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**International Tax Reform**

**Full Imputation**

**Part 2**

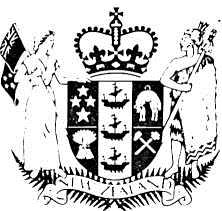
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**Report of the**

**Consultative Committee**

JULY 1988

Office of the

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

PO Box 3724  
WELLINGTON

30 June 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 the final report of the Committee. It covers matters which were outstanding after our first two reports and expands on the details of the regimes. The report is in two volumes. The first volume outlines the Committee's recommendations while the second contains the Committee's draft of the legislation covering both the international reforms and imputation.

When the details of tax reforms are developed, it is inevitable that minor changes need to be made to previous decisions and this has proved to be the case here. There are, however, no fundamental or significant changes. To a large extent, the recommendations in the present report merely cover the details necessary to implement the regimes approved in response to our earlier reports.

As was the case with our earlier reports, the recommendations in this report represent the unanimous views of Committee members.

We have been very ably assisted in the preparation of the draft legislation by Mr Graeme Smaill, Mr John Bassett and Mr Paul MacKay. The legislation has not been considered fully by officials or by parliamentary counsel but we consider that it is sufficiently well-developed for wider circulation and comment from interested parties and for introduction into the House.

The Committee is indebted to officials of the Treasury and Inland Revenue Department for their assistance. In particular, we thank Messrs Alex Duncan, David White, Ken Heaton, Peter Goss, Ross Judge and Mrs Jenny Whyte of the Treasury and Messrs Anthony Grace, Michael Rigby, John Moreno and Ms Jane Tait of the Inland Revenue Department.

Yours sincerely



Arthur Valabh

# 

# STATEMENT BY

Minister of Finance, Hon R O Douglas

Minister of Revenue, Hon T A de Cleene

## Introduction

This document is the final report of the Consultative Committee on Full Imputation and International Tax Reform. It contains the recommendations of the Committee on the further detailed measures required for the operation of the imputation and international tax regimes. The draft legislation for these regimes is set out in a separate annex to the Committee's report.

As noted by Mr Valabh in his covering letter, the report involves a number of changes to the regimes developed by the Committee and presented in its first reports but nothing which could be described as fundamental. These changes reflect the detail required to implement the regimes in accordance with the structure and principles already approved.

The Government supports the Committee's recommendations subject to some minor changes and reservations on definitional matters as highlighted further below. An enormous amount of detail has had to be developed in a relatively short space of time. We concur with the Committee that the overall regime is now at a sufficiently advanced stage for the legislation to be circulated. After being introduced to the House, the Bill will be referred to a Select Committee. There will then be a final opportunity for submissions.

## Imputation

The Government endorsed the Committee's recommendations on imputation set out in its earlier report. There were relatively few issues that required further work. The Committee now makes additional recommendations on the rules governing the allocation of imputation credits, the inclusion of co-operative companies and producer boards within the imputation regime, the treatment of returns of capital, the carry forward of unutilised imputation credits, the operation of the dividend withholding payment system, and on consequential changes to the definition of a dividend and to the excess retention tax and deemed dividend provisions. All these recommendations are supported subject to the following changes.

First, the Committee recommends that distributions subject to the winding up distribution tax of 10 percent should not also be subject to non-resident withholding tax. It had been envisaged that the winding up distribution tax would be enacted along with the imputation and international tax reforms later in the year. The Government considers that it would instead be preferable to enact this measure as soon as possible to facilitate the winding up process. Accordingly, the Government has decided that the measure will be enacted through the Taxation Reform (No.4) Bill.

Secondly, the Committee has recommended that fringe benefits received by a major shareholder/employee be subject to the FBT regime rather than the current deemed dividend provisions, in respect of fringe benefits other than loans with effect from 1 April 1988, and in respect of loans with effect from 1 October 1988. The Government agrees with the extension of the FBT regime but has decided that the change apply to fringe benefits including loans with effect from 1 April 1988. It will give further consideration to the details of the change to take account of anti-avoidance rules which are being developed to strengthen the provisional tax regime. Consideration also needs to be given to the implications for companies which wind up before the legislation extending the FBT is passed.

In its earlier report the Committee recommended that the date for the first withholding payment by companies, in respect of foreign-source dividends received after 1 April 1988, be the 20th of the month following the month in which the necessary legislation is passed. Given the scheduled enactment of the legislation later this year, the Government has decided that, in order to provide greater certainty for taxpayers, the date for the first withholding payment will be 20 January 1989.

## International Tax

The international tax regime recommended by the Committee in its first report comprises a branch-equivalent (BE) regime, a foreign investment fund (FIF) regime, and a revised trust regime. The regimes are designed to reduce the myriad opportunities for residents to avoid or defer New Zealand tax where they interpose foreign entities between themselves and income-producing assets.

The legislation has been drafted to ensure that the three regimes support one another and other recent tax reform. The provisions are necessarily detailed and are supported by a number of anti-avoidance provisions. These should not be read down given the clear objective of the reforms. The purpose of the BE regime is to tax on a current basis New Zealand residents having economic or financial interests, including contingent interests, in the

income of any foreign company where five or fewer residents in any manner whatsoever have a 50 percent or more interest in the company. The purpose of the FIF regime is also to tax residents on a current basis where they have interests in, but do not control, foreign entities in which they are able to accumulate income and obtain taxation advantages. Such interests include policies with foreign life offices and superannuation funds. The revised trust regime supports the BE and FIF regimes by generally taxing on a current basis the foreign-source trustee income of trusts having a New Zealand settlor, and taxing to New Zealand resident beneficiaries distributions from non-resident trustees.

We highlight the following features:

### – Aspects of BE Regime

Two important aspects here include the measurement of interests and an additional transitional measure. The Committee originally considered that a resident's control and income interests be measured on each day of the foreign company's accounting year. After further consideration, in light of the high compliance costs of daily measurement, the Committee now recommends that a resident's control and income interests be measured at the end of each quarter in a year and that anti-avoidance measures be adopted. In our view, this line strikes the right balance between minimising compliance costs and countering avoidance.

The Committee recommends that in respect of existing investments taxpayers should have the option of applying the BE regime before the end of the transitional period so that losses during that period may be accounted for in determining future BE income. In exercising this option, however, taxpayers cannot bring in losses and not profits. Accordingly, taxpayers will be entitled to elect, in respect of all of their income interests held on 17 December 1987 in all CFCs resident in countries not on the transitional list, to apply the BE regime for the accounting years of such CFCs falling in whole or in part during the period 1 April 1988 to 31 March 1990.

The Government has also decided the composition of, and the nature of the qualifications to, the permanent and transitional country lists as discussed below.

### – Grey List

The costs of complying with the BE regime should not exceed the revenue to be gained. For this reason, taxpayers with interests in CFCs resident in certain listed countries will not be subject to the regime. However, if stated preferences are utilised the BE regime will apply and income will be computed on a simplified basis. This list of countries is called a grey list.

Australia, Canada, France, Japan, the Federal Republic of Germany, the United Kingdom, and the United States of America will be on the grey list (see Attachment A). The relevant considerations in deciding the list included: the definition of taxable income, the extent of any tax preferences, the level of income tax rates, the efficiency of tax administration, and the extent of protection of the domestic tax base (including a comprehensive international tax regime) in each country.

It might be argued in certain circumstances that a taxpayer with an interest in a CFC in a grey-list country will be treated more favourably than a taxpayer with a similar interest in a non-listed country. However, favourable treatment in this context means only that some taxpayers are freed from additional income calculations; it does not necessarily mean that there is any anomaly in terms of tax liability. Rather than make all taxpayers calculate their BE income, it is preferable to relieve at least some from compliance costs where there is little risk to revenue.

### – Qualification of Grey List

The general qualification to the grey list relates to business income derived by a CFC from outside the listed country in which it is resident which is not subject to tax in that country. Other forms of income such as interest and dividends are also being considered for qualification. A general qualification rather

than a qualification by country is favoured at this stage. Should it be necessary to introduce country qualifications they will have prospective effect.

### – Transitional List of Low Tax Countries

Under the transition recommended by the Committee, residents with interests acquired on or before 17 December 1987 in companies resident in countries other than low tax jurisdictions will be exempt from the BE regime until 31 March 1990. The list of low tax jurisdictions for this purpose is contained in Attachment B. The list is an updated and more detailed version of the illustrative list set out in the Committee's earlier report.

### – Trusts

The Committee has recommended changes to the trust regime set out in Part 1 of its report but these are of detail rather than of principle. The Committee continues to hold to the following principles:

* the taxation of foreign-source trustee income (ie income which is not taxed as beneficiary income) should be determined by the residence of the settlor, rather than by the residence of a trustee as is currently the case;
* where there is a resident settlor of a trust in the year in which the trustee of the trust derives foreign-source trustee income, the liability for New Zealand tax on that income should rest in the first instance with the trustee (whether that trustee is a resident or a non-resident) and if the trustee does not meet the liability and is not resident in New Zealand, the liability should fall to the resident settlor.

Transitional provisions apply where a resident settled a trust on or before 17 December 1987.

In addition, the Government has decided that testamentary or inter vivos trusts settled by a person who dies a resident of New Zealand, should also be subject to New Zealand tax on their foreign-source income where such trusts have a. resident trustee. Although in these cases there is no resident settlor in the year trustee income is derived, the resident trustee provides a sufficient basis for taxation.

With respect to the recommended taxation of distributions from trusts, effective from 1 April 1988, the Government has decided to modify the treatment recommended by the Committee for foreign trusts (trusts which at no time since 17 December 1987 have had a settlor who is a New Zealand resident). As recommended, distributions from the trustee income of such trusts derived in income years commencing after 1 April 1987, other than of corpus and capital profits, would be assessable to a beneficiary at his or her marginal tax rate but other distributions from such trusts would be non-assessable. The Government has decided that distributions of trustee income of such trusts derived in income years commencing on or before 1 April 1987 should also be assessable to a beneficiary but at a flat rate of 10 percent. This treatment is consistent with the transitional provisions recommended by the Committee in respect of trusts settled before 17 December 1987 which are either wound up by 31 March 1989 or brought within the new settlor regime for the 1989 income year.

Under the new trust regime recommended by the Committee, the existing distinction between specified and non-specified trusts will be removed with effect from the income year commencing 1 April 1988 (the distinction was originally made to limit the scope for income splitting). Along with this change, the Committee has recommended a widened definition of beneficiary income to include income of a trust which vests in a beneficiary, as well as income paid to or applied for the benefit of a beneficiary within six months of the end of a trustee's income year. The Government wishes to consider further the definition of beneficiary income.

### – Residence Rules

The definitions of residence under the Income Tax Act will be amended in order to reduce the scope for individuals and companies to manipulate their affairs to obtain taxation advantages. The new definitions, building on existing concepts, make it easier for a person to become a resident of New Zealand and harder to become a non-resident, and they more precisely define residence for companies.

In brief, if a person has a permanent place of abode in New Zealand or is present here for at least 183 days in any year he or she is resident, only ceasing to be so if absent for at least 325 days in any year having during that time no permanent place of abode here. A company will be resident in New Zealand if it is incorporated here or has its head office or its centre of director control or executive management here. There will be no special rule for banking companies.

### – Other Legislative Changes

To support the regime recommended by the Committee, two other legislative changes are required. These will be made through the Taxation Reform (No.4) Bill.

The first change is to the low income earner rebate. Despite the substantial reduction in the incentives for income splitting as a result of the flattening of the income tax scale, the Government is concerned to reduce them even further. Accordingly, it has decided to include beneficiary income in income which does not qualify for the low income earner rebate.

The second change relates to the rate of taxation of trustee income. The Committee has recommended a complete upgrading of the taxation of trusts including the removal of the distinction between specified and non-specified trusts from 1 April 1988. The uniform treatment of trustee income is an integral part of the trust regime and hence of the overall international regime since the BE, trust, and FIF regimes are mutually interlocking.

Accordingly, the trustee income of all trusts will be taxed at a rate of 35 percent or at the marginal composite rate scale for individuals (whichever is the higher) in the current year. From the 1989 income year, trustee income will be taxed at the top marginal rate for individuals (33 percent in that year).

This change will mean that some trustee income will be subject to a higher rate of tax than it would otherwise have been in the current year. This move towards a more uniform taxation of trustee income has been foreshadowed both in terms of the rates as originally set out in the No.4 Bill and the Government's acceptance of the Committee's earlier recommendations on the reform of the taxation of trusts.

### – Earlier Reservations

There were three issues on which Government expressed reservations in response to the Committee's first report on international tax reform:

a the exclusion from the fund regime of the interests of residents in active businesses in low tax countries;

b the treatment of capital profits from certain trusts; and

c the transitional provisions in respect of trusts settled by residents before 17 December 1987.

The Government maintains its reservation in (a) and will be closely monitoring the FIF regime and strengthening it if necessary. As mentioned below, the reservations in (b) and (c) are removed in the light of changes to the Committee's recommendations on trusts.

The Committee recommends that where a trust settled on or before 17 December 1987 does not wind up before 1 April 1988 or the settlor, trustee or a beneficiary does not pay a tax of 10 percent on the net assets of the trust at 31 March 1988, distributions from the trust would be treated as non-qualifying

distributions. This means that all such distributions (other than of corpus) would be taxable to beneficiaries at a tax rate of 45 percent. The Government considers that this measure provides a sufficient incentive for settlors in a position to do so to wind up such trusts or subject their foreign-source trustee income to tax in New Zealand.

Under the non-qualifying distribution provisions, distributions of capital profits would be taxed to a beneficiary. Distributions of capital profits which are not non-qualifying distributions would be non-assessable. Capital profits would of course, in some cases, continue to be taxable as trustee or beneficiary income. Capital profits of trusts that are foreign investment funds would also be taxable to residents. The recommended taxation of distributions of capital profits from trusts is broadly in line with existing treatment. However, it will need to be reviewed in considering the introduction of a capital gains tax.

## Conclusion

The Government supports the recommendations of the Consultative Committee subject to some relatively minor changes and reservations. The changes, as discussed, relate to:

* the timing of the implementation of the winding up tax on distributions;
* the timing of the extension of the fringe benefit regime to major shareholders/employees for concessionary loans;
* the taxation of the foreign-source trustee income of certain trusts which have a resident trustee but no resident settlor; and
* the taxation of certain distributions from foreign trusts.

As discussed, the only points on which the Government reserves its position at this stage concern:

* the definition of a foreign investment fund. The Government maintains its earlier reservation and will strengthen the fund regime if necessary;
* the need for anti-avoidance rules to support the extension of the fringe benefit tax; and
* the definition of beneficiary income under the new trust regime.

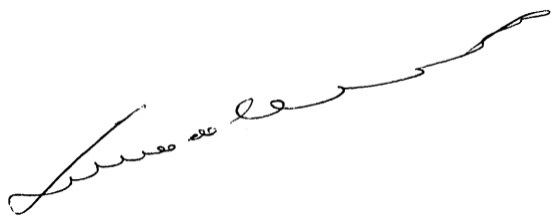
The Government has also decided that in order to provide greater certainty for taxpayers the date for the first withholding payment by companies, in respect of foreign-source dividends received after 1 April 1988, will be 20 January 1989.

In addition to the legislation to implement the measures recommended by the Committee, two other consequential legislative changes are required. One is the addition of beneficiary income to the list of income which does not qualify for the low income earner rebate. This is designed to counter income splitting. The other change required is the rationalisation of the rate of taxation of trustee income. This is necessary given the removal of the distinction between specified and non-specified trusts under the new trust regime. These changes together with the distribution winding up tax will be implemented through the Taxation Reform (No.4) Bill.

The Government has decided the composition of, and the nature of the qualifications to, the permanent and transitional country lists for the purposes of the BE regime. The lists are set out in Attachments A and B to this statement.

Once again we record our thanks to the Committee. It is to be commended for its report and for its professional commitment to seeing through an extremely difficult job. Chaired by Mr Arthur Valabh, the Committee comprises Dr Robin Congreve, Mr Stuart Hutchinson, Dr Susan Lojkine, Professor John Prebble and Mr Tim Robinson.

After being introduced to the House, the Bill giving effect to the imputation and international tax reforms will be referred to a Select Committee. There will then be a final opportunity for submissions. We commend a close examination of the Committee's report and the draft legislation to all interested parties.

Roger Douglas Trevor de Cleene

Minister of Finance Minister of Revenue

**ATTACHMENT A**

**PERMANENT LIST OF EXCLUDED COUNTRIES**

Australia, excluding the Territory of Norfolk Island;

Canada;

Federal Republic of Germany;

French Republic, including the European and Overseas Departments, but excluding the Overseas Territories;

Japan;

United Kingdom of Great Britain and Northern Ireland;

United States of America, but excluding its possessions and territories.

Notes

1. The Government has considered the Consultative Committee's recommendations concerning the listing of preferences and has decided that initially it would be more appropriate to list general features of tax systems which might be used to avoid the BE regime rather than listing specific preferences in relation to individual countries listed above. However, the Government intends to monitor developments in the seven listed countries. Once it is decided to list a particular preference or feature, or amend a listing, the change will apply prospectively.

2. The legislation presented to Parliament will include one general qualification which will apply to all of the above listed countries. Interests in a CFC resident in a listed country will be subject to the BE regime where a CFC derives certain forms of foreign source income which are not subject to income tax in the listed country of residence. At this stage, it has been decided that the general qualification will apply to foreign source "business" income. Other forms of foreign source income, such as interest and dividends, are being considered for inclusion in this general qualification too.

**ATTACHMENT B**

**TRANSITIONAL LIST OF LOW TAX JURISDICTIONS OR TERRITORIES**

Andorra Isle of Man

Angola Jamaica

Anguilla Jordan

Antigua and Barbuda Kuwait

Bahamas Lebanon

Bahrain Liberia

Barbados Liechtenstein

Bermuda Luxembourg

British Channel Islands Macau

British Virgin Islands Madeira

Campione Maldives

Cayman Islands Marshall Islands

Cook Islands Monaco

Costa Rica Montserrat

Cyprus Nauru

Djibouti Netherlands Antilles and/or Aruba

Dominica Nevis

Ecuador New Caledonia

French Polynesia Norfolk Island

Greece Oman

Grenada Panama

Gibraltar Palau

Guatemala Puerto Rico

Hong Kong Saint Helena

Saint Kitts Switzerland

Saint Lucia Turks and Caicos Islands

Saint Vincent United Arab Emirates

San Marino Uruguay

Seychelles Vanuatu

Solomon Islands Venezuela

Sri Lanka

Belgium – companies which are regarded as Foreign Sales Corporations by the United States of America and which therefore qualify for reduced Belgian taxation

– companies approved under Royal Decree No 187 of 30 December 1982 as Co-ordination Centres (as defined by the original Royal Decree or by subsequent amending laws)

Brunei – companies deriving income from sources outside Brunei

Ireland – companies obtaining relief or exemption from tax under Part V of the Corporation Tax Act 1976 or section 43 of the Finance Act 1980 (profits from trading within Shannon Airport)

– companies obtaining relief or exemption from tax under Part IV of the Corporation Tax Act 1976 or section 42 of the Finance Act 1980 (profits from exporting certain goods)

– companies certified by the Minister of Finance to provide international financial services or to carry on any other activities in the Customs Dock area

Kenya – companies having income granted exemption from tax under paragraph 11 Schedule 1 of the Income Tax Act 1973

Malaysia – companies exempt from tax in relation to shipping

– companies subject to tax at 5 percent in relation to inward reinsurance

– companies deriving income from sources outside Malaysia

Netherlands – companies exempt from tax under the Decree for the Avoidance of Double Taxation 1985 for foreign source business profits

– companies which have obtained a participation exemption under article 13 of the Corporate Income Tax Act 1969 or under article 18 of the Corporate Income Tax Act 1969

– companies which are regarded as Foreign Sales Corporations by the United States of America and which therefore qualify for reduced Netherlands taxation

– companies which have obtained an advance ruling from the Ministry of Finance in relation to income earned with respect to intercompany loans

Philippines – companies which are regional headquarters companies

– companies which operate as an Offshore Banking Unit or a Foreign Currency Deposit Unit

– companies which receive interest on deposits with a Foreign Currency Deposit Unit, or other interest subject to reduced rates of tax under the National Internal Revenue Code

Singapore – companies subject to the concessionary rate of tax for insurance and reinsurance of risks outside Singapore

– companies which operate Asian Currency Units which have income -

* taxed at a concessionary rate by virtue of section 43A of the Income Tax Act
* exempted from tax under the Income Tax (Income Arising from Syndicated Offshore Loans) Regulations 1984

– companies which are exempt from tax on the income of a shipping enterprise

– companies which derive any income to which section 43E of the Income Tax Act applies (headquarters companies)

– companies which are incorporated in Singapore but not managed and controlled from Singapore and which derive any income from sources outside Singapore

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# CHAPTER 1 – INTRODUCTION

## 1.1 Purpose of This Report

1.1.1 The Committee's recommendations on the main features of the international tax reforms and the imputation scheme were outlined in Part 1 of its Report on International Tax Reform and its Report on Imputation. The Government's response to these recommendations was outlined in press statements issued jointly by you and the Minister of Revenue. These were published with the Committee's reports. With three reservations, the Government accepted the Committee's recommendations on the international reforms while those on imputation were accepted in full.

1.1.2 The purpose of this report is to outline the Committee's recommendations on the outstanding issues relating to both sets of reforms and to present the Committee's draft of the legislation. We comment only on those areas where we have found it necessary to modify our original recommendations and on issues which were left undecided in our earlier reports. In all other respects, the draft legislation implements the recommendations of the previous reports.

1.1.3 The aim of this report is therefore to provide interested parties, once you have made your decisions, with an explanation of the policy behind the draft legislation. The report is not intended as an exhaustive guide to the draft legislation. It does not restate all of the arguments or conclusions reached in the Committee's first two reports. This report should therefore be read in conjunction with the earlier reports. We do, however, elaborate our views on a number of the issues which have been raised in response to our previous reports.

## 1.2 Outline of the Report

1.2.1 The report is contained in two volumes. Our recommendations are presented in this volume. The Committee's draft of the legislation covering the international regimes, the imputation and the withholding payment system and related reforms is contained in a separate volume which forms an annex to this report.

1.2.2 The present chapter includes further comment on a number of issues which are central to the Committee's recommendations. Chapters 2, 3 and 4 outline the Committee's recommendations on the remaining details of the branch-equivalent ("BE") regime to apply to certain controlled foreign companies ("CFCs"). Chapter 5 discusses the outstanding issues relating to the foreign investment fund ("FIF") regime. Trusts are dealt with in chapter 6, while disclosure and default provisions are the subject of chapter 7. Transitional issues relating to the international reforms are considered in chapter 8.

