlled foreign companies in which the control interest held by the taxpayers is less than 100 percent.

5.4 The effect of the procedure for tracing control down a corporate tier described in paragraph 5.3 is that, where a controlled foreign company holds a control interest of less than 50 percent in a foreign company, the control interest held by the controlled foreign company would be considered to be held by its New Zealand resident shareholders.

5.5 The following example illustrates the operation of the indirect control rules.



NZCO, a company resident in New Zealand has a 40 percent control interest in SUBCO1, a non-resident company in which another resident holds a control interest of 30 percent, making SUBCO1 a controlled foreign company. NZCO also holds a direct control interest of 40 percent in CFC, another non-resident company. SUBCO1 holds a 60 percent control interest in SUBCO2, which in turn holds a 25 percent control interest in CFC. NZCO would determine its indirect control interest in CFC by multiplying its control interest in SUBCO1 by SUBCO1's control interest in SUBCO2, and SUBCO2's control interest in CFC. As SUBCO1's control interest in SUBCO2 is 60 percent, SUBCO1 would be deemed to hold a 100 percent control interest in SUBCO2 for the purposes of computing NZCO's indirect control interest in CFC. NZCO's control interest in CFC held indirectly would therefore be 10 percent (i.e. 40% x 100% x 25%). NZCO's aggregate control interest in CFC would be 50 percent, being the sum of its direct control interest (40 percent) and its indirect control interest (10 percent).

5.6 In the example set out in paragraph 5.5, if SUBCO1 was not a CFC, NZCO would not be required to multiply its control interest in SUBCO1 by any of SUBCO1's control interests. Similarly, if SUBCO2 was not a controlled foreign company, NZCO would not be required to multiply its control interest in SUBCO2 by any of SUBCO2's control interests. However, where five or fewer New Zealand residents have an indirect income interest in a foreign company of 50 percent or more, a rule described in paragraph 2.13 of Annex 2 will apply to make the company a controlled foreign company.

## 6 Constructive Ownership Rules

6.1 The Committee considers that constructive ownership and control rules are necessary in order to prevent avoidance of the regime by spreading ownership of foreign companies among a number of associated persons. For the purpose of determining the control interest in a foreign company held by a New Zealand resident, constructive ownership rules would attribute to the resident ownership and control rights that in fact or in law belong to his or her associates or relatives.

6.2 Constructive ownership rules should only apply for the purposes of the control test and to determine the minimum level of interest before income is attributed to a taxpayer (described in Annex 2). Constructive ownership rules would not apply for the purpose of determining the basis on which income would be attributed.

6.3 Persons considered to be associated for the purposes of the controlled foreign company rules would include, as a minimum:

a any two persons with shared interests;

b any two companies which consist of substantially the same shareholders;

c any two persons who are relatives connected within the second degree of relationship;

d any company and any person (other than a company) who are associated persons within the meaning of section 8(1)(b) of the Income Tax Act;

e a partnership and any person who is a partner in the partnership.

6.4 The associated persons rule in conjunction with the constructive ownership rule may be illustrated by way of example. Suppose four New Zealand residents together own 40 percent of Nonresco, a non-resident company. A fifth New Zealand resident owns a further 2 percent. However, the fifth resident has four children, each of whom also owns 2 percent. In these circumstances, the shareholding of the children will be attributed to the fifth resident whether the children are resident in New Zealand or abroad. Nonresco would thereby be considered to be a controlled foreign company.

6.5 A further example of the operation of the associated persons rule in the context of constructive ownership provisions is a large New Zealand company with many shareholders that establishes a foreign associated company, with the same shareholders as the New Zealand company, holding interests in the same proportion. If the shares of the two companies are 'stapled' (that is, they may be transferred only if kept together) the companies have a relationship that is somewhat similar to a holding company and subsidiary. The subsidiary would be a controlled foreign company, but, in the absence of special rules, the stapled associated company would not, unless by chance it was controlled by five or fewer New Zealand residents. However, the associated persons rule treat the two companies as one person as they have shared interests.

6.6 The Committee is reviewing the definitions of associated persons and nominees in the Income Tax Act to make the definitions more consistent and effective, where necessary.

## 7 De-facto Control and Anti-avoidance Rules

7.1 The Committee favours an anti-avoidance rule as part of the control test that would apply to taxpayers who exercise de facto control of a foreign company. Residents who are entitled to call for or prevent the distribution of the profits of a foreign company, or who have the power to call for the wind-up of a foreign company would be deemed to have a 50 percent control interest and the company would therefore be a controlled foreign company, irrespective of the proportion of the equity of the company held by New Zealand residents. The anti-avoidance rule would also be aimed at arrangements, such as voting trusts and understandings, which have the effect of defeating the intent and application of the control test. The Committee considers that these anti-avoidance rules will support the nominee rules.

7.2 Taxpayers will include all the interests they hold in a foreign company to compute a control interest, irrespective of whether these were acquired before or after 17 December 1987. However, in respect of investments in countries that are not on the transitional list of specified low tax jurisdictions, income would be attributed during the transitional period only in respect of interests acquired after 17 December (see Annex 2) .