1.2.3 Chapter 9 outlines the Committee's views on the remaining issues concerning the imputation and withholding payment regimes. Consequential and related changes to other aspects of the existing tax law are dealt with in chapter 10. Finally, chapter 11 draws together all of the recommendations of the previous chapters and makes a number of concluding remarks.

1.2.4 Annex 1 of the separate volume consists of the Committee's draft of the legislation on the international tax reforms. Annex 2 in the same volume presents the Committee's draft of the legislation on imputation, the withholding payment system and related matters.

## 1.3 "Grey List Exemption"

1.3.1 Residents are to be exempt from the BE regime in respect of interests in CFCs resident in certain "grey list" countries unless such a CFC utilises a listed significant tax preference available in a grey list country. These countries are the United States, the United Kingdom, West Germany, Canada, Australia, France and Japan. The list is referred to as "grey" because it may be qualified by the listing of certain significant tax preferences.

1.3.2 Since by far the bulk of existing New Zealand investment overseas is in these countries, it is not surprising that further elaboration of the exact details of the operation of the grey list exemption have been sought by tax practitioners and businesses. In addition, a number of criticisms have been made: that the list should be expanded, perhaps to include all of the countries with which New Zealand has a tax treaty; that it should not be qualified by the listing of preferences; that no criteria have been given for deciding what preferences would be listed; that there should be no "look through" of a CFC resident in a grey list country to CFCs underneath it; and that the compliance costs of the regime would be unmanageable if it frequently applied to CFCs in grey list countries.

1.3.3 These concerns to some extent reflect the uncertainty that arises when tax reforms are developed during a consultative process. Though everyone would wish to see uncertainty minimised to the greatest extent possible, some considerable uncertainty is inevitable if the Government's reform proposals are to be the subject of private sector input and consultation. The trade off is that a better result will usually emerge. It is not possible to have consultation and certainty.

1.3.4 In Part 1 of our Report on International Tax Reform, we said the list should include countries "which have comprehensive

international tax rules including CFC regimes" (page 19 of our report). The governing principle for listing a country is that, if the BE regime were applied in respect of CFCs resident in that country, it would be probable that the tax credit allowed for tax paid by a CFC resident there would be sufficient to offset the New Zealand tax liability on that income. In other words, the compliance costs of the regime would be excessive in relation to any revenue likely to be raised.

1.3.5 Whether or not the income tax paid by a CFC is likely to be comparable to the tax that would be levied on its income under the BE regime will depend on the definition of taxable income in its country of residence (such as whether there are significant tax preferences), income tax rates, the efficiency of the tax administration and the extent to which the domestic tax base is protected from avoidance. The existence of comprehensive international tax rules is relevant to the last factor, in particular. The tax legislation by itself may suggest that nominally high rates of tax will be payable, but if there are international planning opportunities effective rates may be very different.

1.3.6 We consider that the existence of a CFC regime is indicative of an income tax system and administration in respect of which it can reasonably be assumed that the effective tax rates on business income in those countries do not depart substantially from the statutory rates. In addition, the CFC regime of the grey list country tends to support the New Zealand BE regime where residents hold interests in CFCs resident outside a grey list country through intermediate companies resident in such a country.

1.3.7 We do not consider that the list should be extended to include all of New Zealand's tax treaty partners. The treaties are entered into to relieve double taxation, promote trade and advance our relationships with other countries. They say nothing

about the robustness of the tax system of the treaty partner nor its comparability with New Zealand's. That is not relevant to the decision to establish a treaty. Indeed, we have suggested that a number of our treaty partners should be listed on the transitional list of low tax jurisdictions.

1.3.8 If the grey list is to serve its purpose, provision must be included for its qualification by the listing of preferences. Until recently, countries such as the United States and the United Kingdom gave substantial tax preferences to a broad range of businesses. If the list were being considered, say, four years ago, it would have been necessary to either exclude these two countries or to designate the preferences that would trigger the application of the BE regime. Because so much of New Zealand's investment is in these countries, the compliance costs of the BE regime will depend importantly on whether a country is listed with preferences or the country is excluded from the list altogether. Listing with a qualification for certain preferences is the more flexible approach and the one which will have lower compliance costs.

1.3.9 The general arguments for not preserving the effect of tax preferences under the BE regime were set out in section 2.3 of our previous report. The main counter argument is that the claw-back of tax preferences will make foreign subsidiaries of New Zealand companies uncompetitive. In our view, this argument exaggerates the importance of tax considerations in investment decisions. Factors such as relative labour costs and inflation rates, access to capital and raw materials and proximity to markets will generally be far more important determinants of international competitiveness than relative tax burdens.

1.3.10 Nevertheless, one of the objectives of the BE regime is to minimise the extent to which tax influences the location of investment. Over time, the regime will tend to equalise the effective tax rates on the income of foreign and domestic

companies owned by New Zealand residents. The potential effect of a tax preference on investment decisions should be the principal criterion for determining whether the preference should be listed. Developments in the tax systems of the grey list countries will need to be monitored by the Government. If a country introduces a tax preference that is significant enough to attract New Zealand investment, the preference should be listed. A number of generous preferences are to be or are currently being phased out in grey list countries but, because of their limited future, they are unlikely to influence investment decisions.

1.3.11 Even if no preferences are listed, the possibility of one being listed does introduce uncertainty. To minimise this, we recommend that the listing of a preference should have prospective application. Since an existing or a newly established CFC in a grey list country could take advantage of a preference, it is not sufficient to restrict the effect of the listing of a preference to CFCs established after its introduction. Thus, we propose that, if a preference is listed, the listing should not take effect until the beginning of the next income year.

1.3.12 We commented in our previous report on the need for the New Zealand regime to "look through" CFCs resident in grey list countries to CFCs owned by them. If this were not done, New Zealand would not have one CFC regime, but eight - those of the seven grey list countries as well. Residents could choose which of the eight was most favourable to them and establish an intermediate CFC in the relevant country which would own the underlying CFC. It would be pointless to have such a system. As noted above, the existence of a CFC regime in the grey list countries is indicative only. The complete exemption of a grey list CFC and all of its underlying interests should not turn on this factor.

1.3.13 Chapter 4 outlines the Committee's views on how the BE regime should apply in respect of a CFC resident in a grey list

country which does utilise a listed preference. We propose that the computation of the BE income of the CFC for any accounting year should be simplified by taking it as the taxable income of the CFC for that year, measured according to the tax laws of its country of residence, adjusted for the effect of the preference. This approach should significantly reduce compliance costs. The major avenue for minimising the compliance costs of the regime in respect of grey list CFCs should be the listing of significant preferences only. It may well be that the best approach initially is to refrain from listing preferences until the regime has been introduced and some experience with its operation has been gained.

## 1.4 Compliance and Administration

1.4.1 The grey list exemption will remove most of New Zealand's offshore investment from the regime. This will substantially reduce the compliance and administrative costs of the BE regime to the extent that it will affect relatively few taxpayers. The Committee has, however, been concerned to reduce as far as possible the compliance costs of the regime where it will apply. In our previous report, we recommended that the BE regime should apply to a foreign company that is controlled at any time during its accounting year. In principle, this would require taxpayers to compute their interests daily though, in practice, this computation would obviously be necessary only when a taxpayer's interest changed. Nevertheless, the compliance and administrative costs of the scheme will be raised the more frequent the measurement of interests is required.

1.4.2 For this reason, we recommend in chapter 3 that interests in foreign companies for both control and income attribution purposes be measured on four days during the year -on the last day of each calendar quarter. A consequence of this decision is the need to have rules to deal with disposals and

related acquisitions straddling a measurement day but, for taxpayers who do not engage in such activity, the reduction to four measurement days should considerably simplify compliance.

1.4.3 The definition of an interest for control and income attribution purposes is, of necessity, broad - we have defined five categories of interest in a company. For most normal share structures, the five categories will, however, reduce to only one or two. Where complicated share structures and rights exist, greater computational requirements will arise. Similarly, greater compliance costs will arise where there are relationships between companies which complicate the calculation of indirect interests. These can be reduced by simplifying corporate group structures.

1.4.4 We mentioned in the previous section the Committee's recommendation for a simplified basis of computing the BE income of a CFC resident in a grey list country. This should considerably reduce the compliance costs of the regime to the extent that it applies to such companies.

## 1.5 Trust Transition

1.5.1 A further issue which has attracted comment is the transition to apply to trusts with non-resident trustees settled on or before 17 December 1987. Once again, the concern is in part due to uncertainty since your earlier decision on the transition was only provisional. We discuss this matter further in chapter 8.

## 1.6 Credit Streaming

1.6.1 The Committee proposed a number of provisions to reduce the streaming of imputation and withholding credits. By streaming, we mean the allocation of credits disproportionately to taxpayers able to use them rather than to those, like non-residents, who will be unable to. Streaming would not be a concern if tax revenue were not an issue, but since it is, rules are needed to minimise its impact.

1.6.2 A related matter is whether New Zealand shareholders in non-resident companies with New Zealand subsidiaries should be able to receive credits for any New Zealand tax paid by the subsidiaries. One mechanism to achieve this would be to issue "stapled" shares in the subsidiaries to the resident shareholders.

1.6.3 The Committee considered this issue in its report on imputation. Imputation cannot be considered in isolation from the international reforms. If non-resident companies could direct credits to their resident shareholders through stapled stock and similar arrangements, a constraint on the adoption of a non-resident corporate structure in order to avoid the international reforms would be removed. Hence, we see the disallowance of stapled stock arrangements as a quid pro quo for non-resident status and relief from the international reforms. We consider that this argument also applies to companies which are already non-resident.

1.6.4 It has also been suggested that, if stapled stock type arrangements were to be disallowed in general, an exception should apply for Australian companies, in particular, and perhaps others. It is for the Government to consider whether a special arrangement is warranted with Australia. We would note, however, that a number of New Zealand's tax treaties have non-discrimination articles and most favoured nation provisions which

might mean that a special arrangement could not be confined to only one of our treaty partners.

## 1.7 Draft Legislation

1.7.1 The Committee's draft of the legislation is contained in the annex to this report which is presented in a separate volume. The legislation has not been fully considered by officials nor parliamentary counsel, but we consider that it is sufficiently well-developed to provide a considerable degree of certainty to tax practitioners and businesses. Refinements to the legislation will, however, be needed. We understand that it will be considered by the Finance and Expenditure Select Committee so that interested parties will have an opportunity to comment on it.

# CHAPTER 2 – BRANCH-EQUIVALENT REGIME PART 1: DEFINITIONS

## 2.1 Introduction

2.1.1 Chapters 2, 3 and 4 outline the Committee's recommendations on the outstanding issues relating to the branch-equivalent ("BE") regime. The main elements of this regime were outlined in Chapter 2 of Part 1 of the Committee's Report on International Tax Reform. For ease of reference to the draft legislation, the issues are discussed in the order that they arise in the legislation. This chapter deals with the definitions which are central to the BE regime.

## 2.2 Relationship of BE Regime to Existing Act

2.2.1 The BE and the Foreign Investment Fund ("FIF") regimes will represent substantial additions to the existing Income Tax Act 1976 (the "Act") and, as a practical convenience, are best located together in Part IV of the Act. Their particular location is a minor matter - we have proposed that they form new sections 245A, 245B, etc. The regimes do, however, require a number of definitions. Definitions which are intended to apply generally throughout the Act are contained within section 2, while definitions which are specific to particular sections are usually included within those sections. The BE regime will apply when five or fewer New Zealand residents hold interests, either directly or through nominees or associated persons (which include certain relatives and trustees), which in aggregate equal or exceed 50 percent of the shares, voting rights, etc, of a foreign company. Thus, the definitions of residence, nominee, associated person, relative, trustee and company are critical to the effective operation of the scheme.

2.2.2 For this reason, we have reviewed existing definitions in the Act in order to consider their appropriateness for the purposes of the BE regime. We have proposed new definitions of a company, a trustee a resident which we recommend apply generally throughout the Act. Our proposed definitions of a nominee, associated person and relative are, however, intended to apply only to the international regime. The main reason for this limitation is that these definitions are pivotal to the operation of other sections of the Act as well as the sections that will form part of the international regime and should not be amended for the purposes of those other sections without careful consideration of the consequences. In the time available, we have not been able to undertake this task. There are, however, a number of deficiencies in the existing definitions and they should be reviewed at some stage. To this end, we have included in an appendix to the draft legislation new drafts of section 7, the present section defining associated persons, and section 8, the section dealing with control of a company, which could be considered in this review. Special definitions for particular sections may still be required.

## 2.3 Definition of "Company" and "Trustee"

2.3.1 As noted in the previous section, we recommend that the existing general definition of a "company" in section 2 of the Act be changed. It should be expanded to include any entity with a legal personality or existence separate from those of its members, which is created by way of incorporation or otherwise whether in New Zealand or elsewhere. This change is not fundamental but aims to more clearly include within the definition the variety of legal entities in overseas jurisdictions that are equivalent to companies. We understand that it is the intention of the Inland Revenue Department to publish for the guidance of taxpayers a list of the types of non-resident entities it considers to be the equivalent of companies under New Zealand law.

2.3.2 We also propose a minor amendment to the existing section 2 definition of a trustee to make it clear that a reference to a trustee of a trust means the trustee only in his or her capacity as trustee of that trust and includes all trustees of that trust.

### Recommendation

2.3.3 Accordingly, the Committee recommends that:

a the definition of a "company" in section 2 of the Act be amended to include any entity which has a legal personality or existence separate from that of its members, which is created by way of incorporation or otherwise whether or not in New Zealand; and

b the definition of a trustee of a trust in section 2 of the Act be clarified to mean that trustee only in his or her capacity as a trustee of that trust and includes all trustees of that trust.

## 2.4 Residence: Individuals

2.4.1 The BE regime will apply to residents in respect of interests in foreign companies which are controlled by residents. Similarly, the settlor regime for trusts will apply to trusts which have a New Zealand resident settlor. Thus, the definitions of residence of an individual and of a company for tax purposes are key elements of the regimes. Residents should not be able to cease temporarily or regularly to be resident in order to avoid the control test and income attribution under the BE regime nor the settlor designation under the trust regime. In addition, residents should not be able to lose temporarily their residence status in order to receive a taxable distribution from a trust

or company without suffering New Zealand income tax.

2.4.2 The present definitions are contained in section 241 of the Act. A natural person is deemed to be resident in New Zealand if he or she:

a has a permanent place of abode in New Zealand; or

b is personally present in New Zealand for a continuous period of not less than 365 days except that, where the person has a permanent place of abode outside New Zealand, he or she may request to be treated as a non-resident.

2.4.3 Where a person is absent from New Zealand for a continuous period of not less than 365 days, the person is deemed not to be resident in New Zealand during that period except that, where a person has a permanent place of abode in New Zealand at all times during the period, he or she may request to be treated as a resident.

2.4.4 For the purposes of both 365 day tests, two or more periods are defined to be continuous if there are not more than 28 days between them and the intervening days do not exceed 56 days in that 365. In order to cease to be a New Zealand resident, a natural person must therefore be absent from New Zealand for at least 309 (i.e 365 less 56) days of a 365 day period and not be present here for any period exceeding 28 days. An absence of only 29 days is sufficient under the definition to break the residence link where the person in question does not have a permanent place of abode in New Zealand.

2.4.5 A person who is not a New Zealand resident can remain a non-resident by having a permanent place of abode outside of New Zealand and no permanent place of abode in New Zealand, irrespective of the time they are in New Zealand. Thus, a New Zealand resident can cease to be resident here by disposing of any permanent place of abode in New Zealand and acquiring a

permanent place of abode outside New Zealand.

2.4.6 In our view, the permanent place of abode test needs to supplemented by a strengthened personal presence test. As noted above, the present test can be avoided by disposing of one's permanent place of abode in New Zealand and spending 29 continuous days out of New Zealand or by maintaining a permanent place of abode outside New Zealand. The continuous period concept in the existing personal presence tests adds little. We propose that they be simplified by determining residence according to whether a person is present or absent from New Zealand for a certain number of days. Thus, we propose that a natural person be deemed to be a New Zealand resident if:

a his or her permanent place of abode is in New Zealand; or

b he or she is personally present in New Zealand for not less than 183 days of any 12 month period.

2.4.7 In addition, we propose that a natural person who is a New Zealand resident may cease to be a resident only if:

a he or she is absent from New Zealand for not less than 325 days in any 12 month period; and

b he or she has, at no time during that period, a permanent place of abode in New Zealand.

2.4.8 The effect of these changes would be to make it easier for a person to become a New Zealand resident and harder to cease to be one. We propose that the amendment come into effect from the commencement of the 1989 income year.

### Recommendations

2.4.9 Accordingly, the Committee recommends that the residence tests applying to natural persons be amended with effect from the income year commencing on 1 April 1988 so that:

a a person is deemed to be resident in New Zealand if he or she:

i has a permanent place of abode in New Zealand; or

ii is personally present in New Zealand for at least 183 days of any 12 month period; and

b a person ceases to be resident in New Zealand only if he or she:

i is absent from New Zealand for 325 days of any 12 month period; and

ii has at no time during that period a permanent place of abode in New Zealand.

## 2.5 Residence: Companies

2.5.1 Temporary changes of residence by companies do not present the same problems under the international regime as do those by individuals. A company controlled by residents which became a non-resident to avoid the control and income attribution rules under the BE regime would itself fall within the regime. The present definition of the residence of a company is contained in section 241(2). A company is deemed to be resident in New Zealand if it:

a is incorporated in New Zealand; or

b has its "centre of administrative management" in New Zealand.

An exception applies to a "banking company" which is deemed to be resident only if its centre of administrative management is in New Zealand.

2.5.2 There are two problems with this definition. The first is the ambiguity of the term "centre of administrative management". The Inland Revenue Department interprets this to mean the place where the day to day administration of a company is carried out. By contrast, a number of tax practitioners consider that it means the place where the highest (i.e board of director) level of decision-making takes place. Many other countries use the term "place of central management and control" to designate the place where the board of directors meets.

2.5.3 The second problem with the definition is the administrative difficulty of applying a place of management test (whether central or day to day). To a large extent, the need for a CFC regime arises because of this difficulty. The place of management test has, however, much more economic substance than the place of incorporation test. In addition, most of New Zealand's double tax agreements employ a management and control test to settle the residence of a company resident within the jurisdiction of both treaty partners. Thus, a management and control test is an integral part of our tax law since the treaty tests override the Income Tax Act provisions where the two are in conflict. For these reasons, we favour retaining a place of management test of corporate residence.

2.5.4 To clarify the present definition, the level of management on which it is intended that residence depend should be spelt out more precisely. To avoid altering substantively the present test, we propose that the place of both the board and

executive levels of management be included and that the term "head office" (where both levels of management would normally be located) be retained. Thus, a company would be resident in New Zealand if it:

a is incorporated in New Zealand; or

b has its centre of director control in New Zealand; or

c has the centre of its executive management in New Zealand; or

d has its head office in New Zealand.

For the purposes of the second test, the substantive issue is whether control by directors is exercised in New Zealand, irrespective of whether board meetings are also occasionally held outside New Zealand. We propose that the new residence definition apply with effect from the present (i.e. 1989) income year.

2.5.5 We have asked the Inland Revenue Department to investigate the origin of the special residence rule applying to banking companies. It dates from 1941 and was apparently intended to permit banks incorporated in New Zealand for the purposes of issuing banknotes here to do so without being subject to tax on their worldwide income, as would be the case if the place of incorporation test applied to them. Since this consideration is no longer relevant, we propose that the residence of a banking company be determined under the normal rules.

### Recommendation

2.5.6 Accordingly, the Committee recommends that the residence test for companies be amended with effect from the income year commencing on 1 April 1988 so that a company, including a **banking** company, is resident in New Zealand if it:

a is incorporated in New Zealand; or

b has its centre of director control in New Zealand; or

c has the centre of its executive management in New Zealand; or

d has its head office in New Zealand.

## 2.6 Definition of "Nominee"

2.6.1 Since the BE regime will apply whenever residents hold a certain threshold percentage of the "control interests" (meaning generally the various rights or powers of ownership which when aggregated sufficiently enable a person to control a company) in a foreign company, there is an obvious incentive for a person to disperse interests among nominees or associated persons. To counteract this, interests held by a nominee of a person must be deemed to be held by that person. The treatment of interests held by associated persons is referred to in the next section.

2.6.2 The scope of the definition of nominee will depend to some extent on its application. There are at present two definitions of nominee in the Act but they are both framed in relation to the sections to which they apply. For example, they differ according to the way in which relatives are brought within the definition. In principle, it is not necessary to deem relatives to be nominees of a person but, in practice, where

it is likely certain relatives will be acting as nominees, it is reasonable to shift the burden of proof on to the taxpayer to establish that this is not so.

2.6.3 For the purposes of the BE regime, the definition of nominee needs to be framed in terms of the rights and powers which, if a person held them directly, would be taken into account in determining his or her control interest. With respect to relatives, given that the tax consequences for a person of having someone else deemed to be his or her nominee may be substantial, we propose that only children under 18 years of age be deemed to be nominees of a person unless the person can establish otherwise. In addition, we propose that a bare trustee (i.e. a trustee who holds property to the order of a beneficiary) be included in the definition. (A broader inclusion of relatives and trustees is proposed for the definition of associated persons.)

2.6.4 To support the definition, we propose that the definition of a nominee include a person who has entered into an arrangement or understanding with another person with respect to the holding or exercising of rights or powers in relation to foreign companies.

### Recommendation

2.6.5 The Committee therefore recommends that, for the purposes of the BE regime, a nominee of a person be defined to include:

a a child of the person under 18 years of age, unless the person can establish otherwise;

b a bare trustee; and

c a person who has entered into an arrangement or understanding with that person with respect to the holding or exercising of rights or powers.

## 2.7 Definition of "Associated Persons"

2.7.1 A nominee of a person is in effect that person's agent. The definition of associated persons aims to embrace persons who are not related as principal and agent but who, because of their personal or economic relationship, can reasonably be assumed to have similar economic interests. For example, two companies owned by the same shareholders may not be related as principal and nominee but will nevertheless have substantially similar if not identical economic interests. They should therefore be treated as associated persons.

2.7.2 In the context of the BE regime, we propose that interests in foreign companies held by associated persons be aggregated for the purposes of the control test, but not for the purposes of income attribution. The income attributed to any person would depend only on the interests that the person holds directly, through nominees, or through other controlled foreign companies. (Interests held by the nominees of a person should be aggregated with that person's own direct and indirect interests for the purposes of determining both the control and income interests of the person.)

2.7.3 The present Act contains a general definition of associated persons in section 8. In brief, this section defines associated persons as any two companies which consist of substantially the same shareholders or that are under the control of the same persons; a person and a company where that person owns 25 percent or more of the shares in the company; two persons who are relatives; and a person and a partnership where that

person is associated with a partner. This definition is not appropriate for the purposes of the BE regime. First, the relationship between two companies or another person and a company needs to be extended and defined in terms of the rights and powers to be taken into account in determining control and income interests under the BE regime. Secondly, the 25 percent ownership threshold should be raised to 50 percent for consistency with the control threshold under the BE regime. Thirdly, the term relative means persons connected within the fourth degree of relationship (such as first cousins). This is too broad for the purposes of the BE regime. Fourthly, the present definition does not include trust relationships.

2.7.4 Accordingly, we propose that, in relation to the BE regime only, the term associated persons mean:

a any 2 companies:

i which consist substantially of the same shareholders, as presently defined in section 7; or

ii which are under the control of the same person or persons, as presently defined in section 7; or

iii where any group of persons holds income interests in each company totalling in aggregate 50 percent or more;

b any person and a company if that person holds an income interest of 50 percent or more in that company;

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

d a partnership and any person, where that person is a partner of the partnership;

e a partnership and any person, where that person and any partner are associated persons;

f a trustee of a trust and any person where that person (or any person associated with that person) has derived a benefit from that trust or, being a person associated with the settlor of the trust, could derive a benefit from it (except where the trust is for the benefit of employees only and the person, or an associated person, does not manage or control the affairs of the trust); and

g a trustee of a trust and any person where that person (or a person associated with that person is a settlor of that trust (except where such an association exists as a result of an employer settling a trust, such as a superannuation fund, for the benefit of employees only and the employer or any associated person does not manage or control the affairs of the trust).

2.7.5 In addition, two persons who habitually act in concert with respect to the holding or exercising of interests in foreign companies should be deemed to be associated persons with respect to those interests.

### Recommendations

2.7.6 Accordingly, the Committee recommends that, in relation to the BE regime only, the term associated persons mean:

a any 2 companies:

i which consist substantially of the same shareholders, as presently defined in section 7; or

ii which are under the control of the same person or persons, as defined in section 7; or

iii where any group of persons holds income interests in each company totalling in aggregate 50 percent or more;

b any person and a company if that person holds an income interest of 50 percent or more in that company;

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

d a partnership and any person, where that person is a partner of the partnership;

e a partnership and any person, where that person and any partner are associated persons;

f a trustee of a trust and any person where that person (or any person associated with that person) has derived a benefit from that trust

or, being a person associated with the settlor of the trust, could derive a benefit from it (except where the trust is for the benefit of employees only and the person, or an associated person, does not manage or control the affairs of the trust);

g a trustee of a trust and any person where that person (or a person associated with that person) is a settlor of that trust (except where such an association exists as a result of an employer settling a trust, such as a superannuation fund, for the benefit of employees only and the employer or any associated person does not manage or control the affairs of the trust); and

i two persons who habitually act in concert with respect to the holding or exercising of interests in foreign companies, with respect to those interests.

# CHAPTER 3 – BRANCH-EQUIVALENT REGIME PART 2: DETERMINATION OF CONTROL AND INCOME INTERESTS

## 3.1 Introduction

3.1.1 The BE regime will apply when five or fewer residents control 50 percent or more of the rights or powers of ownership which when aggregated sufficiently enable those residents to control a company. A person's proportionate share of the total of such rights or powers will be referred to as his or her "control interest" for the purposes of the control test and his or her "income interest" for the purposes of income attribution. Depending on whether interests are held directly or indirectly through companies or associated persons, a person's control interest may be different from his or her income interest.

3.1.2 The objective of this chapter is to set out the Committee's recommendations on the determination of control and income interests. These matters are dealt with in sections 245B to 245G of the accompanying draft legislation.

## 3.2 Definition of Interests In a Company

3.2.1 The attributes of a company which are critical for the purposes of calculating control and income interests are the rights or powers which give the holders the ability to receive or control the disposition of the company's income or capital. In general, these rights or powers attach to shares and are held by the shareholders of the company. Different classes of shares may, however, have a wide variety of rights attached to them so that it is not sufficient to focus on the percentage of the shares held by a person. Thus, control and income interests in a foreign

company need to be defined in terms of:

a paid-up capital;

b nominal capital;

c rights to vote or participate in any decision-making concerning distributions, the constitution of the company or variations in its capital (e.g. the issuing, redemption, acquisition or cancellation of any shares);

d income of the company which the person would be beneficially entitled to receive or to have dealt with in his or her interest or behalf if it were distributed; and

e net assets of the company (or the proceeds from the realisation thereof) which the person would be beneficially entitled to receive or to have dealt with in his or her interest or behalf if they were distributed.

3.2.2 The ownership of or an entitlement to acquire any one of these things in relation to a foreign company will be referred to as an "interest" in the company. Thus, the list above specifies five categories of interest. A foreign company should be deemed to be a controlled foreign company (CFC) when five or fewer residents, directly or indirectly, own or are entitled to acquire 50 percent or more of any category of interest. The meaning of "directly or indirectly" is outlined in the next section. For example, if five or fewer residents own 50 percent of the voting rights in relation to the distributions of a foreign company, it should be a CFC.

3.2.3 The income attributed to any resident having an interest

in a CFC will, however, depend on that person's income interest in the CFC. The definition of an income interest is explained further in section 3.5.

3.2.4 In determining how voting rights are held, those of directors to decide distributions, such as interim dividends, should be excluded. These are exercised by directors acting in their capacity as directors under an authority delegated by shareholders in terms of the articles of the company.

3.2.5 The calculation of an interest under category d would require taxpayers to decide how the income of a company would be allocated if it were distributed as a dividend on a particular day. Certain shares, such as preference shares, may be entitled only to a fixed rate of dividend payable on specified days during the year. To accommodate these types of share, category d interests need to be measured on the basis that all of the foreign company's income for the accounting year is distributed as a dividend on the last day of the accounting year and all interests held on a measurement day are treated as if they were held on the last day of the accounting year.

3.2.6 In some circumstances, the percentage of the income or the net assets of a company that a person could acquire may differ from the percentage of its paid up capital, nominal capital or votes that he or she may hold. For example, minority shareholders of private companies may have no rights, or the powers given to a majority shareholder, directors or managers may be such that the shareholders who control the company could cause to be distributed to them or for their benefit a disproportionate share of the income or assets of a company. In cases such as this, the income interest of a person or group holding a control interest of more than 50 percent should be taken as 100 percent.

### Recommendation

3.2.7 Accordingly, the Committee recommends that residents' control and income interests in foreign **companies** be defined in terms of:

i paid-up capital;

ii nominal capital;

iii rights to vote or participate in any decision-making concerning distributions, the constitution of the company or variations in its capital (e.g. by the issuing, redemption, acquisition or cancellation of any shares);

iv income of the company which the person would be beneficially entitled to receive or to have dealt with in his or her interest or behalf if it were distributed; and

v net assets of the company (or the proceeds from the realisation thereof) which the person would be beneficially entitled to receive or to have dealt with in his or her interest or behalf if they were distributed.

## 3.3 Frequency of Measurement of Interests

3.3.1 The objective of the BE regime is to tax residents on the income of certain CFCs that remains undistributed from one year to the next. Thus, the regime needs to determine which residents hold interests in a CFC from one year to the next. This requires the determination of the interests held by residents at least once a year. There are, however, several problems with a single annual measurement of interests. First, there would obviously be an incentive for residents to avoid holding interests on that particular day. To counter this incentive, rules would be required to catch "bed and breakfast" transactions whereby interests were disposed of prior to the measurement day and reacquired after that day. Where a right of repurchase existed, the disposal would not be effective since the measurement of a control interest will require taxpayers to take into account interests that they are entitled to acquire. In addition, a provision would be needed to counteract temporary changes in the aggregate interests of a CFC in any category of interest (e.g. by the issue and cancellation of shares around the measurement day). Both of these types of rule would be needed if measurement of interests takes place on only a number of specified days during the year. A single measurement day would, however, put more pressure on the rules than more frequent measurement.

3.3.2 Secondly, a single measurement day would enable taxpayers in some cases to avoid the regime by holding companies for the interval between measurement days - that is, up to 364 days but not the measurement day. Income could thus be accumulated in a CFC which might then be sold to a non-resident prior to the measurement day for a gain that reflected the accumulated income. The longer the period between measurement days, the greater the scope for such activity. Thirdly, a single measurement day may be unfair on taxpayers who hold interests for

short periods that included the measurement day, since their proportionate share of the income of the CFC for the whole of the year would be attributed to them. In principle, the anticipated tax liability could be taken into account in the purchase price of the interest.

3.3.3 At the other extreme, measurement of interests could be required on each day of the foreign company's accounting year. This was the approach we favoured in our earlier report and is the method adopted in the United States and Canadian CFC regimes for the purposes of determining control. The major disadvantage of this option is the compliance cost involved. In practice, residents would not need to compute interests daily, but they would need to do so for each day on which there was a change in their own interests, those of associated persons or in indirect interests held through CFCs and for each day on which there was a change in the aggregate of any category of interest in the relevant foreign company. The compliance costs could thus be onerous where taxpayers had complex holdings of interests and where the aggregate interests in the foreign company changed relatively frequently, such as may be the case for listed companies (which, for example, may regularly issue shares to finance acquisitions). While the compliance burden of this approach to measuring control interests may be acceptable under the United States and Canadian regimes, which are directed mainly at "passive" investment income, they could be excessive under the New Zealand regime which is targeted more widely.

3.3.4 The choice of the interval between the measurement of interests needs to weigh up the compliance costs of more frequent measurement on the one hand and, on the other hand, the possible reduction in the effectiveness and fairness of the regime if measurement is relatively infrequent. The Committee favours a compromise of requiring measurement four times a year at the end of each calendar quarter. A resident having a control or an income interest on a measurement day would then be deemed to have

held the interest on every day of the previous quarter. If no interest were held on a measurement day, the resident would be deemed not to have held a control or income interest at any time during that previous quarter.

3.3.5 As noted above, a trade off for less than daily measurement is the necessity to have provisions to counteract bed and breakfast transactions and temporary changes in the aggregate interests in a foreign company. In essence, the bed and breakfast provision would deem a person who had disposed of an interest in a CFC before a measurement day which had the effect of reducing his or her attributed income not to have disposed of it to the extent that an interest in the CFC was acquired within a certain period, which we propose be 183 days, after the date of the disposal. A parallel rule would apply where a person temporarily increased an interest before a measurement day which had the effect of increasing an attributed loss.

3.3.6 A person's attributed income will depend, first, on whether a foreign company in which he or she holds an interest is a CFC and, secondly, on his or her income interests in the foreign company if it is a CFC. As discussed further below, whether a foreign company is a CFC will depend on the interests held by residents, their associated persons and CFCs in which they have a direct or indirect interest. Thus, a disposal and acquisition around a measurement day by any of these parties will affect the control interest of the person. This means that it is necessary to draw the bed and breakfast provision widely, so that it applies not just where one person reduces and subsequently increases an interest in a foreign company, but also where such a reduction occurs and any other party connected with the person whose interests affect that person's control interest subsequently acquires an interest. The provision should not, however, apply where a disposal or acquisition is made by one person and an opposite transaction is made by another person whose control interests do not affect the other's control

interests.

3.3.7 The rule to reverse the effect of temporary changes in the aggregate interests in a CFC would deem the change not to have occurred to the extent to which it is reversed within a certain period, which we propose be 365 days. Where the provision applies, it would require residents to determine their interests on each measurement day in the period on the basis of the deemed aggregate interests.

3.3.8 The effect of these rules is to ignore for interest measurement purposes changes in interests in foreign companies which have the effect of defeating the intent and application of the BE regime. A remaining problem is the acquisition and disposal of interests within a period between successive measurement days. This would have the effect of converting what would be income under the BE regime to a gain. The principal provision dealing with the taxation of such gains is section 65(2)(e). This taxes gains on the disposal of personal property (which includes shares):

"if the business of the taxpayer comprises dealing in such property, or if the property was acquired for the purposes of selling or otherwise disposing of it, and all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit".

3.3.9 In practice, this section has proved difficult to administer because, for example, of the need for the Department to establish the taxpayer's purpose of acquiring property at the time of its acquisition. In addition, the section cannot be successfully administered without sufficient disclosure by taxpayers. With adequate disclosure, however, we consider that this provision will be more effective in taxing gains on the disposal of interests in foreign companies in the circumstances

outlined in the previous paragraph since, in many instances, the substantive purpose of the acquisition of such interests will be to dispose of them at a gain.

3.3.10 To reinforce the need for disclosure, we propose that residents who have a control interest in a foreign company at any time during its accounting year equal to or higher than 10 percent should be required to disclose the interests they hold in the company on its balance date and any disposals of interests in the company made during its accounting year. Similarly, where a resident has a control interest of 10 percent or more in a CFC at any time during its accounting year and that CFC has a control interest of 10 percent or more in another foreign company, the resident should be required to disclose the interests in that foreign company held by the CFC on its balance date and any disposals of such interests the CFC has made during its accounting year.

3.3.11 The circumvention of the BE regime by the disposal of shares for a capital gain can be addressed comprehensively only by the general inclusion of capital gains within the income tax system. The income tax system will always be vulnerable if taxable income can be converted, in one way or another, into an exempt capital gain. Accordingly, we commented on the need for the inclusion of capital gains within the income tax base in our two previous reports.

### Recommendations

3.3.12 The Committee therefore recommends that:

a for the purposes of determining control and income interests in a foreign company, residents be required to measure their interests in the company in each category of interest listed in

paragraph 3.2.7 on the last day of each calendar quarter;

b an interest held on a measurement day be deemed to have been held on every day of the previous quarter;

c provisions be included to reverse the effect of short term transactions and changes in the aggregate interests in foreign companies which have the effect of reducing the income attributed to residents or increasing an attributed loss; and

d residents who have a control interest in a foreign company at any time during its accounting year equal to or higher than 10 percent be required to disclose the interests they hold in the company on its balance date and any disposals of such interests made during its accounting year and where a resident has a control interest of 10 percent or more in a CFC at any time during its accounting year, the taxpayer be required to disclose the equivalent information in respect of the CFC.

## 3.4 Calculation of Control Interests

3.4.1 We referred in chapter 2 to the need to aggregate interests held by residents through nominees, associated persons and other controlled companies in order to counteract the incentive for the dispersion of interests aimed at avoiding the control test. Interests held by a person directly will be referred to as "direct control interests". Those held indirectly through CFCs will be referred to as "indirect control interests".

A person's total or aggregate control interest in each category of interest listed in paragraph 3.2.1 should be calculated by aggregating the person's direct and indirect control interests in that category and those of associated persons. Any person's interest in any category should include interests held by nominees.

3.4.2 The calculation of indirect interests requires the attribution to New Zealand residents of the direct control interests of CFCs and their associated persons (hereafter together referred to as "qualified control interests"). We propose that, where one CFC is controlled by a second CFC, the qualified control interests of the first CFC be attributed to the second CFC. The resulting qualified control interests deemed to be held by the second CFC should then be deemed to be held by the persons who control that CFC. This tier by tier or step by step attribution process means that the interests being attributed at each stage are direct control interests only.

3.4.3 As a general principle, we propose that such interests be attributed to the smallest group of residents who have a control interest of 50 percent or greater and, where there is more than one such group, to the group with the highest aggregate control interest. In particular, we propose that:

a qualified control interests held by a CFC in another foreign company be attributed to the group of residents who control the CFC (i.e. who together have control interests totalling 50 percent or more);

b if there is more than one such group, the qualified control interests held by the CFC be attributed to the smallest group;

c if there is more than one such smallest group,

the qualified control interests held by the CFC be attributed to the group with the highest aggregate control interest in the CFC;

d if there is more than one group which satisfies rule c, the qualified control interests held by the CFC be divided equally among them; and

e if there is more than one person in any group selected by rules a to d, the qualified control interests held by the CFC be apportioned among them according to their income interests in the CFC.

3.4.4 In summary, a resident's control interest in any category of interest would be the sum of the direct and indirect interests of the person and associated persons. A foreign company would be deemed to be a CFC if there is any category of interest in which the aggregate control interests of five or fewer residents equals or exceeds 50 percent.

3.4.5 The control interests of two persons who are associated would each be included in the control interest of the other so that, when interests are aggregated for the purposes of determining whether a foreign company is a CFC, multiple counting of control interests may arise. It is therefore necessary to have a general proviso to the effect that any person's (including a CFC's) direct control interests shall be counted only once for the purpose of determining whether a foreign company is a CFC.

3.4.6 Another source of potential double counting is the inclusion, for the purposes of determining control interests, of interests which a person holds and those which another person is entitled to acquire. Where one person holds an interest in a foreign company and another person is entitled to acquire that interest and both are in the same group of 5 or fewer persons

for the purposes of determining whether the foreign company is a CFC, the interest would be double counted. We have therefore included in the draft legislation a provision which would avoid this type of double counting.

3.4.7 It is necessary to base the control test on the aggregate interests of a small number of persons, though the particular number is arbitrary, because the larger the group, the smaller each person's respective interest will be and the less likely it is that they will have sufficient incentive or opportunity to concert their actions in order to control a company. Where, however, the directors of a company control it, the size of the group is irrelevant. We therefore propose that a foreign company in which the New Zealand resident directors (or their nominees) have an aggregate control interest of 50 percent or more be included in the definition of a CFC, irrespective of the number of such directors.

3.4.8 It is important to note that the calculation of a person's control interest in a foreign company requires the person to include interests which he or she is contingently or absolutely entitled to acquire in the future. Thus, interests which a person could acquire under an option to buy shares or an option to acquire such an option must be taken into account. Similarly, interests which a person would acquire if another person exercised an option to sell such interests to them need to be taken into account where the terms of the agreement are such that the exercise of the option is a matter of course. Hence, so-called "shot-gun provisions" in a buy-sell agreement requiring a purchaser to buy shares in certain circumstances must be taken into account. In addition, a right or entitlement to acquire shares or voting rights given to a creditor in terms of a debt instrument needs to be taken into account.

3.4.9 Instances have arisen in other jurisdictions where a parent company has tried to avoid having direct control of a

foreign subsidiary by issuing shares in the subsidiary to the parent's own shareholders. In order that the subsidiary's shares are not traded separately from those of the parent, they are "stapled" to the former. To accommodate this possibility, we propose that, where shares in a foreign company (the "stapled" company) can ordinarily be transferred only in conjunction with the shares of a New Zealand resident company or a controlled foreign company, shares in the stapled company should be deemed to be held by the New Zealand resident company or the controlled foreign company. This is simpler than the alternative provision, discussed in our previous report, of treating the stapled company as an associated person of the parent company.

### Recommendations

3.4.10 Accordingly the Committee recommends that:

a the control interest of a resident in a foreign company in any category of interest be defined as the aggregate of the person's direct and indirect control interests in that category and those of associated persons;

b as a general principle, interests in a foreign company held by a CFC or associated persons of the CFC be attributed to the group of residents with the highest aggregate control interest in the CFC and, where there is more than one such group, to the smallest one and, where there is more than one person in any such group, the interests of the CFC be apportioned among them according to their income interests in the CFC;

c any interests held by a nominee of a person be deemed to be held by that person;

d a foreign company be defined as a CFC in respect of any accounting year of the company if, on any of the measurement days that fall within that accounting year, there are five or fewer residents whose aggregate control interest in the company in any category of interest is 50 percent or more;

e where residents are directors of a foreign company and in aggregate have a control interest in the company in any category of interest of 50 percent or more, the company be deemed to be a CFC irrespective of the number of such directors; and

f where shares in a foreign company (the "stapled" company) can be transferred only in conjunction with the shares of a New Zealand resident company or a controlled foreign company, shares in the stapled company be deemed to be held by the New Zealand resident company or the controlled foreign company.

## 3.5 Calculation of Income Interests

3.5.1 As noted above, the interests in a foreign company to be taken into account in determining the income to be attributed to a person under the BE regime can be referred to as his or her "income interest" in the foreign company. We propose three differences between the determination of control and income interests.

3.5.2 First, while it is necessary for the purposes of the control test to take into account interests held by associated persons, this should not be the case for income attribution

purposes. The income interest of a resident should depend only on his or her direct and indirect interests, including those of nominees, and not those of associated persons. Where both parties are residents, income attributable to any interests they hold will be taxable in their hands. Thus, there is an important distinction between nominees and associated persons.

3.5.3 Secondly, we propose that the circumstances in which an entitlement to acquire an interest in a foreign company gives rise to an income interest be more circumscribed than we propose for control purposes. A person who is entitled to acquire an interest in a foreign company will have a control interest in that company, but it will not always be appropriate to attribute income to that person. For example, the interest to be acquired may be held by another resident and income would be attributed to that resident. In addition, entitlements may not be exercised. This will generally be the case if the consideration payable to exercise the entitlement exceeds the market value of the interest to be acquired. Conversely, where a resident is entitled to acquire an interest in a foreign company at less than its market value, it is reasonable to assume that the entitlement will be exercised. The resident should then have an income interest in that company. Similarly, an income interest should arise if a resident is entitled to acquire an interest held by another person who has received financial assistance from the resident to acquire that interest.

3.5.4 In view of these considerations, we propose that an entitlement to acquire an interest in a foreign company give rise to an income interest whenever the consideration payable to exercise the entitlement is less than the market value of the interest to be acquired or when a person who is entitled to acquire an interest has given any form of financial assistance, such as a loan, cancellation or reduction of a debt, guarantee or other form of indemnity, to the person who holds the interest for the purposes of acquiring or holding that interest.

3.5.5 In addition, it is necessary to support these provisions by a general anti-avoidance measure the effect of which would be to deem a person to hold an interest which he or she is entitled to acquire if the holding of that entitlement has the effect of defeating the intent and application of these provisions. Such a provision clearly needs to be supported by full disclosure. Entitlements to acquire interests in foreign companies are to be taken into account for control purposes and therefore must be disclosed. Where a person's income interest in a foreign company is significantly less than his or her control interest, the Commissioner should require a reconciliation of the two.