# ANNEX 2 – ISSUES RELATING TO THE DETERMINATION AND ATTRIBUTION OF BRANCH-EQUIVALENT INCOME

## 1 Introduction

1.1 As noted in the Committee's report, we favour a taxation regime that only requires taxpayers with interests in excess of a minimum level in controlled foreign companies to report income on a branch-equivalent basis. The amount of income to be reported would be determined by applying the attribution rules to the total annual income of the company, computed on the basis of New Zealand tax rules.

1.2 Income attributed under this regime would be included in a taxpayer's assessable income and taxed at personal or corporate rates applicable to income derived by the taxpayer. The Committee is still considering appropriate rules for the treatment of losses.

1.3 The two aspects of the international tax regime addressed in this annex will be details of the attribution rules and guidance for taxpayers on procedures for computing the income of a controlled foreign company on a branch-equivalent basis.

## 2 Attribution of Branch-equivalent Income

### Determination of an Annual Income Interest.

2.1 The annual branch-equivalent income of a controlled foreign company would be attributed to a taxpayer on the basis of the income interest held by the taxpayer. A taxpayer's income interest in a controlled foreign company is the basis upon which income is attributed under the proposed regime. It is computed by reference to the control interest held by the taxpayer and the nominee of the taxpayer as described in Annex 1.

2.2 The Committee considers that a taxpayer should be required to include in assessable income only income to which he or she can reasonably be considered to have access. Consistent with this view, control interests in a foreign company held by associated persons of the taxpayer and attributed to the taxpayer for the purpose of determining his or her control interest should be excluded when determining the income interest held by the taxpayer.

2.3 As would be the case in determining a control interest, indirect interests held by a taxpayer would be taken into account when determining an income interest held by a taxpayer. However, an income interest would be computed by reference to the actual interests held at each tier in a chain of controlled foreign companies rather than deemed interests as would be the case when determining a control interest. The calculation of an income interest held indirectly is explained below in paragraphs 2.11 to 2.14.

2.4 In addition to the important differences between an income interest and a control interest described above an income interest differs from a control interest in the following respects:

a it excludes rights held by the taxpayer to acquire a future interest in a foreign company in circumstances described in paragraph 2.5 below; and

b it takes account of the varying levels of interest in a controlled foreign company the taxpayer may have held during the course of the company's accounting year.

2.5 To avoid attribution of the undistributed income of a controlled foreign company, taxpayers may hold rights to acquire interests in a foreign company in the form of options or other contingent interests. Rights held by a taxpayer that entitle the taxpayer to acquire a future interest in the company are taken into account when determining a control interest (as explained in Annex 1). It is the Committee's view that such rights are also to be taken into account when determining an income interest in relation to any accounting year of a foreign company in which the company derives a taxable profit. For this purpose, however, a taxpayer may exclude any rights to acquire interests in the company pursuant to normal commercial transactions where the rights, such as options or convertible debt, are acquired or are exerciseable by the taxpayer at fair market value.

2.6 Taking account of the varying levels of interest held during the accounting year of a controlled foreign company is considered to be more equitable than attributing income on the basis of the income interest held at the end of its accounting

year. The former approach will reflect more accurately an interest built up by a taxpayer during the course of a controlled foreign company's accounting year.

2.7 The first step in establishing the level of a taxpayer's income interest would be to calculate the interest in the company for each period during its accounting year in which the control interest remained unchanged. The income interest in each period would be determined according to the rules for determining an ownership interest set out in Annex 1 subject to the modifications set out in paragraphs 2.1 to 2.5 above.

2.8 The next step would be to pro-rate the income interest determined for each period by the proportion of the year (or part-year where the non-resident entity has an accounting period of less than a year) the interest remained unchanged. A taxpayer's overall income interest will be the sum of the pro-rated interests computed for each period in the non-resident entity's accounting year. In respect of any accounting year of a controlled foreign company, income attributable to a resident is derived by multiplying the income interest computed for that year by the annual branch-equivalent income for that accounting year (or part-year as appropriate).

2.9 The pro-rating of interests for any relevant period during the accounting year of the controlled foreign company would be on the basis of the number of days in that period as a proportion of 365, or the number of days in the controlled foreign company's accounting period if this is less than a year.

2.10 The method for determining the level of a taxpayer's interest in a non-resident entity for the purpose of attributing income is illustrated in the example set out below:

### Example

Taxpayer X holds an interest in Nonresco, a controlled foreign company. A summary of X's control interest during Nonresco's accounting year, modified to conform with the adjustments set out in paragraphs 2.1 to 2.5 above, is:

* 33 percent for the first three months;
* 50 percent for the next six months;
* 66 percent for the last three months.

X's interest is computed as follows:

Pro-rated interest for the first 3 months = 33% x 25% = 8.3%

Pro-rated interest for next 6 months = 50% x 50% = 25.0%

Pro-rated interest for last 3 months = 66% x 25% = 16.5%

Total Income Interest = 49.8%

If Nonresco's branch-equivalent income for its relevant accounting year was (say) $100, $49.80 would be attributed to X on the basis of X's interest.