3.5.6 Thirdly, indirect income interests (i.e. those held through CFCs) need to be calculated differently from indirect control interests. As explained in the previous section, for control purposes it is necessary to deem all of the interests held by a CFC in a foreign company to be interests of the controlling shareholders of the CFC. The income of the underlying company would, however, normally be distributed to its shareholders in proportion to their interests in it. Thus, a 51 percent shareholder, even though controlling a company, would normally expect to receive only 51 percent of the income of the company, not 100 percent (although, as noted in section 3.2.6, in some circumstances, shareholders should have 100 percent of the income attributed to them). It is therefore necessary to compute a person's income interest in a CFC held through another CFC by multiplying the person's direct income interest (and that of any nominees) in the first CFC by that CFC's direct income interest in the second CFC, and so on.

3.5.7 The direct and indirect interests of a person in a CFC will be measured on each of the measurement days falling within the accounting year of the CFC. It will be necessary for the person to determine, for each of those measurement days, his or

her direct and indirect income interests in each category of interest. The person's income interest for any quarter should then be taken as the highest of the five categories of income interest of the person on the last day of the quarter. In other words, the person would be deemed to have held that highest interest on each day of the preceding quarter.

3.5.8 The calculation of income interests will in most cases be a good deal simpler than the previous paragraph might suggest. In most companies, the rights of members by virtue of share ownership to vote, to share in dividends, to participate in winding up and so on do not vary from share to share, except where there are shares carrying a fixed dividend entitlement only. Thus, generally speaking, a shareholder will not need to examine his or her shares category by category to determine what percentage of rights he or she has in each case. In closely held companies, on the other hand, where a variety of share categories is more common, there is relatively little change in shareholding from year to year. Moreover, where a company is closely held, a New Zealand shareholder should not find the task of checking his or her income interest excessively onerous.

3.5.9 In order to determine a person's income interest with respect to a CFC and an accounting year, his or her income interests in each quarter, calculated as outlined in the previous paragraphs, should be averaged over the year. The resulting income interest represents an average interest of the person in the CFC for that year. This interest would be the basis of calculating the income to be attributed to the person in respect of that CFC and that accounting year. An equivalent rule is needed for short or long accounting periods arising from changes in balance dates or residence.

3.5.10 On page 85 of out first report, we indicated that we were considering an anti-avoidance rule aimed at situations where five or fewer taxpayers structured their affairs to achieve an

income interest in a foreign company of more than 50 percent but a control interest of less than a 50 percent. On further examination, we consider that such an arrangement is possible only where the taxpayers hold interests in the company through a non-controlled company. This would mean that the group may not exercise control over the disposition of the underlying company's income and assets. We therefore consider that special provision for this situation is not needed. The definition of associated persons and of a nominee should be sufficient to deal with circumstances where there is any understanding or arrangement between the group and the non-controlled foreign company to act in concert.

### Recommendations

3.5.11 Accordingly, the Committee recommends that:

a the income interest of a resident in a CFC for any calendar quarter be the highest of the sum of the resident's direct and indirect income interests in the CFC on the last day of that quarter in the five categories of interest defined in paragraph 3.2.7;

b an entitlement to acquire an interest in a foreign company give rise to an income interest where:

i the consideration payable to exercise the entitlement is less than the market value of the interest to be acquired; or

ii the person holding the entitlement has given any form of financial assistance to the person holding the interest for

the purpose of acquiring or holding that interest; or

iii the holding of the entitlement has the effect of defeating the intent and application of the BE regime;

c the income interest of a resident in a foreign company held through a CFC be calculated by multiplying the resident's direct income interest in the CFC by the CFC's direct income interest in the other company, and so on where the interest is held through more than one CFC; and

d the income interest of a person in a CFC for any accounting period of the CFC be calculated as the average of the person's income interests for the quarters which fall in that accounting period.

# CHAPTER 4 – BRANCH EQUIVALENT REGIME: PART 3 – ATTRIBUTION AND COMPUTATION OF BRANCH EQUIVALENT INCOME, LOSSES AND FOREIGN TAX CREDITS

## 4.1 Introduction

4.1.1 Residents with an income interest of 10 percent or more in a CFC will be required to compute the income or loss to be attributed to them in respect of that CFC. This will depend on their income interest in the CFC and the BE income or loss of the CFC. BE income and losses will generally be calculated according to New Zealand tax law though, as outlined in section 4.4 below, a number of departures from domestic law are required. Where the CFC is resident in a grey list country, its resident shareholders will be exempt from the regime unless the company utilises one or more of what the Committee considers, as discussed in chapter 1, should be a very limited list of significant tax preferences. Where such a CFC does utilise a listed preference, we propose that a much simplified basis of computing the BE income or loss of the company should apply.

4.1.2 Where residents have an amount of attributed income or loss in respect of any accounting year of a CFC, they will be able to claim a credit for their proportionate share of the foreign tax paid by the CFC in that year. We propose that provision be made for the carry forward of excess foreign tax credits. We also propose that BE losses be "ring-fenced" on a jurisdictional basis.

4.1.3 The broad outline of these provisions was decided in response to the Committee's first report. This chapter outlines our recommendations on the remaining details of the attribution and computation of BE income and losses, the operation of the

grey list exemption, the calculation of foreign tax credits and a number of related issues. The corresponding parts of the draft legislation are sections 245E to 245N.

## 4.2 Attribution of Income and Losses

4.2.1 In Annex 2 of our earlier report, we indicated that we favoured an exemption for persons with income interests in a CFC of less than 10 percent. Though such residents would need to compute their control and income interests on each of the four measurement days during a year in order to determine that their income interests fell below the 10 percent threshold, they would not have to incur the possibly much more substantial costs of computing the BE income of the CFC and their proportionate share of the foreign tax paid by it. An alternative would be to have an exemption for residents with BE income below a certain threshold but this would be self-defeating from the point of view of minimising compliance costs since the residents would first have to compute BE income before determining whether they were exempt. Hence, the Committee continues to favour an exemption for residents who have an income interest of less than 10 percent. In order to prevent residents from fragmenting their income interests among associated persons, for the purposes of this exemption only, a person's income interests should include those of associated persons.

4.2.2 Where a resident, together with associated persons, has an income interest in a CFC which is above the 10 percent threshold, an amount of income or loss will be attributed to the person. The attributed income or loss in respect of any accounting year of the CFC should be calculated by multiplying the resident's income interest in the CFC for that year by the BE income or loss of the CFC for that year.

4.2.3 As explained in chapter 3, the definition of an

interest in a foreign company needs to be wide in order to cover the variety of instruments or arrangements which a resident could use to control and accumulate income in such a company. The consequence of such a wide definition is, however, that an attributed loss may arise where a person has no economic or financial loss. For example, a person may have an option to acquire shares in a foreign company which, because it makes a loss, is not exercised. The economic or financial loss of the person is limited to the amount he or she paid for the option. No part of the loss of the company should be attributed to the person. Similarly, where a person owns shares in a company which makes a loss, but the person has an option to require another person to purchase the shares at a certain price, the economic or financial loss of the person is restricted by the option.

4.2.4 A general response to this issue would be to have a wash-up on disposal of an interest to the effect that the cumulative attributed income or loss of a person in relation to any income interest would be limited to the overall gain or loss he or she realises on the disposal of the interest. This type of provision could be considered as a complement to the general taxation of capital gains.

4.2.5 For the present, we propose that an attributed loss of a resident not be recognised where the person suffers little or no economic or financial loss. In applying this provision, it would be necessary to have regard to such things as the extent to which an attributed loss is due to a right to acquire an interest in a CFC with a BE loss and to the extent to which interests in a CFC with a BE loss could be disposed of under an option to require another person to purchase them.

4.2.6 A further consequence of the way in which we have defined an interest is that it is possible that the aggregate income interests of residents may exceed 100 percent. For example, one resident may own 100 percent of the voting rights of

a foreign company while another holds 100 percent of the dividend rights, though such an outcome would be unusual. Where it does occur, more than 100 percent of the BE income or loss of a CFC could be attributed to residents. To avoid this possibility, we propose that, where the income interests of 10 percent or more of residents in a CFC in any accounting year when aggregated would otherwise exceed 100 percent, the income interest of each resident be apportioned downward so that the aggregate income interest does not exceed 100 percent.

### Recommendations

4.2.7 The Committee therefore recommends that:

a residents be exempt from the BE regime in respect of a CFC and an accounting year of the CFC where their income interest in the CFC for that year and that of any associated persons is less than 10 percent;

b the attributed income or loss of a resident with respect to a CFC and any accounting year of the CFC be calculated by multiplying the resident's income interest in the CFC for that year by the BE income or loss of the CFC for that year

c an attributed loss of a resident not be recognised where the resident suffers little or no economic or financial loss; and

d where the aggregate income interests of 10 percent or more of residents in a CFC in any accounting year would otherwise exceed 100 percent, the income interest of each resident be apportioned downward so that the aggregate income interest equals 100 percent.

## 4.3 Adoption of CFC's Accounting Year

4.3.1 In Annex 2 of our previous report, we considered that residents should bring to account any attributed income or loss of a CFC in the income year corresponding to the accounting year of the CFC pursuant to section 15 of the Act. Thus, for example, if a CFC had a balance date between 1 April and 30 September, any attributed income of residents in respect of that CFC would be brought to account in the income year ending on the preceding 31 March. The advantage of this rule is that it is the same as that applying domestically. A problem with this approach, however, is that where a CFC's balance date falls after that of the resident taxpayer (it could be up to one year later), the taxpayer would have obvious difficulty calculating the BE income or loss of the CFC in the time required to file a tax return for the year and little if any information on which to base his or her provisional tax payments.

4.3.2 The alternative rule would be to require attributed income and losses to be allocated to the income year in which the balance date of the CFC falls. This would mean that the balance date of the CFC could never be later than that of its resident shareholders, thus reducing the compliance problem of computing BE income or losses. For this reason, we now favour this approach.

4.3.3 As a general rule, we propose that residents be required to compute their control and income interests in a CFC and its BE income or loss based on the accounting year of the CFC. Where the accounting year of the CFC changes, the Commissioner's approval of the use of the new accounting year for the purposes of the BE regime should be required. Since New Zealand has no jurisdiction over non-residents, it is not practicable to require the CFC itself to obtain the Commissioner's consent to the change.

4.3.4 In determining whether to give his consent to the use of a new balance date by residents, the Commissioner could consider such factors as a change of ownership of the CFC, the requirements of the tax law of the country of residence of the CFC and the balance dates of any other companies in the same group as the foreign company. Where the Commissioner declines to give his consent, residents would be required to continue to compute their control interests, income interests and the BE income or loss of the CFC on the basis of its old accounting year. To avoid unnecessary complexity, the Commissioner's decision should apply to all residents with an interest in the foreign company.

4.3.5 Where a CFC changes its balance date to a later date and the Commissioner consents to residents using the new accounting year, residents would compute the BE income of the company for the long accounting period but, to avoid incentives for balance date changes in order to defer attributed income, the corresponding attributed income should be brought to account in the income year in which the old balance date falls.

4.3.6 Since it would be possible to avoid seeking the Commissioner's consent to a balance date change by instead acquiring a new company with the desired balance date, consideration may need to be given to strengthening the Commissioner's powers such that he could require taxpayers to compute the BE income of a CFC on the basis of an accounting year different from that of the CFC.

### Recommendations:

4.3.7 **Accordingly**, the Committee recommends that:

a residents be required to report attributed income in respect of a CFC in any accounting year in the income year in which the balance date of the CFC falls;

b where a foreign company changes its balance date, residents be required to obtain the Commissioner's consent to compute their control interests, income interests and attributed income or loss in respect of that company on the basis of its new accounting year and the Commissioner's decision apply to all residents with interests in the company;

c where a CFC changes its balance date to a later date and the Commissioner consents to the residents using the new accounting year, any attributed income of a resident for the resulting long accounting period be brought to account in the income year in which the old balance date falls.

## 4.4 BE Income Calculation

4.4.1 In Annex 2 of our first report, we outlined our views on the general approach that should be adopted for the calculation of BE income or losses. As a general rule, the BE income or loss of a CFC should be calculated as if it were a New Zealand resident. A number of departures from domestic law are, however, required:

a rules are needed to determine the opening value of the depreciable assets and trading stock of a CFC in the year it first comes within the regime. As discussed previously, we propose that residents have the option of using the values used by the CFC for tax purposes in its own jurisdiction (provided that they are not higher than market value or the values that would apply had the CFC been at all times a New Zealand resident). Having elected either option, the taxpayer should be required to value all of the depreciable assets and trading stock of the CFC on that basis;

b the acquisition price of financial arrangements in the initial year should be, at the option of the taxpayer, the market value of the arrangement or its adjusted base price (being its original acquisition price, plus the amount of interest which has accrued since acquisition or issue, less the the sum of all consideration paid, in the case of an issuer, or received in the case of a holder);

c the BE income or loss of a CFC should be computed in the currency which the CFC uses for financial reporting purposes or, if there is no such reporting, the currency of the country in which the CFC is resident. We propose that the foreign currency annual income or loss then be converted into New Zealand dollars at an average of the mid-month New Zealand dollar/foreign currency spot exchange rates for the months falling within the reporting period;

d a number of sections contain incentives relating to the encouragement of investment in New Zealand, most of which are now being phased out, which should not apply for the purposes of computing BE income or losses;

e other sections have references to the carrying on of a business in New Zealand. In order that they can apply to the computation of BE income or losses, where applicable, the business carried on by a CFC needs to be deemed to be carried on in New Zealand;

f dividends received by resident companies from non-resident companies after 1 April 1988 are to be subject to the withholding payment regime. It is therefore necessary to tax or subject to the withholding payment dividends received by a CFC. Dividends received by one CFC from another should, however, be exempt in order to avoid multiple taxation. We therefore propose that, in determining the BE income or loss of a CFC with respect to any resident taxpayer, dividends received by the CFC be taxable, other than dividends which are received from another CFC in respect of which the taxpayer has an income interest of 10 percent or more. One consequence of this provision is that the BE income or loss of a CFC may differ for different taxpayers according to whether the CFC has received dividends from another CFC in which some but not all of its resident controllers also have an income interest;

g section 67, the section dealing with profits on land transactions, gives rise to an assessable profit where a taxpayer disposes of land and, at the time of acquiring the land, the taxpayer or an associated person was a dealer in land, a land developer or a builder. We consider that, for the purposes of the BE regime, the assessable income of a CFC should not be affected by the activities of associated persons who are not New Zealand residents. A similar provision exists in section 191(4A). If this section applied to a CFC, it could bring within the BE income of the CFC profits or gains derived by other companies in the same group. We consider that neither section should apply to the extent that the activities of associated persons of a CFC who are not New Zealand residents would give rise to income which would be assessable to the CFC;

h a number of sections refer to other New Zealand statutes (e.g. the Bankruptcy Act 1908 and the Companies Act 1955). These sections should apply as if such references were references to equivalent legislation in the country of residence of the CFC;

i section 117 of the Act deals with the recovery of excess depreciation on the disposal of an asset. The amount of depreciation recovered is equal to the lesser of the sum of the depreciation deductions allowed over the life of the asset and the difference between its written down value and its cost price. For the purposes of applying this rule, the written down value of an asset should be deemed to be

its cost less the sum of the depreciation deductions allowed under the BE regime. The maximum amount of depreciation recovered would then be the aggregate of the depreciation deductions allowed in computing BE income;

j section 129 is the section dealing with the recovery of interest on money borrowed to acquire or develop land which is sold within 10 years of its purchase. The section now applies only to land not used in the primary sector. In order that the section applies to interest on money borrowed by a CFC, it is necessary that the interest expense of a CFC which is deducted in computing the BE income of the CFC be treated as if it were a deduction allowed to the CFC;

k any value added tax in an overseas country should be accounted for in the same way as GST in New Zealand, as determined by section 140B;

l where a taxpayer finances expenditure by way of a Government grant or subsidy, a deduction for the expenditure is not permitted. Where the expenditure relates to a depreciable asset, the depreciable value of the asset for tax purposes is reduced by the amount of the grant or subsidy. We propose that a comparable treatment apply to grants or subsidies received by a CFC from other governments. Where a subsidy or grant does not relate to deductible or depreciable expenditure, we propose that it should be treated as assessable income for the purposes of computing BE income;

m the loss carry forward and grouping rules in

sections 188 and 191 should not apply since, as explained in section 4.6, residents will be able, subject to certain restrictions, to carry forward and group attributed losses. There would be double counting if losses were also able to be carried forward and grouped in the computation of BE income;

n in paragraph m above, we proposed that the BE income or loss of a CFC should be calculated without taking into account the BE income or loss of any other company. A CFC with a loss in its country of residence may, however, transfer the loss to a related company under grouping provisions similar to those in section 191. For example, the transfer may be effected by way of a subvention payment made to the CFC by another company. The effect would then be to increase the income tax paid by the CFC in future years. This would in turn increase the foreign tax credit that residents could claim under the BE regime. We therefore propose that any gain of a CFC which arises as a result of the transfer of a loss to another company should be included as assessable income under the BE regime;

o section 208(1)(a) of the Act currently exempts from tax underwriting profits of an insurance company derived from insurance business carried on out of New Zealand. Section 208(1)(b) denies a deduction for reinsurance premiums paid out of New Zealand. In order that the CFC regime extends to so-called "captive" insurance companies (i.e. one that insures the risks of its parent in New Zealand and/or associated persons), the exemption in section 208(1)(a) should

not apply, except where the income of a CFC consists of a reinsurance premium paid by a New Zealand insurance company which has been denied a deduction for the premium by virtue of section 208(1)(b);

p sections 214A to 222 deal with the taxation of mineral and petroleum mining. Legislation implementing a new petroleum mining regime is currently before the House. A number of the provisions of the new regime are linked to the holding or relinquishment of prospecting or mining licences issued by the Ministry of Energy. It is not possible to specify parallel licences that might exist overseas. Hence, we have included a general provision in the draft legislation requiring that these sections apply with any necessary modifications for the purposes of computing BE income; and

q the specified lease provisions should not apply to any leases entered into by the CFC before the first day of the accounting period in which it becomes a CFC, not being a day before 1 April 1988.

4.4.2 The above modifications also have implications for the computation of the income of foreign branches of New Zealand resident companies. We therefore recommend that consideration be given to requiring the income of foreign branches to be computed on the same basis as the BE income of CFCs.

## 4.5 Foreign Tax Credits

4.5.1 Residents with income interests in CFCs (together with those of associated persons) in excess of the 10 percent threshold will be assessed on their pro rata share of the BE income of the CFC and will receive a pro rata credit for the income tax paid by that company. It is therefore necessary to have provisions for determining how the tax credit is to be calculated.

4.5.2 New Zealand, like most countries, currently allows residents a credit for foreign taxes paid on foreign-source income up to the amount of New Zealand tax that is payable on that income. This is provided for under section 293 of the Act. The most important application of this section is to foreign-source income earned by resident companies through foreign branches. A branch is not a separate legal entity so its income is amalgamated with that of its parent company for New Zealand tax purposes. The company is then able to claim a credit for the foreign tax paid by the branch.

4.5.3 The general approach of the BE regime, as the name suggests, is to treat CFCs in the same way as branches. The foreign tax credit provisions applying to the BE regime should therefore be based as far as possible on the existing provisions. Section 293 is, however, rudimentary. While it may suffice when, as at present, it has limited application, it will not do so for the much more significant purposes of the BE regime. We therefore propose modifications to the section 293 provisions for the purpose of the BE regime. These modifications could apply equally to branches, suggesting that section 293 should itself be amended.

4.5.4 The first issue to consider is the definition of the

foreign taxes which can be credited. Under the present section, creditable income tax is any tax which, in the opinion of the Commissioner is of "substantially the same nature" as New Zealand income tax. This definition has some ambiguity but most tax practitioners consider that it includes income taxes levied by central, state or local governments, provided that they are of substantially the same nature as New Zealand income tax. The Department takes the view that only federal level income taxes are creditable. To clarify the issue, a legislative amendment is necessary. We propose that, for the purpose of the BE regime, any income or withholding tax paid by a CFC be creditable. Since a CFC may pay New Zealand income tax if it has New Zealand-source income, such tax should also be creditable under the BE regime.

4.5.5 In some cases, a CFC may earn income which is not subject to tax in either the jurisdiction in which it is derived or the jurisdiction in which the CFC is resident. The income tax paid by the CFC on its taxable income would then be credited towards the resident's income tax payable on the total BE income of the company, including that which is exempt to the CFC. This would permit income tax paid in one jurisdiction to relieve New Zealand income tax on income which was exempt in another. We therefore propose that the proportion of the total income tax paid by a CFC that is creditable under the BE regime be the proportion of its total income that is taxable in its country of residence or the country of source of the income.

4.5.6 A resident's proportionate share of the total creditable income tax paid by a CFC in any accounting year should equal the proportion that the resident's attributed income or loss in that year in relation to that CFC makes up of the BE income or loss of the CFC in that year. This should be found by multiplying the person's income interest in the CFC by the total amount of the creditable income tax it has paid. Where residents with income interests in a CFC of 10 percent or more have an aggregate income interest in that CFC of more than 100 percent, the tax

credit allowed to each person would be scaled down according to the rule outlined in section 4.2.

4.5.7 As noted above, section 293 currently limits the maximum credit allowed in respect of any foreign income to the New Zealand income tax payable on the income. We consider that it is necessary to have an equivalent provision in the BE regime since foreign tax could otherwise be used to offset New Zealand income tax payable on New Zealand-source income.

4.5.8 As a result of this limitation, the credit allowed to residents will sometimes exceed the New Zealand income tax payable on their attributed income. The question therefore arises of whether residents should be able to offset excess tax credits in respect of one CFC against their New Zealand tax payable on attributed income derived from another CFC. The CD proposed that credits should be limited on an entity by entity basis and a source by source basis. That is, residents would be required to separate out the taxable income (measured under New Zealand rules) of each CFC according to the jurisdiction in which the income was sourced, determine the foreign tax paid by the CFC in respect of each category and the New Zealand tax payable on each category. This approach would therefore be complicated. In addition, the dual limitation would not be effective where the New Zealand resident controllers of more than one CFC could shift income between CFCs. The scope for such shifting will be greatest when the CFCs are in the same jurisdiction.

4.5.9 An alternative approach advocated in submissions would be to have a global computation of attributed income and foreign tax credits. This would, however, allow the tax paid by a CFC in a high tax jurisdiction to offset New Zealand tax payable on attributed income derived through CFCs in low tax jurisdictions. Thus, the income of tax haven companies, which could include income diverted from New Zealand, could be sheltered by foreign tax paid by a CFC in a high tax jurisdiction. This would not be

consistent with the anti-avoidance objective of the international reforms.

4.5.10 The Committee favours an intermediate approach of a country by country limitation. That is, residents would be able to aggregate the attributed income or loss they derive from CFCs which are resident in the same jurisdiction. Similarly, they would aggregate allowable foreign tax credits in respect of those CFCs. The resulting aggregate foreign tax credit would be able to be credited towards the New Zealand tax payable on the resident's aggregate attributed income derived in that jurisdiction, with the maximum credit equal to the New Zealand tax payable. This approach recognises that scope exists for shifting income between companies in the same jurisdiction but, as far as it is possible to do so, avoids allowing residents to use tax paid in high tax jurisdictions to shelter income in low tax jurisdictions. In addition, we note that a country by country limitation is consistent with the existing rules in section 293.

4.5.11 A further issue is the extent to which excess tax credits with respect to any jurisdiction should be able to be carried forward or backward. Excess foreign tax credits could arise because New Zealand and the foreign country calculate taxable income differently or because the New Zealand tax rates differ from those in the other country. We consider that an adjustment to take account of differing tax rates is not necessary for the purposes of the BE regime as long as the maximum allowable credit in any year is limited to the New Zealand tax payable on attributed income derived in that year.

4.5.12 The main argument for allowing excess credits to be carried into another income year is to smooth out the effect of income measurement differences. For example, under our accrual rules, interest income is accrued over the term of the instrument. If another country taxes interest only on receipt, there may be no foreign tax payable in a particular year because

no interest is received, and hence no foreign tax credit, whereas a New Zealand resident would be taxed under the BE regime on accrued interest. When the interest is received, it would be taxable in the other jurisdiction but, provided that it had been accrued correctly, no income would be derived under the New Zealand rules. Thus, both New Zealand tax and foreign tax would be payable on the same income and no foreign tax credit would be allowed because the foreign and the New Zealand taxable income would fall into different years. To avoid such consequences, we propose that excess credits of a resident with respect to an interest in a CFC should be able to be carried forward for credit against the New Zealand tax payable on attributed income of the resident in future income years derived in respect of that CFC or other CFCs resident in the same jurisdiction. In principle, carry back might also be allowed but we do not favour it because of the administrative difficulties of reopening past assessments.

4.5.13 For consistency with our proposed treatment of losses, which is discussed in more detail in the next section, we propose that the carry forward of a credit by a company should be subject to a 40 percent continuity of shareholding test equivalent to that in section 188, the company loss carry forward provision. For the same reason, we recommend that credits be able to be transferred between the companies in a group of companies. Transfer of losses by way of subvention payments has no parallel in the case of foreign tax credits. Thus, we propose that the grouping of credits be permitted only in the case of specified groups (i.e those with 100 percent common shareholding), subject to provisions equivalent to those in section 191.

4.5.14 Finally, we note that a double taxation problem may arise when a company falls within both the BE regime and the CFC regime of another country. For example, a New Zealand resident may own a United Kingdom ("UK") company which in turn owns a company in Cyprus. The UK company may incur a tax liability under the UK's CFC regime in respect of the Cyprus company. The New

Zealand BE regime would attribute a New Zealand tax liability to the New Zealand resident in respect of the Cyprus company but credit would not be allowed for the UK tax paid by the UK company since it was not paid by the Cyprus company. To avoid double taxation in these circumstances, we propose that foreign income tax paid by a CFC in respect of income attributable to another CFC be deemed to be paid by the latter.

### Recommendations

4.5.15 Accordingly, the Committee recommends that:

a subject to recommendation b, income and withholding tax paid by a CFC be creditable under the BE regime;

b the proportion of the total income tax paid by a CFC that is creditable under the BE regime be the proportion of its total income that is taxable in its country of residence or the country of source of the income;

c residents be able to aggregate their proportionate shares of the creditable taxes paid by CFCs resident in the same jurisdiction;

d the maximum credit allowable to a resident in any income year in respect of his or her aggregate attributed income derived from interests in CFCs resident in the same jurisdiction be the New Zealand income tax payable on that income in that year;

e residents be able to carry forward excess tax credits in respect of CFCs resident in the same jurisdiction for offset against New Zealand

income tax payable in any future income year on attributed income in respect of CFCs resident in that jurisdiction;

f the carry forward of an excess credit by a company be subject to a 40 percent shareholding continuity test equivalent to that in section 188;

g a credit allowed to one company in a specified group of companies in respect of an income interest in a CFC be able to be transferred to another company in the specified group for offset against the New Zealand income tax payable by that company on attributed income derived from a CFC resident in the same jurisdiction as the first-mentioned CFC, subject to provisions equivalent to those in section 191; and

h foreign income tax paid by a CFC in respect of income attributable to another CFC be deemed to be paid by the latter CFC.

## 4.6 Attributed Foreign Losses

4.6.1 In the domestic context, the New Zealand tax system is based on a global computation of income. That is, residents amalgamate their profits and losses from all their activities and are taxed on the basis of the net result. There are two reasons to depart from this global treatment in the context of the BE regime. First, a BE profit is not equivalent to a domestic profit as far as the consequences for tax revenue are concerned because of the allowance of a foreign tax credit. New Zealand will collect revenue on the BE profits of CFCs only to the extent

that the foreign tax credit allowed is less than the New Zealand tax payable on the profits. For this reason, a BE loss should also be treated differently from a domestic loss. The regime would be asymmetric if it permitted attributed losses to be aggregated with domestic income but then allowed a credit for foreign tax paid by a CFC once a resident had attributed income. Thus, one of the consequences of allowing a credit for income taxes paid by a CFC is the need to restrict the offset of attributed losses against domestic income.

4.6.2 Secondly, unrestricted offset of BE losses would give rise to problems where New Zealand residents were able to acquire losses in foreign companies. We referred earlier to the need for a special provision to counter this, but such provisions can never be fully effective.

4.6.3 For these reasons, we consider that attributed losses under the BE regime should not be able to be offset against other taxable income. At the same time, we recognise that loss ring-fencing is seldom very effective, particularly in the absence of interjurisdictional allocation rules. Taxpayers invariably find ways to mitigate its effect. Nevertheless, unrestricted offset of BE losses against domestic income could not be justified.

4.6.4 The Committee proposes that taxpayers be able to aggregate attributed income and losses from income interests in CFCs resident in the same jurisdiction. As noted in the previous section, the rationale for not permitting grouping of attributed income and losses derived in different jurisdictions is that this would permit income accumulated in low tax jurisdictions to be sheltered by losses derived in high tax jurisdictions. This would not be consistent with the basic anti-avoidance objective of the regime.

4.6.5 Where a taxpayer's aggregate attributed income for a

jurisdiction is a loss, we propose that it be able to be carried forward for offset against future attributed income derived from income interests in CFCs resident in that jurisdiction. Where the taxpayer is a company, the carry forward of an attributed loss should be subject to provisions equivalent to those in section 188. In addition, as for tax credits, we propose that companies in the same specified group that have income interests in two or more CFCs in the same jurisdiction should be able to aggregate their attributed income and losses in respect of those interests, subject to provisions equivalent to those in section 191.

### Recommendations

4.6.6 Accordingly, the Committee recommends that:

a an attributed loss of a taxpayer derived from an income interest in a CFC be able to be offset only against attributed income derived from income interests in CFCs resident in the same jurisdiction as the first-mentioned CFC in the same or a future income year;

b the carry forward of an attributed loss by a company be subject to a 40 percent shareholding continuity test equivalent to that in section 188; and

c companies in the same specified group be able to aggregate attributed income and losses in respect of income interests in CFCs resident in the same jurisdiction subject to provisions equivalent to those in section 191.

## 4.7 Application of the Regime to CFCs Resident in a "Grey List" Country

4.7.1 The BE regime will not apply to a CFC resident in "grey list" countries (i.e the United States, United Kingdom, West Germany, Japan, France, Canada and Australia) unless the CFC utilises a specified significant tax preference. Where such a CFC did utilise a listed preference, we recommended in our first report that its resident controllers should be required to adjust the taxable income of the CFC, measured according to the tax law of its country of residence, for the effect of the preference. If the foreign tax paid by the CFC as a percentage of the adjusted taxable income equalled or exceeded the New Zealand company rate, the CFC would remain exempt from the regime.

4.7.2 The application of the regime in these circumstances can now be spelt out in more detail. We consider that the best approach is to adopt a simplified computation of BE income whenever a CFC resident in a grey list country utilises a listed significant preference in a particular income year. In such cases, the BE income of the CFC would equal its taxable income in that year computed according to the tax law of its country of residence before taking into account any losses incurred by the CFC in other years or losses incurred by any other company, adjusted for the effect of the listed preference.

4.7.3 The adding back of any losses incurred by the CFC or any other company is necessary in part for consistency with the way in which the BE regime will apply outside of the grey list countries and in part to prevent possible double counting of losses, once in the computation of the BE income of a grey list CFC and again as an attributed loss in the hands of resident taxpayers.

4.7.4 In all other respects, the BE regime would apply to grey list CFCs in the same way as for other CFCs. Where a grey list CFC fell into the regime by virtue of utilising a significant preference, no New Zealand tax would be payable on its BE income to the extent that it paid income tax at least equal to the New Zealand tax that would be payable on its income. Thus, the allowance of a tax credit has the same effect as the rate test outlined in paragraph 4.7.1.

### Recommendation

4.7.5 The Committee therefore recommends that where a CFC resident in a grey list country utilises a listed significant preference in any accounting year, the BE regime apply as for CFCs resident in other jurisdictions except that the BE income or loss of the CFC be computed as its taxable income or loss for that year, measured according to the tax law of its country of **residence** (before taking into account any losses of the CFC incurred in other years or losses incurred by any other company), adjusted for the effect of the listed preference.

## 4.8 Change of Residence of CFC or Taxpayers

4.8.1 Provisions are required to deal with changes of residence of foreign companies and New Zealand residents. For example, where a resident company ceases to be resident, it should be deemed to have an accounting period that commences on the day on which it ceases to be resident so that, if it falls into the BE regime as a result of its change of residence, an accounting period with respect to the computation of BE income is defined. These rules are therefore necessary for the mechanics of the BE regime.

4.8.2 The compliance costs of computing BE income for a short accounting period required as a result of a change of

residence may be excessive. Thus, residents should have the option of pro rating the income derived by the CFC in its actual accounting year.

## 4.9 Determination of Residence

4.9.1 A number of provisions of the proposed regime depend on the residence of a company. For example, we have proposed that the carry forward of losses and excess tax credits be limited on a jurisdictional basis. In addition, the transitional provisions are related to the fiscal residence of a foreign company. This means that it is necessary to have provisions for determining unambiguously the residence of a foreign company.

4.9.2 The fiscal residence of a company will normally be the jurisdiction in which it is liable for tax. Where a company is resident in two or more jurisdictions, it should be regarded as being resident in the jurisdiction which the New Zealand residence rules would assign it to. If this still does not prescribe a single residence to the company, the country in which most of its assets are located should be its fiscal residence. Where none of these rules settles the residence of a company, there is no option but to let the Commissioner decide.

# CHAPTER 5 – FOREIGN INVESTMENT FUNDS

## 5.1 Introduction

5.1.1 The foreign investment fund regime is to apply to interests in offshore investment vehicles which fall outside the BE regime but nevertheless confer tax advantages on residents because of a favourable tax treatment in the country of residence of the fund. An investment fund in the form of a unit trust domiciled in a tax haven is a typical example of such an entity. By accumulating rather than distributing most of its income, the fund can convert income such as interest and dividends into a capital gain to the investor, which can be realised either by sale through a stock exchange or by repurchase by the fund or its managers.

5.1.2 We defined a foreign investment fund in our previous report as any entity:

a which derives its income or value primarily or substantially from holding or trading portfolio investments in shares, investments in debt instruments, real property, commodities, etc; and where

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

5.1.3 The taxable income derived by a New Zealand resident from an interest in a foreign investment fund in any income year is to be calculated as the increase in the market value of the

interest over the income year, plus any distributions receivable by the resident.

5.1.4 This chapter outlines the Committee's recommendations on the remaining issues which need to be decided in order to implement the foreign investment fund ("FIF") regime. The relevant section in the draft legislation is section 245O.

## 5.2 Definitions

5.2.1 The definition of a FIF in the draft legislation follows closely the one outlined above with the following changes. Instead of referring to an "entity", the definition lists the types of entities which could be FIFs, namely, a foreign company, a foreign unit trust and a foreign superannuation fund ( which together can be referred to as "foreign entities"). Although a unit trust is deemed to be a company by section 211 of the Income Tax Act, we have expressly referred to unit trusts to emphasise their inclusion in the FIF definition. We propose that the new definition of "superannuation fund" to be added to section 2 as a result of the current review of the tax treatment of superannuation also apply for the purposes of the FIF definition.

5.2.2 The explicit inclusion of unit trusts and superannuation funds in the definition recognises that some countries give favourable tax treatment to such entities. A parallel change is therefore needed to the second leg of the definition, which requires a person to have regard to the jurisdiction in which the entity is resident, requiring a person to also have regard to be concessionary tax regimes applying within that jurisdiction.

5.2.3 An interest in a FIF is defined in the same way as a direct income interest in a foreign company for the purposes of the BE regime. As explained in chapter 3, income interests are defined in terms of the things that a shareholder of a company, or a person entitled to acquire shares, would hold. A person

may, however, have rights to the income of a foreign entity by holding a life insurance or superannuation policy issued by that entity. Consequently, life insurance or superannuation policies must be added to the definition of an interest in a foreign entity for the purposes of the FIF regime. Such an interest will, however, be taxable under the regime only if the foreign entity that issued the policy falls within the definition of a FIF.

5.2.4 Constructive ownership rules are not needed in this regime since there is no control test, nor do we propose a minimum interest threshold before the regime applies. Given that the market value of an interest in a FIF will reflect the value of the FIF's direct and indirect interests, it is necessary to focus on direct interests only.

### Recommendation

5.2.5 Accordingly, the Committee recommends that the foreign investment fund regime apply to interests in foreign companies, foreign unit trusts and foreign superannuation funds that fall within the definition of a foreign investment fund and that the definition of an interest in a foreign **investment** fund include policies of life insurance or superannuation issued by a foreign investment fund.

## 5.3 Calculation of FIF Income or Loss

5.3.1 The income or loss in any income year that a person derives from an interest in a FIF is to be measured by the change in value of the interest over the year. Taking into account purchases and sales within a year, the taxable income or loss of a person holding an interest in a FIF in any income year can be defined as:

(a + b) − (c + d)

where a = the market value of the interest held at the end of the income year;

b = the market value of all distributions and any other consideration receivable by the person in that income year with respect to that FIF, including any consideration resulting from any disposal of an interest during the income year;

c = the market value of the interest held at the end of the previous income year; and

d = the market value of any consideration paid by the person for the acquisition of an interest during the year.

This definition is essentially the same as the one that you approved in response to our recommendation in Part 1 of our Report on International Tax Reform.

5.3.2 The term "b" in the above formula is defined to include within FIF income all distributions of a FIF. All such distributions, whether of income or capital, need to be included within the definition since any distribution will reduce the end of year market value of a FIF interest. Furthermore, distributions should be taxed in the year they become receivable, rather than the year that they are received, since the corresponding reduction in the market value of a FIF interest resulting from a distribution will be taken into account on an accrual basis. Finally, all distributions must be included, whether they are in cash or otherwise and whether or not they are received directly or are credited in account or are otherwise dealt with in the interest or on behalf of the person.

## 5.4 Treatment of Losses

5.4.1 FIFs have been defined so that it can be reasonably assumed that the change in the market value of an interest in a FIF over an income year will reflect the change in the market value of its net assets over the year. The growth in a FIF's net assets over a year will in turn depend on its income for that year, reduced by any tax paid and by any amount distributed to interest holders during the year. Thus, FIF income or losses will be measured net of any income tax paid by the fund. This means that it is not appropriate to allow interest holders a credit, or a deduction, for any income tax paid by a FIF.

5.4.2 By contrast, a tax credit is to be allowed under the BE regime. We recommended in respect of the BE regime that attributed income and losses of a person under the regime should not be amalgamated except where they are derived in respect of interests in CFCs resident in the same jurisdiction. Residents would otherwise be able to use credits for tax paid by a CFC in a high tax jurisdiction to offset a New Zealand tax liability in respect of an interest in a CFC resident in a low tax jurisdiction. This consideration is not relevant under the FIF regime since credits will not be given. We therefore propose that residents should be able to aggregate their FIF income and losses derived in any income year, irrespective of the residence of the FIF.

5.4.3 In order to ensure that residents are not double taxed on FIF income, once as it is reflected in an increase in the market value of an interest and again on distribution, it is necessary to allow FIF losses to be deductible. The regime should not, however, permit residents to claim a deduction for a FIF loss of income and/or capital accumulated or contributed prior to the introduction of the regime. It is therefore necessary to limit the FIF loss that can be deducted by a resident in any income year to the amount of the FIF income, if any, derived by the resident in that year or an earlier income year with respect

to any FIF. Thus, where a FIF loss derived by a resident in any income year exceeds his or her FIF income for that year, the excess loss should be able to be deducted from other income of the resident derived in that year to the extent that the excess loss was less than the cumulative FIF income of the resident derived in earlier income years, less the amount of any such excess losses set off against other income in those earlier years. The effect of this rule is that a FIF loss could be deducted only to the extent to which a person has previously or will currently be taxed on FIF income.

5.4.4 To the extent that a FIF loss cannot be deducted in the year that it is derived, it should be carried forward for offset against FIF income derived in subsequent years. Where the taxpayer is a company, such a loss carry forward should be subject to a 40 percent shareholding continuity test, as we have recommended in the case of BE losses. Similarly, FIF income and losses should be able to be amalgamated within a specified group of companies resident in New Zealand, subject to provisions comparable to those applying to the grouping of losses under section 191.

### Recommendations

5.4.5 **Accordingly**, the Committee recommends that:

a residents be able to aggregate their FIF income and losses derived in any income year from all FIFs in which they have an interest;

b where a FIF loss derived by a resident in any income year exceeds his or her FIF income for that year, the excess loss be able to be deducted from other income of the resident derived in that year to the extent that the excess loss is less than an amount equal to the cumulative FIF income of the resident derived in

earlier income years, less the sum of any excess losses set off against other income in those earlier years pursuant to this provision;

c to the extent that a FIF loss cannot be set off against FIF or other income derived in the same income year, it be carried forward for offset against FIF income derived in future income years;

d the carry forward of a FIF loss by a company be subject to a 40 percent shareholding continuity test similar to that in section 188; and

e a FIF loss incurred by one company in a specified group of companies be able to be offset against FIF income derived by another company in the specified group subject to provisions equivalent to those in section 191.

## 5.5 Entry and Exit Provisions

5.5.1 Occasions will arise when an interest in a FIF will fall within or cease to be within the regime without an acquisition or disposal at market value occurring at the same time. This will happen when:

a a person becomes or ceases to be a resident;

b a person disposes of an interest by way of gift or for a consideration which is less than its market value;

c a person dies; or

d an interest in a FIF becomes an income

interest in a CFC of not less than 10 percent, or vice versa.

In such cases, the interest should be deemed to be acquired or disposed of, as the case may be, for its market value on the relevant day.

### Recommendations

5.5.2 **Accordingly**, the Committee recommends that a deemed acquisition or disposal at market value occur when:

a a person becomes or ceases to be a resident;

b a person disposes of an interest by way of gift or for a consideration which is less than its market value;

c a person dies;

d an interest in a FIF becomes an income interest in a CFC of not less than 10 percent; or

e an income interest in a CFC of not less than 10 percent ceases to be such an interest but is an interest in a FIF.

## 5.6 Conflict Provisions

5.6.1 As decided previously, where an interest in a foreign company would give rise to attributed income under both the BE and FIF regimes, the BE regime will apply. This is provided for in section 245P of the draft legislation. The exemption from the BE regime for income interests of less than 10 percent does not, however, apply to the FIF regime. Thus, persons holding income interests in a CFC of less than 10 percent may fall within the FIF regime if the CFC is a FIF.

# CHAPTER 6 – TRUSTS

## 6.1 Introduction

6.1.1 In many circumstances, trusts can substitute for CFCs or FIFs. Hence, it is necessary to support the BE and FIF regimes with a regime applying to trusts. We referred to the trust regime in our first report as "the settlor regime" because it will bring within the tax net the foreign-source trustee income of trusts which have one or more New Zealand resident settlors. This trustee income is now not subject to tax in New Zealand where the trust has non-resident trustees.

6.1.2 A further deficiency with the current rules is the ambiguity about the tax treatment of distributions from non-resident trustees to New Zealand beneficiaries. This was discussed in the Consultative Document released in December and we have drafted legislation to deal explicitly with this type of income. The present rules also attempt to deal, though not very effectively, with the use of trusts for income splitting. With the recent considerable flattening of personal income tax rates, the need for such provisions has lessened. We have therefore taken the opportunity to recommend changes to the existing tax legislation applying to trusts. The result is a new regime for trusts which would apply to domestic trusts as well as to overseas trusts with New Zealand connections.

6.1.3 This chapter outlines the new regime. Transitional issues relating to the treatment of settlements in existence on or before 17 December 1987 are dealt with in chapter 8.

## 6.2 Existing Treatment of Trusts

6.2.1 The present tax treatment of trusts is dealt with primarily in sections 226 to 233 of the Income Tax Act 1976. Section 226 currently distinguishes between "specified" and "non-specified" trusts. Broadly speaking, non-specified trusts include trusts created by will or on an intestacy and inter-vivos trusts created before 19 July 1968. Specified trusts are inter-vivos trusts created on or after that date. The distinction was brought into existence by an amendment to the Land and Income Tax Act 1954 following the 1968 Budget. The difference between the two types of trust is purely a matter of tax treatment of the income derived by their trustees and beneficiaries. It is not founded in any jurisprudential distinction between trusts of different kinds.

6.2.2 The policy behind the distinction was an effort to frustrate income splitting by means of trusts which was thought to have become particularly prevalent in the 1960's. The benefits of income splitting achieved by taxpayers were enhanced by the steeply progressive income tax scales that prevailed at that time and that remained in force until relatively recently. The effect of this policy is that, broadly speaking, income of a specified trust is taxed at a higher rate than income of a non-specified trust.