### Income Interests where there is Indirect Ownership.

2.11 If a controlled foreign company is a second or lower tier company, its income will be attributed directly to New Zealand residents in accordance with their direct and indirect interest in the controlled foreign company. For this purpose, an income interest is determined by multiplying the taxpayer's income interest in the top tier controlled foreign company by the top tier company's income interest in the second tier controlled

foreign company company and so on. A taxpayer would multiply income interests in controlled foreign companies at each tier until the lower tier company either was not a controlled company, or the taxpayer's income interest fell below the minimum level of interest for income attribution.

2.12 The procedure for determining an indirect income interest in a controlled foreign company held through a series of higher tier controlled foreign companies contrasts with that for determining a control interest down a corporate tier described in Annex 1. Under the latter approach, a higher tier controlled foreign company is considered to hold a 100 percent control interest in any lower tier foreign companies it controls.

2.13 Ordinarily, a taxpayer should not be required to multiply an income interest held in a company that is not a controlled foreign company by income interests that the foreign company has in other foreign companies. This is because it is impossible, in normal commercial circumstances, for a taxpayer to 'look through' a company that is not a controlled foreign company to trace indirect interests. However, the Committee is considering a rule aimed at situations where five or fewer taxpayers structure their indirect interests in order to collectively hold more than 50 percent of an income interest in a foreign company but hold a control interest of less than 50 percent. Such a rule might require a taxpayer to multiply an interest in a top tier foreign company that is not a controlled foreign company by an income interest the top tier company holds in a lower tier foreign company where there was such an arrangement and its application resulted in the lower tier entity becoming a controlled foreign company.

2.14 The following example illustrates the operation of these rules:



X, a resident company, holds a 60 percent income interest in Nonresco1, a controlled foreign company. Nonresco1 has a 60 percent income interest in Nonresco2 which in turn, has an income interest of 25 percent in CFC. X also holds directly an income interest of 35 percent in CFC. X's income interest in CFC held indirectly through Nonresco1 and Nonresco2 would be 9 percent (i.e. 60% x 60% x 25%) which, when combined with X's direct interest of 35 percent, gives an overall income interest held by X of 44 percent.

### Minimum Interest for the Attribution of Income

2.15 The Committee considers that where an income interest of a taxpayer in a controlled foreign company is below 10 percent, branch-equivalent income of the company should not be attributed to the taxpayer.

2.16 To prevent fragmentation of shareholding in order to fall below this threshold, constructive ownership rules that combine the interests of associated persons of any taxpayer with those of the taxpayer, will be used to determine whether a taxpayer's interest is above the minimum threshold. This means, for example, that if a taxpayer held a five percent income interest in a controlled foreign company and associated persons of the taxpayer held income interests of another five percent, the income interest of the taxpayer for the purpose of applying this test will be ten percent. As the interest of the taxpayer is above the minimum threshold, branch-equivalent income of the controlled foreign company would be attributed to the taxpayer and persons associated with the taxpayer.

2.17 While the interest held by a taxpayer and associated persons of the taxpayer would be combined when applying the minimum interest test, income would be attributed to the taxpayer, and persons associated with the taxpayer, on the basis of the interests held by each individually.

### Transition Rule

2.18 Whether an income interest is above the minimum threshold for attribution needs to be determined having regard to the proposed transitional measures. To determine whether income interests are above the minimum threshold, a taxpayer would

take into account all income interests held irrespective of whether they were acquired before or after 17 December 1987. However, during the transitional period, should it apply, income would be attributed to the taxpayer only on the basis of income interests acquired after 17 December 1987.

2.19 For example, a taxpayer may have an income interest of 15 percent in a controlled company resident in a country that is not on the transitional list of designated low tax jurisdictions. The transitional provisions would therefore apply. The taxpayer's income interest in the company as at 17 December was 8 percent and the taxpayer acquired a 7 percent income interest in the company after 17 December. Income of the controlled foreign company would be attributed to the taxpayer on the basis of the 7 percent income interest acquired after 17 December during the transitional period.

### Changes of Residence

2.20 The CD proposed on page 20 that a person would not be a resident of New Zealand for the purposes of income attribution where the person had been a resident of New Zealand for a cumulative period of less than 24 months in the immediately preceding 15 years.

2.21 The Committee will review this proposal together with the appropriate treatment under the regime of persons who become, or cease to be New Zealand residents. The rules for determining residence in the Income Tax Act, particularly as they relate to individuals, will also be reviewed to ensure that they do not provide scope for unacceptable avoidance of the regime by taxpayers.

## 3 Calculation of the Income of a Controlled Foreign Company on a Branch-equivalent Basis.

### 3.1 Opening Balance Sheets

3.1.1 In order for taxpayers to compute the income of controlled foreign companies on a branch-equivalent basis, some of the opening balance sheet items will need to be restated, in the foreign currency, but as if New Zealand tax rules applied. The proposals set out below are designed to reduce compliance costs where there is little, if any, revenue consequence.