6.2.3 The current law further distinguishes between trusts or, more precisely, between different streams of trust income, according to whether income is accumulated by trustees or distributed to beneficiaries and, if the latter, according to whether the distribution is pursuant to a discretion vested in the trustee or to a provision of the trust that fixes the rights of a beneficiary to income. Finally, a distinction is drawn in some circumstances according to whether the beneficiary is an infant or an adult.

6.2.4 Income accumulated by a trustee is taxed in the hands of the trustee at the rates that would apply if the trustee were an individual and had no other income. For specified trusts, there is a minimum rate of 35 percent, reflecting the 1968 policy of harsher treatment for these trusts.

6.2.5 When a trustee does not accumulate income but instead it is derived in trust for a beneficiary "entitled in possession" to the income, it is taxable to that beneficiary. This rule works well enough in the case of adults. If income vests in them by virtue of the provisions of a trust or by virtue of the exercise of a discretion by the trustee, they are entitled in possession to that income because they can call on the trustee to pay it over. This is not the case with infants (nor with persons who lack full legal capacity for other reasons, such as unsoundness of mind) since an infant is not entitled to the possession of income.

6.2.6 Thus, where, in the exercise of a discretion by a trustee, income is paid to or applied for the benefit of a beneficiary by a "bona fide transaction" which places the income beyond the possession and control of the trustee, the beneficiary is deemed to be entitled in possession to the income so long as the payment or application is made within six months of the end of the income year in which the income is derived. The six month rule enables a trustee to calculate the trust's income for the relevant year before applying the money for the benefit of a beneficiary.

6.2.7 An additional condition applies in the case of a specified trust or an infant beneficiary. In that case, where the income comes within the possession or under the control of the trustee or is used for the purposes of a business carried on by the trustee, it is reassessed to the trustee instead of the beneficiary. This rule is part of the harsher regime for specified trusts mentioned in paragraph 6.2.4.

6.2.8 The precise effect of the "bona fide transaction" requirement is not certain. In many cases this requirement poses few problems because income is employed to meet current needs of the beneficiary. In other cases, trustees go to some lengths to ensure that there has been something that qualifies as a payment or an application. A common technique is for the trustee to establish a sub-settlement for the benefit of the beneficiary and for income to be channelled to that sub-settlement. The second requirement outlined in paragraph 6.2.6 in many cases is also able to be avoided, albeit at some cost in the establishment of sub-settlements and other planning devices.

6.2.9 In the case of fixed trusts other than specified trusts, income that vests in an infant beneficiary is also deemed to be income to which the beneficiary is entitled in possession.

6.2.10 In view of the ineffectiveness of the specified/non-specified trust distinction in countering income splitting and of the substantial flattening of the personal income tax scale, the Committee considers that the distinction should be removed. In addition, because the settlor regime supersedes the current trust provisions to some extent it is simpler to replace all of sections 226 to 233 by new provisions which cover both wholly domestic trusts and trusts with foreign elements.

### Recommendation

6.2.11 Accordingly, the Committee recommends that the present distinction between specified and non-specified trusts in sections 226 to 233 of the Act be removed from 1 April 1988.

## 6.3 Overview of Trust Regime

6.3.1 The major difference between the existing tax treatment of trusts and the proposed new regime is that the latter brings within the New Zealand tax net the trustee income of trusts with

non-resident trustees which have a New Zealand resident settlor. Such income has previously not been subject to tax in New Zealand except where it has a New Zealand source. As explained in Part 1 of our report, the new regime recognises that the economic substance of a trust may differ from its legal appearance. A settlor may have substantial influence over the trustee, usually on an informal basis though there may be specific provision in the trust deed so that, in practice if not in law, a settlor may be able to wind up a trust and influence or control the disposition of its property.

6.3.2 If this assumption does not accord with the circumstances of a particular trust, then in future New Zealand residents can settle trusts on resident trustees and divest themselves of any liability for tax on trustee income. If they wish to use non-resident trustees, they must be prepared to have the trustee's liability for New Zealand tax on trustee income fall back on them should the trustee default. We recognise that this choice may not be available in respect of trusts that were settled before 17 December 1987 and so have recommended that the settlor in these circumstances not be liable for tax on trustee income. A number of transitional provisions relating to these trust are outlined in chapter 8.

6.3.3 Thus, under the new regime, the foreign-source trustee income of any trust will be taxable in New Zealand where, at any time in an income year, a settlor of the trust is resident in New Zealand. Trustee income is income derived by a trustee of a trust in any year that is not beneficiary income of any beneficiary of the trust. The tax treatment of trustee income is discussed in section 6.5. We refer to a trust in respect of which trustee income has been taxable in New Zealand in every income year since its settlement as a "qualifying trust". The liability for the tax on trustee income will fall on the trustee. Where there is no resident trustee, the New Zealand resident settlor will be liable as agent of the trustee. In effect, the settlor is treated as the "taxpayer of last resort" in respect of trustee income.

6.3.4 We propose that settlors of trusts that are charitable trusts or superannuation funds not be liable for tax on trustee income as agents of the trustees. In addition, we propose that, where a trust is settled by a new resident before he or she becomes resident in New Zealand, the settlor should not be liable for tax on trustee income provided that the settlor has not been resident in New Zealand at any time after 17 December 1987. These provisions are outlined in sections 6.6 to 6.8. We propose, however, that a new resident in the above circumstances should be able to elect to become liable for tax on trustee income. Similarly, a trustee of a trust which has a settlor who is no longer resident or who has died should be able to elect to continue to pay tax on foreign-source trustee income so that the trust retains it status as a qualifying trust.

6.3.5 The income derived by a trustee of a trust in any income year is either "trustee income" or "beneficiary income". Beneficiary income is, broadly, that part of the income derived by the trustee in any income year which vests in or is distributed to a beneficiary in the same year. Section 6.9 sets out the proposed treatment of such income. A beneficiary may also receive distributions from a trust other than beneficiary income. Such distributions could consist of income received by a beneficiary after the income year in which it is derived by the trustee or distributions from current or prior year gains that are not taxable income. Any payment, benefit, property or other consideration derived by a beneficiary from a trust, including beneficiary income, will be referred to as a "distribution". The draft legislation refers to the taxable portion of such a distribution as a "taxable distribution". The taxation of distributions is discussed in sections 6.10 to 6.12.

6.3.6 As noted above, trusts in respect of which trustee income has been subject to tax in New Zealand in all income years since their establishment will be called "qualifying trusts". We use the term "qualifying" since we propose that distributions

from such trusts, other than beneficiary income, should qualify as non-assessable income in the hands of beneficiaries.

6.3.7 A second category of trust will be called a "foreign trust". We define a foreign trust as a trust that has not had a settlor who is or was a resident of New Zealand at any time after 17 December 1987. We propose that distributions of the trustee income of these trusts derived by the trustee in accounting years commencing on or after 1 April 1988 and any beneficiary income derived by a beneficiary of such a trust be taxable in New Zealand but other distributions be non-assessable. These proposals are discussed in section 6.11.

6.3.8 Distributions, other than beneficiary income, which are made by the trustee of a trust that is neither a qualifying trust nor a foreign trust will be referred to as "non-qualifying distributions". This term is not used in the draft legislation but, for convenience of exposition, we have employed it in this report. For example, distributions from trusts in respect of which trustee income has not been subject to tax in New Zealand in all income years since their settlement, other than foreign trusts, will be non-qualifying distributions. Since non-qualifying distributions may consist of income which has never been taxed in New Zealand and may not have been taxed in any other jurisdiction, they should not be non-assessable in the hands of beneficiaries. Our proposals in relation to these distributions are outlined in section 6.13.

6.3.9 The distinction between qualifying, foreign and other trusts is therefore an important determinant of the way in which we propose that distributions from trusts should be taxed.

## 6.4 Definition of a Settlor

6.4.1 A cornerstone of the regime is the definition of a settlor. This is dealt with in section 226 of the draft legislation. There are several legs to the definition:

a a settlor is defined, broadly, as any person who, directly or indirectly (e.g. via nominees, solicitors, accountants, financial institutions, etc) and whether by one transaction or a series of transactions, makes or has made any disposition of property on a trust. A disposition of property is in turn defined widely;

b where a trust is settled by a resident company and the company is wound up, any person who at the time of the settlement had a direct control interest, as that term is defined for the purposes of the BE regime, in the company would be deemed to be a settlor if the person's direct control interest together with that held by associated persons is 10 percent or more. A parallel rule applies where such a person is a company and is itself wound up, and so on;

c where a trust is settled by a CFC, any resident who at the time of the settlement, or at the time a CFC becomes a settlor by virtue of rule b above, has a control interest in the CFC is deemed to be a settlor of the trust if the resident's control interest and that of associated persons is 10 percent or more;

d where a trust is settled by a trustee of another trust, any person who is a settlor of the first trust is deemed to be a settlor of the second;

e where the trustee of a trust is a company and a resident acquires an interest in that company with the effect or purpose of requiring the trustee to treat the resident, or any person he

or she nominates, as a beneficiary, the resident is deemed to be a settlor;

f a general anti-avoidance rule is included to define as settlors any persons who make an arrangement in relation to a trust which has the effect of defeating the intent and application of this definition.

6.4.2 The above definition of a settlor elaborates for the purposes of the draft legislation the very wide definition of a settlor and a settlement recommended in our previous report.

## 6.5 Trustee Income

6.5.1 As mentioned above, "trustee income" means income derived by a trustee of a trust in any income year that is not beneficiary income of any beneficiary of the trust. Where trustee income is derived in New Zealand, the trustee, whether resident or not, will be liable for tax in New Zealand on the income.

6.5.2 The settlor regime brings into the New Zealand tax net trustee income which is derived outside New Zealand in any income year if the trust has a settlor who is resident in New Zealand at any time during the year. Thus, where there is a resident settlor, both New Zealand- and foreign-source trustee income will be assessable in New Zealand.

6.5.3 As the Committee recognised in Part 1 of its report, where trustee income is to be subject to New Zealand taxation, the best course is to tax it in the hands of the trustee as if he or she were a resident. It is the trustee who derives the income and it is to the trustee that one should look in the first instance for the resultant tax. Consequently, in the case of a trust where there is a New Zealand resident settlor at any time during the income year, the primary liability for income tax should

fall on the trustee.

6.5.4 As discussed in our previous report, where there may be difficulties in enforcing the trustee's liability for tax on non-New Zealand source income, it is necessary to make the resident settlor liable for tax on trustee income as agent for the trustee. Such difficulties may obviously arise where a trust has no resident trustees. If a trustee is resident, the Department can pursue the trustee through the legal process and has recourse to the trustee's assets. Where, however, the trustee is a shell company with no tangible assets in New Zealand, problems of enforcement may still occur. We therefore propose that the settlor of a trust not be liable for tax on trustee income if the trustee is resident in New Zealand and is a natural person, a trustee company within the meaning of the Trustee Act 1956.

6.5.5 In other cases, the settlor of a trust will be liable as agent of the trustee for tax on the trustee income of the trust. This liability will not, however, arise if the trust was settled on or before 17 December 1987 unless the settlor elects to be so liable. We propose a number of other exemptions in respect of superannuation funds, new residents and charitable trusts which are discussed in sections 6.6, 6.7 and 6.8.

6.5.6 In summary, foreign-source trustee income will be liable for tax in New Zealand in any income year in which the trust has a settlor who is resident in New Zealand. The primary liability for the tax will fall on the trustee. Where the trust was settled after 17 December 1987, a liability for tax on trustee income, in the event of the default of the trustee, will also fall on a resident settlor except in certain circumstances. We propose that these circumstances be that:

a the trust has a resident trustee who is a natural person or a trustee company; or

b the trust is a superannuation fund. (This exemption is referred to in section 6.6); or

c the trust was settled by a person before becoming resident in New Zealand who had not been resident in New Zealand at any time after 17 December 1987. (This is the new resident exemption which is discussed in section 6.7); or

d the trust is a charitable trust. (This is discussed in section 6.8).

6.5.7 Where there is more than one resident settlor, the simplest treatment is to make them jointly and severally liable for the tax as agents of the trustee. The use of the term "agent" brings into play all the provisions of the Income Tax Act in respect of agency liability. One of these is that an agent has a right of indemnity from his principal, in this case the trustee. Thus, for mechanical collection purposes, and to fit in with the existing pattern of the Act, it is appropriate to give the settlor the status of agent. This approach should not, however, obscure the policy considerations that make it appropriate for a New Zealand resident settlor to be treated, in effect, as a "taxpayer of last resort" in respect of the trustee income of a trust.

6.5.8 Circumstances will arise where, though there is no New Zealand tax liability in respect of foreign-source trustee income because there is no resident settlor, a settlor or trustee would prefer that a trust be a qualifying trust so that distributions of the trust (apart from beneficiary income) are non-assessable. For example, a settlor who is emigrating may wish to continue to have all of the trustee income of a trust taxed in New Zealand. For similar reasons, the trustee of a testamentary trust or an inter-vivos trust following the death of a resident settlor may wish to retain a qualifying trust status. Accordingly, we propose that a settlor or trustee of a

trust be permitted to elect to make foreign-source trustee income of the trust liable for tax in New Zealand in any income year, even though there may be no settlor of the trust resident in New Zealand in that year, by submitting a return of such income by the due date.

6.5.9 At present the trustee income of specified trusts is taxed at a rate of 35 percent and the trustee income of non-specified trusts at the ordinary marginal tax rates applying to individuals. Since we have recommended in paragraph 6.2.11 that the distinction between specified and non-specified trusts should be abandoned, we consider that there should be a uniform rate of tax in respect of trustee income with effect from 1 April 1988.

Recommendations

6.5.10 Accordingly, the Committee recommends that:

a a trustee be liable for tax on trustee income derived outside New Zealand in any income year in which the trust has a settlor who is resident in New Zealand at any time during the year;

b subject to the recommendations in sections 6.6 6.7 and 6.8, where a trust was settled after 17 December 1987, any resident settlor of the trust be liable for tax on trustee income as agent of the trustee except where the trust has a resident trustee who is a natural person or a trustee company within the meaning of the Trustee Act 1956;

c a settlor or trustee of a trust be permitted to elect to make foreign-source trustee income subject to tax in any income year by making a

return of such income by the due date; and

d a trust in respect of which trustee income has been subject to tax in New Zealand, in the hands of either the trustee or the settlor, in every income year since the settlement of the trust be defined as a "qualifying trust".

## 6.6 Settlor liability: Superannuation Funds

6.6.1 A contributor to a superannuation fund falls within the definition of a settlor where the fund is constituted as a trust. Where, however, the superannuation fund is resident in New Zealand, a separate tax regime is to apply to the taxation of the trustee income of the fund. This regime is the subject of a separate consultative process and supersedes entirely the trust regime which falls within our ambit. Consequently, our proposals for the taxation of trusts do not apply where the trust is a resident superannuation fund.

6.6.2 Where a superannuation fund is a non-resident, our understanding is that the regime under consideration in the separate consultative process would not apply. We would not, however, propose to tax a resident contributor to a non-resident superannuation fund on the worldwide trustee income of a non-resident superannuation fund. Thus, a contributor who is technically a settlor of a superannuation fund should never be liable for tax on the trustee income of the fund.

6.6.3 The only liability that would fall on a contributor would arise if the superannuation fund were a non-resident fund that fell within the definition of a foreign investment fund. As outlined in chapter 5, residents with interests in superannuation funds that are FIFs should be taxed on the income derived from such interests under the FIF regime.

6.6.4 We therefore propose that a person who makes a settlement on a trust that is a superannuation fund, as the term is to be defined for the purposes of the new tax regime for superannuation funds, should not be liable for tax on the trustee income of the trust irrespective of the residence of the trustee. This exemption would apply, for example, to contributions made to a superannuation fund by an employee or an employer, including those made by a CFC.

### Recommendation

6.6.5 The Committee therefore recommends that a person who makes a settlement on a trust that is a superannuation fund, as that term is to be defined for the purposes of the new tax regime for superannuation, not be liable for tax on the trustee income of the trust.

## 6.7 Settlor Liability: New Residents

6.7.1 An immigrant who settles a trust before becoming resident in New Zealand is in a position similar to a settlor of a trust in existence on 17 December 1987, provided that the immigrant has not previously been resident in New Zealand since 17 December 1987. Thus, we consider that a similar relief from liability for tax on trustee income is warranted in such cases. In particular, we consider that, where a person who has never previously been resident in New Zealand after 17 December 1987 becomes resident in New Zealand after that date and has settled a trust before becoming resident, that person should not be liable as agent of the trustee for tax on the trustee income of the trust.

### Recommendation

6.7.2 The Committee therefore recommends that persons who become resident in New Zealand after 17 December 1987 who have settled a trust before becoming resident not be **liable** for tax on trustee income in respect of that trust, provided that they have not previously been resident in New Zealand since 17 December 1987.

## 6.8 Settlor Liability: Charitable Trusts

6.8.1 Trustees of charitable trusts are currently exempt from tax in New Zealand by virtue of sections 61(26) and 61(27) of the Act. The Government has announced its intention to review the tax exempt status of charitable trusts, but this is outside the brief of the Committee. Given that the trustee income of resident trustees of charitable trusts is exempt from tax in New Zealand, a person making a donation to a charitable trust (who would be a settlor under our definition) should not be liable for tax on the trustee income of the trust. Even if the trustee income of charitable trusts were taxable in New Zealand, it would not be appropriate to make resident settlors liable for tax on the worldwide trustee income of non-resident charitable trusts. Thus, we propose that the new regime for the taxation of trustee income should not apply to a person who makes a settlement on a charitable trust. For this purpose, we propose that a charitable trust be defined taking into account the terms of section 61(27). If, however, the definition in this section is changed as a result of the current review, it may be necessary to amend our proposed definition.

### Recommendations

6.8.2 Accordingly, the Committee recommends that a person who makes a settlement on a charitable trust not be liable for tax on the trustee income of the trust.

## 6.9 Beneficiary Income

6.9.1 As outlined in section 6.3, the receipts of a beneficiary of a trust arise from two sources:

a income derived by the beneficiary in the same income year as it is derived by the trustee, or paid to or applied for the benefit of the beneficiary within six months of the end of the income year. This is referred to as "beneficiary income"; and

b distributions of trustee income received by the beneficiary in an income year after the year in which it is derived by the trustee, or distributions from current or prior year gains of the trust that do not represent taxable income.

6.9.2 Beneficiary income, as noted in section 6.2, is currently defined as income derived by a trustee in any income year to which a beneficiary of the trust is entitled in possession in that year. In the light of the Committee's conclusion in section 6.2 that the specified/non-specified trust distinction should be dropped, we propose that beneficiary income be defined more widely as income derived by a trustee in any income year which:

a vests absolutely in interest in a beneficiary during the income year; or

b is paid or applied by the trustee to or for the benefit of the beneficiary during or within 6 months of the end of the income year

whether or not the beneficiary is an infant or is subject to any other legal incapacity.

6.9.3 This definition would remove the conditions that must be satisfied under current law in respect of specified trusts and infant beneficiaries and those of unsound mind. The effect would be to tax in beneficiaries' hands income that the current law attempts to tax to the trustee. We recommend, however, that trustees should continue to be liable for tax on beneficiary income as agents for the beneficiaries, as is now the case.

6.9.4 Where beneficiary income has been subject to tax in another jurisdiction in the hands of the trustee, the beneficiary (and the trustee as agent for the beneficiary) should receive a credit against the New Zealand income tax liability on the income for any foreign income or withholding tax paid by the trustee. In order that a disproportionate amount of the foreign tax paid by the trustee is not credited to a beneficiary, the credit allowed to the beneficiary should be equal to the proportion of the total foreign tax paid by the trustee that the beneficiary income bears to the total income derived by the trustee in that income year.

6.9.5 Where a trustee fails to meet an obligation for tax on beneficiary income and the beneficiary is a New Zealand resident, the liability will fall on the beneficiary. Where a beneficiary is a non-resident, the trustee will be liable, as agent of the beneficiary, for tax in New Zealand on beneficiary income only if that income has a New Zealand source. The rate of tax will depend on whether the income is ordinary income or non-resident withholding income. In either case, the settlor should have no liability for tax on beneficiary income.

6.9.6 The definition of a distribution needs to be wide enough to encompass indirect distributions to a resident beneficiary. For example, a taxable distribution paid through a tax-exempt or non-taxable third party who received the distribution from a trustee on the understanding that it was to be paid to or enjoyed by a beneficiary in a tax-free or lightly-taxed form should retain its character as a trust distribution.

Other types of indirect distributions from a trustee include gifts, a loan, a release or abandonment of a debt and a disposition of property that purports to be a settlement on a non-qualifying or foreign trust for the benefit of the New Zealand resident or an associated person.

6.9.7 The enforcement of tax on such an extended definition of a trust distribution must rely to a large extent on disclosure. Failure by a beneficiary to disclose an indirect distribution would, however, constitute a failure to disclose assessable income and would be subject to the penalties applicable to tax evasion.

### Recommendations

6.9.8 Accordingly, the Committee recommends that:

a the beneficiary income of a beneficiary of a trust be defined as income derived by the trustee of the trust in any income year which:

i vests absolutely in interest in a beneficiary during the income year; or

ii is paid or applied by the trustee to or for the benefit of the beneficiary during the income year or within 6 months of the end of the income year

whether or not the beneficiary is an infant or is subject to any other legal incapacity;

b the credit allowed to a beneficiary of a trust in respect of tax paid by the trustee of the trust in any income year be equal to the proportion of the total tax paid by the trustee

in that income year that the beneficiary income of the beneficiary bears to the total income derived by the trustee in that income year;

c the trustee of a trust continue to be liable for tax on beneficiary income as agent of the beneficiary; and

d the definition of a distribution encompass indirect distributions received from a trustee.

## 6.10 Distributions From Qualifying Trusts

6.10.1 As explained previously, the expression "taxable distribution" in relation to a trust refers to a distribution received by a beneficiary, other than beneficiary income, that we propose should be taxable. The taxation of trusts has never involved double taxation such as occurred under the classical system of company taxation. Where income has been taxed to the trustee and then distributed to a beneficiary, it has not constituted assessable income in the hands of the beneficiary.

6.10.2 Accordingly, we propose that distributions, other than beneficiary income, from qualifying trusts, which are trusts in respect of which the trustee income has been subject to tax in New Zealand in all income years since settlement of the trust, be non-assessable in the hands of beneficiaries. Thus, there would be no taxable distributions from a qualifying trust, other than distributions which represent beneficiary income.