3.1.2 The rules which follow in relation to the opening values of fixed assets and trading stock give the taxpayer the option of choosing opening values in accordance with either New Zealand tax rules or the tax rules of the country of residence or income source of the foreign company. Whichever option a taxpayer elects to use, he or she would be required to use the same basis for determining the opening values of both fixed assets and trading stock to ensure the consistent application of whichever option is chosen.

#### Fixed Assets

3.1.3 The opening tax value of fixed assets for the year in which the taxpayer commences reporting on a branch-equivalent basis should be, at the taxpayer's option either:

a the depreciated tax value determined in accordance with the tax rules of the country of residence of the company, provided that the value does not exceed current market value; or

b the depreciated tax value determined in accordance with New Zealand tax rules.

#### Trading Stock, including Livestock

3.1.4 The opening tax value of trading stock should be, at the taxpayer's option either:

a the tax value determined in accordance with the tax rules of the country of residence of the company; or

b the tax value determined in accordance with New Zealand tax rules.

This opening value of trading stock should be deemed to be cost for the purpose of subsequent value for branch-equivalent income determination.

#### Financial Arrangements

3.1.5 The opening tax value of financial arrangements should be, at the taxpayer's option either:

a market value; or

b adjusted base price, being acquisition price plus accrued expenses less payments in the case of issuers, and acquisition price plus accrued income less payments received in the case of holders.

#### Prepayments

3.1.6 If under New Zealand income tax rules a resident incurs a deductible expense in the accounting year of the foreign controlled company preceding the accounting year in which income is assessed to the resident on a branch-equivalent basis, the taxpayer should not be permitted to include an adjustment for prepayments in respect of the expense in the opening balance sheet. However, if a deduction would not have been permitted in respect of the previous accounting year under New Zealand tax rules, an opening adjustment to the balance sheet for prepayments in respect of the deduction should be permitted.

#### Specified Leases

3.1.7 Specified leases entered into by a controlled foreign company after 1 April 1988 would be brought into the balance sheet for the purpose of computing branch-equivalent income as if New Zealand tax rules had applied from the commencement of the lease. Specified leases entered into before that date should be disregarded.

### 3.2 Calculation of Annual Income

3.2.1 There are two basic approaches to the calculation of annual income on a branch-equivalent basis. One is to apply New Zealand tax rules and conversion to New Zealand currency on a transaction-by-transaction basis. The other is to apply New Zealand tax rules to items in the profit and loss account in the foreign currency, and convert the net annual income to New

Zealand currency as a second step. The latter method is implicit in the CD, and the Committee considers that it is preferable on the grounds of minimising compliance costs.

3.2.2 In general, the application of New Zealand tax rules within the branch-equivalent regime as recommended should not impose undue compliance costs on New Zealand taxpayers. There are at least two types of provision, however, which may need amendment.

3.2.3 Specific references to "New Zealand" in the Income Tax Act will need to be reviewed to determine whether the relevant provision: offers a benefit or concession intended to be confined to New Zealand; contains a definition of New Zealand source income; or limits the scope of the tax net. Such provisions may need to be modified in the context of the branch-equivalent regime. As a general rule, provisions of the Income Tax Act that provide a specific tax concession for income sourced in New Zealand should not be taken into account when computing income on a branch-equivalent basis.

3.2.4 A review will also be undertaken by the Committee of the application of the associated persons provisions of the Income Tax Act. There does not, for example, seem to be any justification for determining the assessability of the income of controlled foreign companies to residents by reference to the activities of associated persons who are non-resident shareholders.

### 3.3 Conversion Rules

3.3.1 It is proposed that branch-equivalent income, expressed as a single figure in foreign currency, be converted into New Zealand currency at the average of the mid-monthly exchange rates for the relevant year. Exchange rate movements in respect of balance sheet items would not be taken into account in determining annual branch-equivalent income.

### 3.4 Differing Balance Dates

3.4.1 A taxpayer's share of the income of controlled foreign companies should be assessable in his or her income year in accordance with section 15(1) of the Income Tax Act. That is, a taxpayer would include the branch-equivalent income of a controlled foreign company in income for the income year ending with the 31st day of March nearest to the end of the foreign company's accounting year.

3.4.2 For interests in controlled foreign companies taxable from April 1 1988, or from the date when the regime may otherwise apply pursuant to the transitional provisions set out in the Committee's report, annual branch-equivalent income would be pro-rated to apply to that proportion of the foreign company's accounting year subsequent to the commencement date of the regime.

3.4.3 This means that a taxpayer would be required to compute income according to New Zealand income tax rules (including adjustments to the opening balance sheet set out in paragraphs 3.1.2 to 3.1.7) for the accounting year of the foreign company that straddles the date from which the regime applies.

### 3.5 Losses

3.5.1 Just as past profits would not be subject to the new regime, the Committee considers that there should also be no relief for past losses, except to the extent that the transitional measures recommended by the Committee will provide a period of adjustment and potential loss recoupment for taxpayers covered by them. With this limited exception, past losses should not be able to be brought forward into the first year of the branch-equivalent regime.

3.5.2 Quite apart from maintaining parity of treatment with past profits, another reason for not permitting past losses to be brought forward is that they will not have been computed according to New Zealand tax rules, and may well be the result of tax preferences in the foreign country which should not be brought through into the New Zealand tax base.

3.5.3 There should, however, be a limited amount of relief for current year losses. The CD (page 7) proposed that losses from interests in non-resident companies could be carried forward or offset against other branch-equivalent income, but not against other assessable income, while losses from interests in trusts could only be carried forward. As noted in our report, the Committee considers that these proposals could lead to a significant erosion of New Zealand tax revenue. Taxpayers could defer New Zealand tax by, for example, offsetting losses in high tax jurisdictions against profits in low tax jurisdictions, while at the same time carrying forward the losses to be offset against subsequent years' profits in the high tax jurisdictions.

3.5.4 One possibility being considered by the Committee would be to allow losses in respect of a taxpayer's income interest in a controlled foreign company to be either carried forward, or offset against the income in respect of income interests held by the taxpayer in a group of controlled foreign companies resident in the same jurisdiction, under the grouping provisions of sections 188 and 191. The Committee will report further on this issue.

### 3.6 Dividends Received by a Controlled Foreign Company

3.6.1 As noted in our report, it is necessary for non-portfolio dividends received by controlled foreign companies to be either subject to the withholding payment system or to be made assessable. This is necessary to prevent controlled foreign companies being used as dividend traps to avoid the domestic rules that apply to non-portfolio dividends. The Committee has yet to consider this issue in detail but considers that the treatment of dividends received by controlled foreign companies would be simplified if they were made assessable. However, to avoid the multiple levying of New Zealand tax on dividends, taxpayers would exclude dividends received by a controlled foreign company from another controlled foreign company in relation to which the taxpayer reports income on a branch-equivalent basis.

### 3.7 Foreign Tax Credits

3.7.1 The CD proposed that foreign tax credits be limited on an entity by entity and a source of income basis and be attributed on the same basis as the branch-equivalent income of a foreign company. It is immediately apparent that foreign tax should be creditable to a taxpayer on the same basis that the

income of a controlled foreign company is attributed (i.e. on the basis of income interests held by taxpayers in controlled foreign companies). However, issues that the Committee has yet to discuss include:

a the character of foreign taxes that should be creditable;

b any adjustments to foreign tax credits over time (such as the recognition of timing differences);

c the nature and extent of any limitations for crediting foreign taxes.

The Committee will report on these issues in its next report.

### 3.8 Treatment of Dividends from Tax Paid Income

3.8.1 The Committee outlines in its report problems that may result from the adoption of the proposal in the CD that taxpayers should be able to deduct dividends they receive from accumulated income of a foreign company for the purposes of computing branch-equivalent income. We consider that the proposed imputation system may provide an appropriate means of affording relief for dividends received by taxpayers from the accumulated income of a foreign company that has been subject to New Zealand income tax. The Imputation Credit Account (ICA) records amounts of New Zealand tax paid by resident companies including that on the attributed income of controlled foreign companies. Appropriate balances in the ICA could, for example, be used to reduce or offset New Zealand tax at the shareholder level on dividends received by resident companies from controlled foreign companies in which they have income interests.

3.8.2 As an alternative to meeting a withholding payment liability in cash, consideration is being given to allowing resident companies the option of meeting withholding payment requirements in respect of dividends received from controlled foreign companies by:

a making appropriate reductions to ICA credit balances; or

b making an appropriate reduction in any carried forward loss of the recipient company.

In either case the reduction in tax benefit arising from the reduction in carried forward loss or the ICA balance will match the withholding payment liability.

3.8.3 In order to avoid multiple levying of New Zealand tax on income derived by an individual through a controlled foreign company, it would be necessary to require the individual to keep the equivalent of an ICA in respect of income attributed directly to him or her under this regime.

3.8.4 The Committee will report further on this aspect of the regime in Part 2 of its report.

# ANNEX 3 – FOREIGN INVESTMENT FUNDS

## 1 Characteristics of Foreign Investment Funds

1.1 Foreign investment funds are usually entities resident in tax havens which hold portfolio interests in shares, or which invest in financial arrangements, real estate, commodities, currencies or a range of such investments. The funds often re-invest their income to increase their value, or they may distribute the income to investors in non-taxable forms.

1.2 A typical foreign investment fund is one which invests the savings of its members in order to provide them with retirement benefits, such as pension or lump sum superannuation. Its constitution is often not a material consideration. It may be organised in a form that has a fiscal personality apart from its members, such as a company or unit trust. Such a fund is 'foreign' if it is not a New Zealand resident for tax purposes.

1.3 The shares or units of some funds are listed on public stock exchanges. Other funds are not listed but offer to re-purchase the shares of members, usually at a price that is published from time to time. Sometimes the price is guaranteed not to fall below a certain minimum, perhaps related to the value of the investments of the fund verified by an independent valuer.