### Recommendation

6.10.3 Accordingly, the Committee recommends that all distributions from the trustee of a qualifying trust (other than beneficiary income) be non-assessable in the hands of resident beneficiaries.

## 6.11 Distributions From Foreign Trusts

6.11.1 "Foreign trust" is the term we have employed in our draft legislation to describe trusts settled by persons who at no time after 17 December 1987 have been residents of New Zealand. These trusts came within the definition of a non-resident trust in Part 1 of our report but the latter term is now superseded. Foreign trusts have no connection with New Zealand apart from the residence here of a potential beneficiary. We therefore concluded in our previous report that distributions of accumulated income from such trusts should be taxable in New Zealand with a credit for any foreign taxes paid by trustees but that distributions of capital profits and corpus should be exempt in the hands of beneficiaries.

6.11.2 As noted in section 6.9, the income of a resident beneficiary from a trust arise from two sources - beneficiary income and distributions of trust accumulations received by a beneficiary in an income year after the year in which it is derived by the trustee, or distributions from current year gains of the trust that do not represent taxable income. Beneficiary income in respect of a foreign trust should be taxable according to the provisions outlined in section 6.9.

6.11.3 It is generally believed that the present law does not tax distributions (as distinct from beneficiary income) from foreign trusts. For this reason, we propose that distributions from foreign trusts of trustee income derived by a trustee in income years commencing on or before 1 April 1987 should remain exempt. Distributions of trustee income of a foreign trust derived in income years commencing after 1 April 1987 should, however, be taxable to resident beneficiaries.

6.11.4 As proposed in our previous report, we recommend that distributions from a foreign trust of capital profits, whenever derived, or corpus should remain exempt. As is the case in the

domestic context with respect to companies, when capital distributions are subject to more favourable tax treatment than income distributions, there is pressure to convert the latter to the former. An anti-avoidance rule is therefore necessary to prevent trustees generating contrived capital profits that could be channelled to New Zealand resident beneficiaries. Hence, we propose that a provision similar to that in section 4 relating to distributions of capital profits by companies be included to the effect that capital gains realised in transactions directly or indirectly with associated persons would be treated as a taxable distribution.

6.11.5 As we have indicated previously but, for clarity, note again, the income derived by a trustee in any income year will consist of taxable income (referred to in the draft legislation as "income") and non-taxable income (which is referred to as "capital gain" or "capital profit"). The taxable income will be either trustee income or, where it vests in or is paid or applied for the benefit of a beneficiary, beneficiary income. Thus, a distribution made to a beneficiary in any income year of income derived by the trustee in that year will be either beneficiary income or a non-assessable profit or gain. Distributions to beneficiaries of income derived in an earlier year will consist of either trustee income or capital profit or gain derived by the trustee in that year. To distinguish among these various sources, an ordering rule is necessary.

6.11.6 We propose that a distribution made to a beneficiary in any income year be deemed to be made first from the taxable income derived by the trustee in that year. Thus, to the extent that the taxable income of the trustee absorbed the distribution it would constitute beneficiary income of the beneficiary. Where distributions made in any income year exceeded the taxable income derived by the trustee in that year, the excess distribution should be deemed to be made first from any capital gains or profits derived by the trustee in that year. To the extent that

a distribution in any income year exceeded both the taxable income and capital gain or profit derived by the trustee in that year, the excess should be deemed to be made from the trustee income of the trust derived in the previous income year not previously deemed to have been distributed pursuant to these rules. Any balance of the distribution exceeding the trustee income of the trust should be deemed to be made from any capital gain or profit derived by the trustee in that previous year not previously deemed to have been allocated, and so on. The last amount deemed to be distributed would be the corpus of the trust.

6.11.7 The corpus of a trust should be defined as any property settled on the trust by natural persons valued at its market value at the time of settlement. Corpus should, however, exclude:

a property settled directly or indirectly, whether by one transaction or a series of transactions, by a trustee of another trust;

b property that would have constituted assessable income of the settlor but for the fact that it is diverted to the trust; and

c property in respect of which a deduction can be claimed by the settlor in calculating his or her assessable income.

6.11.8 Where the ordering rule deems a distribution to be beneficiary income, it would be taxed to a resident beneficiary in the same way as beneficiary income derived from other trusts. The beneficiary would receive a credit for any foreign income or withholding tax or New Zealand income tax paid by the trustee on the income.

6.11.9 Distributions other than beneficiary income are derived either from untaxed income of the trustee derived in the same year as the year of the distribution or of such income or trustee income derived in earlier years. Whenever a beneficiary receives a distribution from trustee income of an earlier year, some deferral benefit is obtained. Because of this, we propose that where a distribution received by beneficiary is deemed to be made from trustee income derived by the trustee, no credit be given to a beneficiary for any tax paid by a trustee on the income. We do, however, propose that withholding taxes should be creditable. The amount of the withholding credit should be the proportion of withholding tax paid in respect of the distribution that the taxable distribution bears to the total distribution received by the beneficiary.

6.11.10 Whether a distribution is deemed to be beneficiary income or a taxable distribution, it should be taxed at the marginal tax rate of the beneficiary.

6.11.11 The ordering rule outlined above would require the trustee on behalf of the beneficiary to determine the deemed source of all of the distributions made to any beneficiaries, not just those resident in New Zealand. A beneficiary should be required to provide sufficient information with a return of income to establish that the appropriate portion of a distribution has been included as assessable income and to establish the basis upon which any credit for foreign tax has been allocated. Where this information cannot be provided or is insufficient, all of the distribution should be taxable in the hands of the beneficiary.

### Recommendations

6.11.12 Accordingly, the Committee recommends that, with effect from 1 April 1988:

a distributions from a foreign trust be taxable to a resident beneficiary to the extent that they are made out of trustee income derived in any income year commencing after 1 April 1988 but all other distributions from a foreign trust, other than beneficiary income, be exempt;

b distributions from a foreign trust be deemed to be made first from the most recent income year of the trustee and, with respect to any income year, first, from taxable income derived by the trustee in that income year and, secondly, from non-taxable gains derived in that year;

c distributions of capital profits realised in transactions directly or indirectly with associated persons be treated as taxable distributions;

d corpus be defined as any property settled on a trust by natural persons valued at its market value at the time of settlement other than:

i property settled directly or indirectly, whether by one transaction or a series of transactions, by a trustee of another trust;

ii property that would have constituted assessable income of the settlor but for

the fact that it is diverted to the trust; and

iii property in respect of which a deduction can be claimed by the settlor in calculating his or her assessable income;

e where a distribution is deemed to be a taxable distribution other than beneficiary income, a credit for any foreign withholding tax be permitted such that the withholding credit does not exceed the proportion of the total withholding tax paid that the taxable distribution makes up of the total distribution; and

f the rate of tax applying to distributions from foreign trusts be the marginal tax rate of the recipient.

## 6.12 Distribution From Trusts Settled by New Residents

6.12.1 In section 6.7, we referred to a person who becomes resident in New Zealand after 17 December 1987 who had not previously been resident here after that date as a "new resident". We recommended that such a person should not be liable for tax on the trustee income of any trust settled before he or she became resident. This does not affect the liability of the trustee - the trustee is liable for tax on all of the trustee income of the trust, wherever it is derived, from the time at which the settlor becomes resident.

6.12.2 A trust settled by a new resident before he or she becomes resident has the status of a foreign trust. We propose

that distributions from such a trust which are attributable to income years prior to the person becoming resident should continue to be treated as distributions from a foreign trust. The provisions for attributing distributions to particular sources were outlined in the previous section.

6.12.3 Once the new resident settlor becomes resident, the trustee of the trust will be liable for tax in New Zealand on the foreign- and New Zealand-source trustee income of the trust derived in or after the income year in which the settlor becomes resident. The settlor could also elect to be liable for tax on such income, pursuant to recommendation c in paragraph 6.5.10. Provided that the liability for tax on trustee income is met by either the trustee or the settlor in every income year after the settlor becomes resident, distributions from the trust attributable to those income years should be treated as distributions from a qualifying trust.

### Recommendation

6.12.4 Accordingly, the Committee recommends that where a trust is settled by a new resident before the person becomes resident in New Zealand and the trustee or the settlor of the trust meets the New Zealand tax liability for tax on the foreign- and New Zealand-source trustee income of the trust in every income year after the settlor becomes resident:

a distributions from the trust which are attributed to income years ending before the settlor becomes resident be treated as distributions from a foreign trust; and

b distributions from the trust attributed to income years ending after the settlor becomes resident be treated as distributions from a qualifying trust.

## 6.13 Non-Qualifying Distributions

6.13.1 By "non-qualifying distributions", we mean distributions, other than beneficiary income, that are not distributions from either qualifying trusts or foreign trusts. In general, these are distributions from trusts in respect of which trustee income has not been subject to New Zealand tax in all years subsequent to their establishment but that have had a settlor who is or was a New Zealand resident at any time subsequent to 17 December 1987. For example, the settlor of the trust may in some years be resident in New Zealand and in other years not. In addition, distributions from a trust settled by a resident on a non-resident trustee before 17 December 1987 would be non-qualifying distributions unless the trust is converted to a qualifying trust pursuant to the recommendations outlined in chapter 8. Similarly, those from a testamentary trust (or an inter-vivos trust following the death of a resident settlor) in relation to which the trustee does not elect to be subject to tax in New Zealand on the foreign-source trustee income of the trust would be non-qualifying distributions.

6.13.2 In your press statement with the Minister of Revenue that accompanied our first report, you indicated that all distributions after 1 April 1988, except distributions of corpus, from trusts that had been settled by New Zealand residents but that do not come within the settlor regime would be taxable. In the terminology we have now adopted, a trust which comes within the settlor regime would be a qualifying trust. Accordingly, we propose that all non-qualifying distributions (other than beneficiary income) received by New Zealand residents be taxable with the exception of distributions of the corpus of the trust.

6.13.3 You also proposed that such distributions should be taxable with an interest charge to offset the benefit to the

recipient of the deferral of tax. As explained further in chapter 8, we consider that an interest charge would be unduly complex if it were to be other than arbitrary. As a simpler alternative, we propose that the deferral advantage enjoyed by a beneficiary in relation to a non-qualifying distribution be reduced by taxing such distributions at a higher rate. We recommend that the rate be 45 percent. For comparison with the effect of an interest charge, this rate would result in a tax impost on a distribution that would equate with the tax that would be payable if the distribution were assumed to be income derived by the trustee over a period of five years immediately preceding its receipt by the beneficiary and interest were charged on the outstanding tax at a compound rate of 16 percent.

6.13.4 In addition, we propose that a credit should be permitted for foreign withholding taxes paid on non-qualifying distributions but not for income taxes paid by the trustee. The amount of withholding tax allowed as a credit should be the proportion of the total withholding tax paid on the distribution that the taxable distribution (which would be the entire amount of the distribution other than that part deemed to be corpus according to the ordering rule outlined in section 6.11) bears to the total distribution received by the beneficiary.

6.13.5 In order that fictional distributions are not counted, such as settlements of sub-trusts, distributions of trust accumulations by a trustee to another trust or distributions over which the trustee retains control should be deemed not to have been made for the purposes of applying the ordering rule. Where a beneficiary cannot provide satisfactory records to support the allocation of a portion of a distribution to corpus in accordance with the procedures set out in the previous paragraph, all of the distribution should be treated as a taxable distribution.

6.13.6 Non-qualifying distributions would also arise where the trustee or a new resident settlor of a trust settled before the settlor became resident here does not meet the New Zealand tax liability on the trustee income of the trust in respect of income years after the settlor becomes resident. All of the distributions of the trust, other than beneficiary income, would be treated as non-qualifying distributions.

### Recommendations

6.13.7 Accordingly, the Committee recommends that:

a distributions from a trust which are not distributions from a qualifying trust or a foreign trust ("non-qualifying distributions"), other than such distributions which are beneficiary income or distributions of corpus, be taxable at a rate of 45 percent;

b non-qualifying distributions be deemed to be made first from sources other than corpus; and

c a credit be permitted for foreign withholding tax paid on a non-qualifying distribution but not for any income tax paid by the trustee.

## 6.14 Financial Assistance to Trusts

6.14.1 In our previous report, we proposed that a resident settlor of a trust settled before 17 December 1987 who did not elect to be subject to tax on trustee income should be liable for tax on income that would be deemed to be derived in respect of any financial assistance the settlor had provided to the trustee of the trust. This was proposed as a quid pro quo for not being liable for tax on the trustee income. The same

argument applies wherever a settlor of a trust is resident here but the trust is such that distributions from it would be non-qualifying distributions. This would be the case, for example, if a settlor or trustee of a trust settled after 17 December failed to meet the New Zealand tax liability on the trustee income of the trust. Similarly, it would be the case where a new resident settlor failed to meet the obligation to pay tax on the trustee income of a trust settled before the person became resident here.

6.14.2 Accordingly, we propose that, where a distribution from a trust would be a non-qualifying distribution and:

a a resident settlor of the trust has a loan outstanding to the trustee and the rate of interest is less than the prescribed interest rate applying for fringe benefit tax purposes, the settlor should be assessed on interest on the loan outstanding computed at that rate. To avoid double-counting, any interest actually assessed to the settlor in respect of the loan should be deducted from the amount of deemed interest; or

b a resident settlor has a form of financial assistance, other than a loan, outstanding to the trustee of the trust, such as a guarantee, the settlor should be assessed annually on an amount equal to the consideration that would have been payable in an arms length transaction, less any consideration returned as assessable income of the settlor.

### Recommendation

6.14.3 Accordingly, the Committee recommends that, where a distribution from a trust would be a non-qualifying distribution and:

a a resident settlor of the trust has a loan outstanding to the trustee and the rate of interest is less than the prescribed interest rate applying for fringe benefit tax purposes, the settlor be assessed on interest on the loan outstanding computed at that rate, less any interest actually assessed to the settlor in respect of the loan; or

b a resident settlor has a form of financial assistance, other than a loan, outstanding to the trustee of the trust, such as a guarantee, the settlor be assessed annually on an amount equal to the consideration that would have been payable in an arms length transaction, less any consideration returned as assessable income of the settlor.

## 6.15 Residence of a Beneficiary

6.15.1 One of the consequences of a sharp distinction between taxable and exempt distributions is that, where an otherwise taxable distribution is large enough, there would be an incentive for the intended recipient beneficiary to become a non-resident in order to receive the distribution. The Committee's proposed changes to the definition of residence of a natural person would make it considerably more difficult for a resident to cease to be resident. Nevertheless, we consider that a further provision is needed to the effect that, where a resident ceases to be a

resident and within 5 years again becomes a resident, any taxable distributions received by the person during the period in which he or she was a non-resident from a trust, other than a qualifying trust, should be assessable in the income year in which the person commences to be resident again.

### Recommendation

6.15.2 The Committee therefore recommends that where a resident ceases to be a resident and within 5 years again becomes a resident, any taxable distributions received by the person during the period in which he or she was not a resident, other than distributions from a qualifying trust, be assessable in the income year in which the person commences to be resident.

# CHAPTER 7 – DISCLOSURE AND DEFAULT METHODS

## 7.1 Introduction

7.1.1 The BE, FIF and trust regimes will be amongst the provisions of the Income Tax Act which are the most difficult for the Inland Revenue Department to administer. This is in part because of their relative complexity and in part because much of the information the Department will need to administer them will be found offshore and often in countries with which New Zealand has no tax treaty and hence no exchange of information agreement. Thus, in the first instance, the administration of the reforms will depend critically on the information which taxpayers provide to the Department. It follows that the information disclosure requirements, far from being a minor aspect, are central to the effective administration of the regimes. Considerable care needs to be given in deciding what information taxpayers should be required to disclose.

7.1.2 This is important not only for administration but also for satisfactory compliance with the regimes. Voluntary compliance is encouraged if taxpayers are required to disclose relevant information and if there are substantial penalties for non-disclosure. Disclosure needs, however, to be selective. Too much information may hinder administration and compliance as effectively as too little.

7.1.3 We commented briefly on the importance of the disclosure of information and appropriate penalties for non-disclosure in our first report. This chapter outlines the Committee's views in more detail. We also comment on the way in which alternative assessment provisions might operate where there is non-disclosure or insufficient information to apply the BE, FIF or trust regimes. You announced in the Government

Economic Statement that the penalty provisions of the Act are to be reviewed and in the light of this we make no further comment on penalties. Special penalties for these regimes are not needed - the general provisions of the Act, strengthened as necessary, should be sufficient.

7.1.4 Section 245R of the draft legislation provides the Commissioner with a general power to require the disclosure of sufficient information to establish the nature of any interest a taxpayer has in a foreign entity, whether or not the entity is a CFC or a FIF, and to compute the taxpayer's attributed foreign income or loss. The disclosure requirements in relation to trusts are provided for in section 231 of the draft legislation.

## 7.2 Disclosure: BE Regime

7.2.1 In general, residents should be required to disclose their direct control interests in foreign companies and the direct control interests held by associated persons. Where a resident does not personally hold a direct interest in a CFC, he or she should not be required to disclose the interests held by associates unless they are non-resident.

7.2.2 In order to avoid requiring taxpayers to disclose interests in companies which are unlikely to be either CFCs or FIFs, exemptions from this general rule will be needed. For example, an exemption from any disclosure requirement could be given for minor interests in listed companies resident in grey list countries. Limiting the scope of any general disclosure provision in this manner would avoid duplication since disclosure of interests in such companies is required for the return of dividends.

7.2.3 Where a resident has a direct control interest in a CFC, his or her income interest in the CFC needs to be computed

and disclosed. In addition, the person needs to disclose indirect interests held through that CFC or an associate of the CFC. Where an underlying foreign company becomes a CFC by virtue of the indirect control provisions, residents need to disclose their income interests in the underlying CFC.

7.2.4 Direct control interests held by persons in the capacity of a nominee should also be disclosed, though disclosure of such interests should also have been made by the principal. The nominee definition includes a person who, pursuant to an arrangement or understanding or otherwise, holds powers or rights on behalf of another person. The starting point in applying a provision such as this is to ask taxpayers to disclose such arrangements or understandings.

7.2.5 In addition to the disclosure of control interests held on any measurement day, disclosure should also be required of dispositions and changes in the capital structure of a CFC to support the "bed and breakfast" rules described in section 3.3 of chapter 3. The information disclosed would also assist in the application of section 65(2)(e) of the Act. Thus, taxpayers would be required to disclose (except where an exemption from disclosure applied):

a any interest in a foreign company disposed of before a quarterly measurement day and interests acquired in the same company within 183 days of the disposition;

b any acquisition of an interest in a foreign company before a quarterly measurement day and any disposition of an interest in the same company within 183 days of the acquisition; and

c any changes in the aggregate interests in a company before a measurement day to the extent to which they are reversed within 365 days.

7.2.6 As discussed in chapter 3, residents who have a control interest of 10 percent or more in a foreign company, whether a CFC or not, at any time during its accounting year should be required to disclose:

a their interests held on the balance date of the company and their disposals of such interests during the accounting year; and

b where a resident has a control interest of 10 percent or more in a CFC and that CFC has a control interest of 10 percent or more in another foreign company, the interests held by the CFC in that foreign company on its balance date and the disposals of such interests that the CFC makes during its accounting year.

Where appropriate, the disclosure requirements should apply to interests held, acquired or disposed of by persons associated with the taxpayer.

7.2.7 Where a person has an income interest of 10 percent or more in a CFC, the person should be required to provide a copy of the accounts of the CFC; details of the adjustments to accounting profit to arrive at the BE income of the CFC; the dividends received by the CFC; and the basis for calculating the person's attributed income or loss and tax credit claimed with respect to that CFC. A separate disclosure should be required in respect of each CFC in which a taxpayer has an interest in order to ensure compliance with the jurisdictional loss and tax credit limitation rules.

7.2.8 Where the aggregate income interests in a CFC of persons resident in New Zealand who hold income interests of 10 per cent or more in the CFC exceeds 100 percent, the names of persons who have those income interests should be disclosed to

ensure that no more than 100 percent of an income interest in a CFC is taken into account in attributing BE income or BE losses.

7.2.9 A number of provisions of the draft legislation relate to arrangements or understandings between taxpayers. These cannot be effective unless the Department requires taxpayers, as a first step, to disclose the existence of such arrangements and understandings. Furthermore, as noted in chapter 3, taxpayers should be required to reconcile significant differences between their control and income interests in a CFC.

### Recommendation

7.2.10 Accordingly, the Committee recommends that the Commissioner be given a general power to require the disclosure of sufficient information to establish the nature of any interest a taxpayer has in a foreign entity, whether or not the entity is a CFC, and to compute the taxpayer's attributed foreign income or loss.

## 7.3 Disclosure: FIF Regime

7.3.1 Interests disclosed under the provisions outlined above will include interests in FIFs that are companies. Where a company is resident or domiciled in a tax haven, it may be a FIF. Thus, taxpayers should be required to disclose interests held in tax haven entities and to compute their FIF income or loss. In order to determine whether a foreign company or a unit trust is a FIF, a taxpayer will need to consider the nature of the assets of the company, its residence for tax purposes, whether it receives a concessionary tax treatment in that country and its distribution policy. In some cases, it will be obvious that a foreign company will be a FIF and, in order to reduce compliance costs, the Commissioner could publish a list of such entities.

7.3.2 In addition, taxpayers should be required to disclose life insurance and superannuation policies issued by foreign companies or superannuation funds. Depending on their characteristics, some such policies will be interests in a FIF.

7.3.3 The basis upon which a taxpayer values an interest in a FIF should be disclosed and copies of any financial reports or equivalent information in respect of the FIF should accompany an income return. Section 245R of the draft legislation gives the Commissioner sufficient power to obtain the necessary information.

## 7.4 Disclosure: Trusts

7.4.1 The primary liability for tax on trustee income will fall on the trustee. Where a trustee is a resident, he or she should be required to disclose the name and address of the settlor of the trust and the names and addresses of beneficiaries who receive distributions or beneficiary income. Residents who have settled trusts on resident or non-resident trustees after 1 April 1988 should also be required to disclose the settlements and the name and address of the trustee(s). As outlined in chapter 6, the definition of a settlor and a settlement are both very broad.

7.4.2 Where a non-resident trustee fails to file a return or meet an obligation to pay New Zealand tax on trustee income, the resident settlor will be liable for the tax. In this event, the resident settlor should be required to provide the accounts of the trust and details of the calculation of its taxable income.