## 2 Need to Counter Taxation Advantages of Foreign Funds

2.1 Where a foreign investment fund is based in a jurisdiction that levies little or no income tax, or where the investments of the fund are taxed at a lower rate than comparable investments in New Zealand, residents who invest in the fund enjoy a fiscal advantage over other New Zealanders who invest domestically. Some funds distribute dividends to their members. Others, however, may 'roll up' their profits each year into more investments so that members must sell their shares or units in order to realise a return. Where a fund rolls up its income, the fiscal advantage may be enhanced since the investor's proceeds on realisation are generally treated as a capital receipt not subject to income tax.

2.2 If the international tax regime did not embrace foreign investment funds, they would provide residents with an easy opportunity to shelter income from New Zealand taxation and thus defeat the intent of the regime. Other countries have found it necessary to deal with such funds, which were being used to circumvent their own international tax regimes. New Zealand must also address foreign investments funds, especially in the light of current proposals to reform the tax treatment of life insurance and superannuation. Domestic superannuation funds are to lose their tax exempt status whereas many foreign investment funds, which provide superannuation benefits, may enjoy significant tax advantages. If, for tax reasons, residents were induced to invest in these foreign funds, a considerable switching of investment would occur to the detriment of both the New Zealand tax base and domestic savings institutions.

## 3 Basis for Taxing Funds

3.1 Investors may obtain tax benefits through foreign investment funds without controlling them. They will therefore slip outside the controlled foreign company regime. Residents should nonetheless be taxed on fund income accruing to their benefit. However, since they do not have control and are unlikely to be able to report income measured according to New Zealand rules, an alternative basis of taxation is necessary. It is considered that, as a proxy or surrogate measure for the direct taxation of income as conventionally defined, the comparative-value basis of taxation (see section 5 below) is appropriate in the following circumstances:

* where an investor has straightforward access to the underlying income of the fund. This will be the case where there are well-defined means of buying and selling interests;
* where the value of the interest is likely to reasonably reflect the underlying income. This will be the case where the investments are essentially of a passive nature and producing systematic gains;
* where it is apparent that the investor is obtaining a tax advantage. This will be the case where the foreign tax levied is lower than the comparable tax in New Zealand.

3.2 It is considered that the regime should apply to any interest held by a New Zealand resident in a foreign investment fund (as defined in section 4 below) where the effect of making the investment is to reduce the tax that is levied on the income earned through the fund to a level below that which would be paid had the income been taxed in New Zealand as it accrued. However,

as those subject to the regime will generally have non-controlling interests, and therefore limited access to information, the effect test will often involve an element of subjectivity. Comprehensive disclosure is therefore essential to ensure its effectiveness. Moreover, other factors such as the domicile or residence of the fund and its distribution policy should be taken into account.

## 4 Definition of Foreign Investment Fund

4.1 A foreign investment fund will be defined by reference to its investments. A fund is any legal entity which derives its income or value primarily or substantially from portfolio (or non-controlling) investments in shares, or from investments of a passive nature.

4.2 Thus, investments characterising an entity as a foreign investment fund include non-controlling investments in companies, trusts, partnerships and other business and investment entities, and investments in land held for rent or other investment return, financial arrangements, annuities, bullion, commodities, foreign currency, rights to royalties, and rights or options to acquire any of these. Fund investments would generally not include controlling interests in active businesses or in companies that carry on active businesses.

4.3 Funds subject to the regime include entities whose primary investments are in other foreign funds, even where those investments represent controlling interests. Hence, a non-resident holding company that controlled a number of trading subsidiaries would not be a fund for purposes of the regime, but it would be if it controlled several investment funds.

4.4 The characterisation of investments is critical because an entity earning mainly active rather than passive income would not be a fund and would fall outside the regime. The distinction between active and passive income is hot precise, so at the margin there will be pressure on the definition of a fund. In order to prevent passive income being disguised as active income, the need for a special anti-avoidance rule is being considered.

## 5 Measurement of Assessable Income

5.1 A New Zealand resident subject to tax on an interest in a foreign investment fund will be taxed on distributions received plus or minus the change in value of the interest from the beginning to the end of the taxpayer's income year. If there is a market for interests in the fund, eg by way of stock exchange listing, market prices will be employed. Otherwise quoted redemption prices offered by fund organisers will be used.

5.2 In the absence of such data, taxpayers will be required to value their interests in offshore funds by some commercially acceptable means. For example, a fund may provide members with market valuations of investments from time to time.

5.3 Where reliable valuation is unavailable, it will be necessary to impute a rate of return on the taxpayer's original investment in the fund and tax the notional income derived.

## 6 Overlap with Controlled Foreign Company Regime

6.1 The definitions of 'controlled foreign company' and 'foreign investment fund' may overlap. Consider a holding company controlled by five or fewer New Zealand residents that invests primarily in portfolio shares. It would be a controlled foreign company as well as an offshore fund. Residents holding more than a 10 percent interest could be subject to tax twice. Hence, a resident in this position will be required to report on a branch-equivalent basis.

# ANNEX 4 – TRUST REGIME

## 1 Introduction

1.1 A trust is created whenever a settlor transfers property to trustees to be held for the benefit of beneficiaries. Strictly speaking, a further settlement on the same trustees for the same beneficiaries upon the same trust provisions creates a new trust. For the sake of clarity, however, the individual transfers will be referred to in this annex as "settlements" and the collection of settlements made on the same terms as a "trust".

1.2 Trust income which vests in or is distributed to beneficiaries is termed "beneficiaries' income". By "trust income" we mean income which is not vested or distributed and therefore belongs to beneficiaries, defined or undefined, whose interests will crystallise only in the future.

1.3 Though there is no present beneficiary in whose hands trust income can feasibly be taxed, the objective of the international tax reforms require that the income be taxed on an annual basis. The issues are therefore:

a when should trust income be subject to New Zealand tax; and

b who should bear the liability for the tax?

## 2 Residence and Taxpayer

2.1 For individuals and companies, the first question is answered in terms of residence and source. The international regime extends this basic structure by attributing to New Zealand resident shareholders a share of the taxable income (including non-New Zealand source income) derived by non-resident companies.

2.2 In the Committee's view, the taxation of trusts should follow that of individuals and companies by developing rules for the residence of trusts.

2.3 Determination of residence defines the income to be taxed (worldwide income or source income). A closely related but separate issue is the identification of the taxpayer. It is desirable for practical and philosophical reasons that, wherever possible, the recipient of the income should be the taxpayer. If this is not possible, the residence of the taxpayer and the income recipient should be the same, since residence is a key criterion for determining the amount of income which is taxable. Failing that, for enforcement reasons, the taxpayer must be a person who is resident.

2.4 The only candidates for payers of tax on trust income are the trustees and the settlor. There is a good case for levying tax on the trustees: they are the legal owners of the income, they have the power of disposition over it and therefore the ability to pay tax from trust funds. The settlor has none of these and ordinarily could not oblige the trustees to meet what would be his or her own tax liability. In fact, the trustees would be in breach of trust if they did so. The best source of tax on trust income is therefore the trustees.

2.5 There are obvious difficulties in determining the residence of trusts by reference to the residence of the trustees. Individual trustees may be resident in a number of countries and it is easy to change the trustees of a trust. This would make residence ephemeral.

2.6 It would be possible, by analogy with companies, to determine residence by a concept such as "centre of administration and control". Where more than one such centre existed, a tie-breaker test or dual/multiple residence rules would be required. Such provisions would, however, be difficult for New Zealand to implement unilaterally in respect of trusts with centres of administration and control outside New Zealand. In addition, this approach would not satisfy the requirement of the international regime to tax foreign-source trust income where the origin of the trust and/or its corpus goes back to New Zealand.

2.7 An alternative approach would be to look for an ownership analogy with companies. Corporate structures provide a nexus of ownership between the offshore corporate income and New Zealand resident shareholders sufficient to justify taxing those shareholders on such income, provided that they have a power of disposition over the income or over systematic gains which are a reasonable surrogate for it.

2.8 The point of trusts, however, is that the ownership nexus is severed, except to the extent that the settlor retains a claim over the settled property in the form of outstanding debt. A nexus does, however, exist in the form of the influence or control which the settlor exercises through the establishment of the trust terms and, in some cases, through the power of the settlor to appoint or replace trustees. In the context of anti-

avoidance legislation, this more tenuous nexus could be regarded as sufficient to justify determining the residence of a trust by the residence of the settlor.

2.9 Since no other definition of residence is feasible as a basis for taxing trust income, including foreign-source income, we propose that trustees should be liable for tax on trust income on the basis of residence as determined by the residence of the settlor.

## 3 Future Settlements

3.1 There are considerable legal difficulties in applying new rules to existing settlements. These are dealt with in section 4 below. New rules can, however, be applied immediately to settlements made on or after 17 December 1987, the date of release of the CD.

3.2 Trustees in a foreign jurisdiction may or may not accept that their trust is a New Zealand resident. It is expected that the majority will do so, and will therefore pay tax on trust income at the greater of the foreign or the New Zealand rate. Should any default occur, it is necessary to provide that any New Zealand settlor will be deemed to be the agent of the trustees and be assessable and liable for tax accordingly. This is not unduly harsh given the fact that the settlor will know the rules at the time of making the settlement and could require an indemnity from the trustees for tax liabilities.

3.3 For these purposes, "settlor" will need to be widely defined as any person who has, directly or indirectly, caused an increment in wealth of the trust by the transfer to it of money,

goods, services of other benefits at less than arms-length prices. Where there is more than one resident settlor, the settlors should be jointly and severally liable. Where residents and non-residents make settlements on the same trust, residents will be treated as having made all settlements on the trust. This rule is necessary to avoid the need for complicated apportionment rules. It is not disadvantageous because residents and non-residents can make settlements on separate trusts.

3.4 In summary, we propose that the rules for future settlements be as follows:

a "settlor" be defined as any person who provides money, goods, services or other benefit to a trust for inadequate consideration, and "settlement" be defined accordingly;

b a trust, being all settlements made on or after 17 December 1987 by a resident settlor subject to the same trust provisions, be resident in New Zealand if and as long as any settlor of the trust is resident in New Zealand;

c settlors be required to make disclosure, within a set period, of any settlements as defined;

d New Zealand resident trusts be taxable in New Zealand on worldwide trust income;

e the trustees of a resident trust be liable for tax at the domestic trustee rate as if the trustees were one individual beneficially entitled to the income and be entitled to a credit for any foreign tax paid, but not

 entitled to tax rebates or income support measures;

f to the extent that any resident trust fails to meet its tax liabilities, the New Zealand settlor be liable for the tax as agent of the trustee or, where there is more than one resident settlor, they be jointly and severally liable.

## 4 Existing Settlements

4.1 If the above rules were applied to existing settlements, they could be unduly harsh because in many jurisdictions a settlor has no way of changing his or her status as a settlor and has no legal access to trust funds from which to pay the tax. Resident shareholders disadvantaged by the new international regime for companies at least have the option of selling their shares. The only way out for a disadvantaged settlor would be to emigrate from New Zealand. The Committee has therefore proposed a transition for trusts which recognises these legal constraints.

## 5 Distributions

5.1 Under the proposed rules for future settlements, trustees and settlors will taxed on income which will eventually accrue to beneficiaries. At present, individuals who derive foreign income are entitled to credits for foreign tax paid on the income and, in the absence of the general taxation of capital gains in New Zealand, they are not taxed on capital gains. It is proposed to carry these principles through to the tax treatment of distributions from trusts settled after 17 December 1987.

5.2 Distributions to New Zealand resident beneficiaries, excluding capital, capital gains, and distributions from assessable income which has already borne New Zealand income tax would be taxed in the hands of those beneficiaries, with a credit for foreign tax paid on the income. For tax purposes, such distributions should be deemed to be made pro-rata from all sources within each income year, and on a last in first out ("LIFO") basis from year to year.

## 6 Extinguishment of a Settlor

6.1 As the trust regime proposed by the Committee has as its basis the residence of the settlor, it is necessary to have rules to determine the residence of the trust on the extinguishment of the settlor. The Committee proposes that, on the death of an individual settlor of a trust, whether inter vivos or testamentary, the future residence of the trust should be determined by the residence of the settlor at death.

6.2 Where a trust is a sub-trust that has itself been settled by a trust, or where a trust has been settled by a company, the settlor of the trust which settled the sub-trust, or the shareholders of the company, as the case may be, will be deemed to be settlors of the first-mentioned trust. Thus, in the Committee's view: :

a on the winding up or extinguishment of a trust which has settled a sub-trust, the residence of the settlor of the trust should determine the future residence of the sub-trust;

b on the winding up, liquidation, or extinguishment of a company settlor, the residence of the shareholders of the company at the date of settlement should determine the future residence of the trust.

6.3 These rules follow the principle that the residence of a trust should be traced back to the residence of the original settlor. With respect to rules (a) and (b) above, the settling of a trust through another trust or through a company should be treated as being equivalent to an indirect settlement by the settlor of the first trust or by the shareholders of the company.

6.4 The Committee are considering whether, for these purposes, the best test of the residence of a trust is the domicile rather than the residence of the extinguished settlor.

## 7. Relationship Between Proposed Regime and Existing Law

7.1 The Committee intends to review the relationship between this proposed trust regime and the present law governing existing trusts and will comment further in its next report.

# ANNEX 5 : AN ILLUSTRATIVE TRANSITIONAL LIST OF LOW TAX JURISDICTIONS

ANDORRA MACAU

ANGUILLA MALAYSIA

ANTIGUA AND BARBUDA MARSHALL ISLANDS

BAHAMAS MONACO

BAHRAIN MONTSERRAT

BARBADOS NAURU

BERMUDA NETHERLANDS ANTILLES

BRITISH CHANNEL ISLANDS NETHERLANDS

BRITISH VIRGIN ISLANDS NEVIS

BRUNEI NEW CALEDONIA

CAMPIONE NORFOLK ISLAND

CAYMAN ISLANDS OMAN

COOK ISLANDS PANAMA

COSTA RICA PHILIPPINES

CYPRUS SAINT HELENA

DJIBOUTI SAINT KITTS

DOMINICA SAINT LUCIA

FRENCH POLYNESIA SAINT VINCENT

GIBRALTAR SEYCHELLES

GRENADA SINGAPORE

HONG KONG SRI LANKA

ISLE OF MAN SWITZERLAND

JAMAICA TONGA

JORDAN TURKS AND CAICOS ISLANDS

KUWAIT UNITED ARAB EMIRATES

LIBERIA URUGUAY

LIECHTENSTEIN VANUATU

LUXEMBOURG VENEZUELA

(Some of the above jurisdictions are listed as they tax on a territorial basis.)

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