7.4.3 Settlors of trusts in existence on 1 April 1988 that were settled prior to 17 December 1987 should be required to disclose the settlement and the nature of any financial assistance outstanding to the trustees of the trust. In addition, they should disclose whether they have elected to have the trust

treated as a "qualifying trust".

7.4.4 Beneficiaries should be required to disclose sufficient information to establish the appropriate basis for the taxation of any property or income of a trust that vests to them in any income year. Where such property or income represents beneficiary income or non-assessable or taxable distributions, the names and addresses of trustees of the trust should be provided. Sufficient information should also be required to support:

a the claiming of a credit for any foreign income or foreign withholding tax paid in respect of beneficiary income;

b that a distribution is a non-assessable distribution; and

c if the tax rate on a distribution is the transitional 10 per cent rate, evidence of either the trust having been wound up on or before 31 March 1989.

7.4.5 Where a person receives income from a trust, the Commissioner's existing powers of disclosure are sufficient. An additional general power of disclosure is required to permit the Commissioner to require disclosure from settlors. A provision to this effect is contained in section 231 of the draft legislation.

### Recommendation

7.4.6 Accordingly, the Committee recommends that provision be included in the legislation to permit the Commissioner to require disclosure of information from residents who are settlors of trusts in existence on or after 1 April 1988.

## 7.5 Default Methods

7.5.1 Cases may arise where taxpayers are unable to obtain the information necessary to apply the BE regime. Alternatively, taxpayers may fail to disclose information requested by the Commissioner. The information necessary to apply the FIF regime will generally be much less than that required under the BE regime though circumstances may occur where market values of interests in FIFs may not be available from published data or from the fund itself. It will then be necessary to estimate market values or, where this is not feasible due to insufficient information, both the taxpayer and the Commissioner will need to resort to alternatives.

7.5.2 Where the primary basis of computing income could be applied by the taxpayer, failure to apply it would constitute evasion. As discussed, the disclosure provisions and associated penalties will encourage compliance. Nevertheless, the alternative methods should not produce a more favourable outcome.

7.5.3 The draft legislation contains a non-exhaustive list of methods that the Commissioner could apply to determine the income or loss of a taxpayer in respect of an interest in a CFC or FIF. In particular, the Commissioner could make an assessment of income or loss by:

a having regard to the accounts or other information of the CFC or FIF prepared for tax purposes (whether in New Zealand or any other country), or for creditors, shareholders or other persons having an economic relationship with the CFC or FIF;

b having regard to the BE or FIF income or loss of the CFC or FIF for a prior period and, where it

is an amount of income, applying a presumed compound rate of increase of not less than 10 percent;

c having regard to the income of the CFC or FIF as reported in its financial accounts for a prior year and applying a presumed compound rate of increase of not less than 10 percent;

d imputing an appropriate rate of return, such as a government stock yield plus a margin, to the value of the interest at the commencement of the relevant period; or

e treating as attributed income or loss or FIF income or loss, as the case may be, any gain derived or loss incurred on disposal of the interests in question or any increase or reduction in the market value of the interest over the relevant period.

7.5.4 A default provision has also been included in the draft legislation to apply to the calculation of trustee income.

### Recommendation

7.5.5 Accordingly, the Committee recommends that provision be included in the legislation for the calculation of the income or loss of a taxpayer where the taxpayer is unable to obtain sufficient information or where there is failure to disclose information.

# CHAPTER 8 – TRANSITION

## 8.1 Introduction

8.1.1 The transitional provisions applying to the international reforms were largely decided in response to Part 1 of our report. We propose one additional provision with respect to the BE regime and comment further on the trust transition where you reserved your decision. These issues are dealt with in this chapter.

8.1.2 No transitional provisions are to apply to the FIF regime which came into effect on 1 April 1988. This means that residents with interests in a FIF on 1 April 1988 will need to establish the market value of their interests on that date.

## 8.2 BE Regime Transition

8.2.1 The transitional arrangements approved for the BE regime provide that:

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

b taxpayers will be exempt from the regime for a one year period (i.e. until 1 April 1989) with respect to income interests which were acquired after 17 December 1987 in CFCs which are resident in a grey list country.

It is possible for a company to have no fiscal residence. Consequently, in order to establish that a CFC is not resident in a country on the transitional list, it is necessary to require taxpayers to establish that the CFC is resident in a country not on the list.

8.2.2 One of the consequences of the BE regime is that, where any provision of the tax law of the country of residence of a CFC has the effect of reducing the income tax it pays in that country, the tax credit allowed to New Zealand residents will also be reduced, thereby increasing the amount of New Zealand tax payable. This is the intended result since a central objective of the regime is to levy New Zealand tax on income which has borne less tax than would be levied under New Zealand law. Tax losses of a CFC, incurred in a past income year or by another company in the same group, which are available under the tax law of its country of residence for offset against its current year income, are an example of such a provision.

8.2.3 Many submissions argued that the benefit of past tax losses in particular (i.e. those incurred by a foreign company before it becomes a CFC or before the BE regime applies to it) should not be "clawed back" under the BE regime. In the Committee's view, it is difficult to distinguish the effect of a CFC's past tax losses from the effect of other provisions of the tax law of its country of residence. If the BE regime were never to offset the effect of a tax benefit available to a CFC, it would be necessary to define BE income as the taxable income of the CFC measured according to the law of its country of residence. The BE regime would then have an impact only where another country had a company tax rate lower than New Zealand's. Thus, we consider that no special provision should be included to preserve the effect of past tax losses of a CFC. Once the BE regime applies in respect of a CFC, attributed losses will be able to be carried forward by resident taxpayers so that it is not necessary to adjust the BE income for tax losses carried

forward by a CFC. The attribution of BE losses to New Zealand resident taxpayers is explained in chapter 4.

8.2.4 While residents can take these considerations into account in making future investment decisions, they cannot do so in respect of existing investments except by disposing of them. We therefore propose an additional transitional measure to the ones proposed in Part 1 of our report. We propose that taxpayers with income interests held on 17 December 1987 in CFCs resident in a country other than those on the transitional list should be able to elect to bring those interests within the BE regime for the accounting years of such CFCs falling (in whole or in part) during the period commencing on 1 April 1988 and ending on 31 March 1990. Taxpayers should not, however, be able to bring in only losses and not profits. The election should therefore be available only if a taxpayer chooses to bring in all of his or her interests held on 17 December 1987 that would give rise to attributed income or losses under the BE regime from 1 April 1990.

8.2.5 The election should be made by taxpayers in their 1991 income year return. The aggregate attributed loss of the taxpayer for the period from 1 April 1988 to 1 April 1990 would be brought to account in the 1991 income year. The measure should not, however, enable taxpayers to increase an attributed loss over what it would have been in the absence of this transitional provision. For the purposes of calculating the attributed loss of a taxpayer in each of the transitional years, the taxpayer's income interest on any measurement day should be taken as the lesser of his or her income interest on that day and the income interest held at 17 December 1987. Any attributed income in one of those years should, however, be calculated according to the rules set out in chapters 3 and 4.

### Recommendations

8.2.6 Accordingly, the Committee recommends that:

a taxpayers be entitled to elect, in respect of all of their income interests held on 17 December 1987 in all CFCs resident in countries other than those on the transitional list, to apply the BE regime for the accounting years of such CFCs falling in whole or in part during the period 1 April 1988 to 31 March 1990; and

b for the purposes of calculating the attributed loss of a taxpayer in respect of each such CFC in the transitional period, the taxpayer's income interest on any measurement day be taken as the lesser of the taxpayer's income interest on that day and the income interest he or she held at 17 December 1987.

## 8.3 Trust Transition

8.3.1 As outlined in chapter 6, residents who settle a trust on or before 17 December 1987 are not to be liable for tax on the trustee income of the trust as agent of the trustee. This does not affect the trustee's liability - the trustee, whether resident or not, will be liable for tax on trustee income in any income year in which there is a settlor resident in New Zealand. Where a settlement is made after 17 December 1987, the settlor will not be liable as agent of the trustee if the trustee is a resident natural person or trustee company.

8.3.2 While residents who settled trusts on or before 17 December 1987 are to be relieved of liability as a settlor, an alternative transitional arrangement is to apply to them. This

was one of the areas in the Committee's first report where you reserved your decision. The Committee recommended that, in respect of settlements by residents on non-resident trustees in existence on 17 December 1987, distributions of income made on or before 31 March 1989 should be subject to a final tax at a rate of 10 percent and distributions of capital profits and corpus should be non-assessable provided that either the trust is wound up on or before that date or the settlor elects to be subject to the settlor regime from that date (i.e. the settlor elects to be liable for tax on the trustee income of the trust). In the terminology of this report and the draft legislation, the settlor regime means the qualifying trust regime.

8.3.3 We recommended that, if neither of these options were taken up and:

a the settlement was not a testamentary settlement:

i all distributions, whether of income or capital (other than the corpus of the trust) should be assessable, with an interest charge calculated from 1 April 1988, with the beneficiary receiving a credit for 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;

b the settlement was by will or as a result of intestacy;

i distributions of capital profits made after 31 March 1989 should continue to be non-assessable in the hands of beneficiaries; and

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

8.3.4 In response to these recommendations, you announced in your press statement with the Minister of Revenue that:

"At this stage, the Government considers that from 1 April 1989 resident trusts [i.e. those with resident settlors] 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."

8.3.5 The main problem with this approach is the administrative burden such a discretion would place on the Inland Revenue Department. Most settlors would be expected to apply for the exemption and the Department would need to decide in each case whether there was "manifest good reason" and either undue hardship or that a trust was subject to tax in a high tax jurisdiction. It is difficult to decide what criteria could be used to establish "manifest good reason". A trustee of a trust would no doubt verify that a settlor who was not a beneficiary had no right to the income or assets of the trust, since this is the legal position. The undue hardship test does not add to the general discretion of the Commissioner to waive tax in the case

of hardship. The substantive operative test would therefore be whether the trustee was subject to tax in a high tax jurisdiction.

8.3.6 Though this is a feasible test, it would bring within the regime settlors who have no way of altering their settlor status and who could therefore suffer a considerable additional tax liability which could not have been anticipated. Our proposed transition aimed to avoid this outcome.

8.3.7 To offset partially the deferral advantage of remaining outside the settlor regime, we proposed that distributions from a pre-17 December 1987 settlement should be subject to an interest charge in the hands of resident beneficiaries. Interest would be charged from the later of the 1988 income year or the year in which the income distributed was derived. The notional tax that would have been paid on the distributed income in the year that the income was derived would then be computed and carried forward at a prescribed interest rate to the year in which the distribution was made. An interest charge would therefore be complicated in practice, especially when the principal purpose of the provision is to encourage such trusts to either wind up or come within the qualifying trust regime. A simpler incentive should suffice.

8.3.8 A trust that was settled by a resident on or before 17 December 1987 would be a qualifying trust only if the trustee had paid New Zealand income tax on the foreign- and New Zealand-source trustee income of the trust in every income year since its settlement. This would generally not be the case if the trust earned foreign-source income and had no resident trustees. If there is a resident trustee, then tax would generally have been paid on all of the trustee income of the trust.

8.3.9 As outlined in chapter 6, where a trust settled by a resident on or before 17 December 1987 is not a qualifying

trust, we propose that all distributions from the trust, other than distributions of corpus, should be assessable at a rate of 45 percent and no credit should be given for any tax paid by the trustee other than withholding tax. We also proposed in chapter 6 that a resident settlor of such a trust should be assessed on income deemed to be derived in respect of any financial assistance outstanding to the trustee. We consider that the treatment of distributions from pre-17 December 1987 settlements by residents as non-qualifying distributions and the taxation of income deemed to be earned on any financial assistance given to the trustee adequately offsets the advantage that the persons connected with the trust derive by virtue of its trustee income not being subject to tax in New Zealand.

8.3.10 Nevertheless, the thrust of our previous recommendations was that the transitional measures should encourage the wind up of trusts settled on or before 17 December 1987. To this end, you agreed that distributions (other than distributions of capital profits or corpus) from trusts that were settled on or before 17 December 1987 are to be subject to a final tax at a rate of 10 percent provided that all of the property of the trust is distributed before 1 April 1989. Such distributions are therefore not to be included in the assessable income of the recipient. The definition of corpus for this purpose was discussed in section 6.11.

8.3.11 In addition, a beneficiary, settlor or trustee of a trust that was settled on or before 17 December 1987 is to have the option of converting the trust into a qualifying trust. In our previous report, we recommended that the conversion should be effected by the settlor electing to be liable for tax on the trustee income of the trust. We have, however, recommended in this report that all distributions from a qualifying trust should be non-assessable. A trust could therefore be converted to a qualifying trust and then wound up free of tax. This would not be consistent with the treatment outlined in the previous paragraph for trusts that wind up before 1 April 1989.

8.3.12 Accordingly, for greater consistency but also to encourage the wind up of trusts rather than their conversion to qualifying trusts, we propose that, in order for a trust to become a qualifying trust, a 10 percent tax should apply to the value of the net assets of the trust as at 31 March 1988. New Zealand income tax would then be deemed to have been paid on the trustee income of the trust in the income years ending before 31 March 1988. Where the value of the net assets of a trust exceed its corpus and any capital profits, this provision would result in a heavier tax impost than would be the case if the trust were wound up before 31 March 1989. We consider that this is appropriate so that there is a bias towards wind up. Since the relevant legislation will not be passed until later this year, we recommend that the last date for payment of the 10 percent tax be 7 February 1989.

8.3.13 Our proposals duplicate to some extent decisions that were made in response to our earlier report but, for the sake of completeness, we gather them together in the following recommendation.

### Recommendation

8.3.14 Accordingly, the Committee recommends that:

a where a trust has been settled on or before 17 December 1987, distributions from the trust, other than distributions of capital profits or corpus, be subject to a final tax in the hands of the beneficiary at a rate of 10 percent and distributions of capital profits and corpus be non-assessable provided that all of the property of the trust is distributed before 1 April 1989; and

b where a trust settled on or before 17 December

1987 is not a qualifying trust or a foreign trust and a beneficiary, settlor or trustee of the trust pays to the Commissioner no later than 7 February 1989 an amount equal to 10 percent of the net assets of the trust as at 31 March 1988, New Zealand income tax be deemed to have been paid on the trustee income of the trust in prior income years.

# CHAPTER 9 – IMPUTATION AND WITHHOLDING PAYMENT SYSTEMS

## 9.1 Introduction

9.1.1 The main features and many of the details of the imputation and withholding payment systems were outlined in the Committee's first report which you accepted in full. Thus, compared with the international tax regimes, few issues remain to be decided in respect of the imputation and withholding payment systems. Chapters 9 and 10 outline the Committee's recommendations on the remaining issues. This chapter deals with the imputation and withholding payment regimes. Consequential changes to other parts of the Act are discussed in chapter 10.

## 9.2 Draft Legislation

9.2.1 Like the international regime, the imputation and withholding payment regimes will result in major additions to the existing Income Tax Act. For ease of reference, each regime is best dealt with in a separate part of the Act. There is no particular significance to the location of these parts but we propose that the imputation legislation make up a new Part XIIA of the Act (immediately following Part XII, which deals with the provisional tax system), the withholding payment legislation a new Part XIIB and the branch equivalent tax account ("BETA") provisions a new part XIIC.

9.2.2 Within each part, the main sets of provisions are those concerning the operation of the imputation credit account ("ICA"), the withholding payment account ("WPA") and BETA respectively; the penalty tax provisions which apply when a company does not comply with the credit allocation rules; the provisions necessary to allow shareholders to utilise the

credits; the anti-avoidance provisions; and, lastly, a number of transitional arrangements.

9.2.3 In addition, a number of consequential changes are necessary to other sections of the Act. For example, we propose a new definition of a dividend and amendments to excess retention tax and the deemed dividend provisions. These are outlined in chapter 10.

## 9.3 Allocation Rules

9.3.1 The provisions concerning the operation of the imputation system by companies are contained in sections 394B to 394H of the draft legislation. The central feature of the scheme is the ICA. Each company will be required to operate an ICA since the balance in this account will determine the amount of credits that the company can allocate to its shareholders in any income year.

9.3.2 The allocation of credits by a company will be subject to the allocation rules proposed in our previous report which are designed to ensure that credits are apportioned across dividends and bonus issues made to all shareholders, rather than directed selectively to certain groups of shareholders. The principal requirement is that a company must maintain the same credit ratio (i.e. ratio of credit to the value of a dividend or taxable bonus share) for all dividends paid in any income year unless it makes a statutory declaration that a ratio change is not part of an arrangement to confer a taxation advantage on a group of shareholders. In our first report, we proposed that such declarations should be made at least 21 days in advance of the first distribution at the changed ratio but we now recommend that they should be able to be made at any time before the dividend is declared.

9.3.3 Where a company does not comply in any income year with

the requirement outlined in the previous paragraph, all the dividends (including taxable bonus shares) it pays in that year will be deemed to have been credited at the highest credit ratio applied by the company during the year. The corresponding aggregate credit deemed to have been allocated will be debited to the ICA of the company.

9.3.4 In addition, in order to ensure that the credit allocated to a dividend is not disproportionate to the amount of the dividend, the maximum ratio of imputation and withholding credit to dividend will be limited to the ratio of 28:72, based on the company tax rate of 28 percent. Where a company exceeds this ratio, it is necessary to impose some penalty. This was not dealt with in our earlier report. We therefore propose that, where the credit ratio of a dividend applied by a company exceeds the maximum ratio, the excess credit should not be allowed to shareholders, nor should it be included in the definition of a dividend. If the credit is an aggregate of an imputation credit and a withholding credit, the excess to be disallowed should be deemed to be, first, withholding credit and, secondly, imputation credit.

### Recommendation

9.3.5 Accordingly, the Committee recommends that:

a where the credit ratio of a dividend applied by a company exceeds the maximum ratio, the excess credit not be allowed to shareholders, nor included in the definition of a dividend; and

b a ratio change declaration be able to be made at any time before the first distribution at the changed ratio is distributed.

## 9.4 Deemed Dividends: Allocation Rules

9.4.1 Under the present Act, a number of types of payment or benefit given to the shareholders of certain companies are deemed to be dividends. As discussed in chapter 10, we consider that these provisions should be retained. Deemed dividends would, however, cause complications in the application of the allocation rules. First, the application of the deemed dividend provisions is uncertain. Thus, a payment or benefit given to a shareholder of a company may not be deemed to be a dividend until some time after the end of the income year in which it is paid or conferred. Since the deemed dividend would not have been credited, it would trigger an additional allocation debit to the ICA of the company in a previous income year. Secondly, the quantification of the value of a deemed dividend is also uncertain under the present rules. Where the Commissioner's assessment differed from the taxpayer's, a breach of the credit allocation rules may result, once again triggering an allocation debit.

9.4.2 In view of these uncertainties, we consider that it is impractical to require companies to allocate credits to deemed dividends in the same way as for cash dividends. As discussed in chapter 10, benefits previously deemed as dividends provided to "major shareholders" who are employees are to be brought within the fringe benefit regime. Consideration could be given to bringing all non-cash benefits provided to shareholders within the fringe benefit regime. In the interim, we propose that deemed dividends be excluded from the allocation rules where they arise in respect of benefits given to shareholders by way of the sale of company property to a shareholder at an inadequate consideration (presently dealt with under section 4(l)(b)); the purchase of property from a shareholder by a company for excessive consideration (a new provision); loans to shareholders other than bona fide loans at commercial interest rates; non-deductible expenditure enjoyed by proprietary company shareholders and associates; and excessive remuneration to

directors or shareholders of proprietary companies, or their relatives.

9.4.3 A separate category of deemed dividends is interest on debentures or convertible notes which fall within sections 192, 195 or 196 of the Act. These need to be treated in the same way as ordinary dividends for the purposes of the allocation rules.

### Recommendation

9.4.3 Accordingly, the Committee recommends that deemed dividends be excluded from the allocation rules where they arise in respect of benefits given to shareholders by way of the sale of company property to a shareholder at an inadequate consideration; the purchase of property from a shareholder by a company for excessive consideration; loans to shareholders other than bone fide loans at commercial interest rates; non-deductible expenditure enjoyed by proprietary company shareholders and associates; and excessive remuneration to directors or shareholders of proprietary companies, or their relatives.

## 9.5 Producer Boards

9.5.1 Co-operative companies and the producer boards (which are to lose their tax exempt status from the beginning of the 1989 income year) are to be included within the imputation system. The boards are created by statute and do not have a shareholding structure on which dividends and credit allocations could be based. They do, however, act on behalf of producers who can be regarded as their owners in an economic if not a legal sense. It is therefore appropriate to impute any income tax paid by boards to their respective producers.

9.5.2 The boards' operations take one of two principal forms:

a the Dairy Board and the Apple and Pear Marketing Board have an export monopoly and purchase produce from producers or producer co-operatives. Thus, these boards make produce payments directly or indirectly to suppliers;

b the Wool and Meat Boards do not have an export monopoly, though they may purchase product for price-smoothing reasons. The activities of these boards are funded principally by way of levies on producers which are proportionate to the value of each producer's output.

9.5.3 In both cases, the return to a producer takes the form of higher product prices as a result of the boards' direct or indirect involvement in price-smoothing, marketing and other forms of representation. Product payments or levies therefore provide an appropriate basis on which the boards could allocate credits to producers. Individual producers will receive product payments and/or pay levies at various times of the year. It is therefore necessary to aggregate product payments or levies over the income year and to base the credits subsequently allocated to each producer on the aggregate annual product payments received or aggregate levies paid by the producer during the year. Where credits are allocated on the basis of product payments, the proportion of the aggregate credit allocated to each producer in any income year would equal the proportion that the producer's product payment made up of the of the total product payments made by the board in the previous year (as the actual allocation could not be made until after the end of the year of production). Alternatively, the allocation could be on the basis of the value of product supplied during the production year, rather than on the payments made. An equivalent proportional allocation rule would apply where credits were allocated on the basis of levies. In either case, no credits could be allocated until after the end of the first year of operation of the scheme.

9.5.4 In practice, the Dairy Board buys produce from dairy companies who in turn purchase milk from their farmer suppliers. Thus, payments for produce pass from the Board to the companies and from the companies to farmers. For the purposes of the credit allocation rule outlined in the previous paragraph, each company can be regarded as a producer with respect to the Board.

9.5.5 Companies incorporated under the Companies Act will be able to allocate credits to either dividends or taxable bonus issues. In our view, the producer boards should have the option of distributing cash dividends as a means of allocating credits to their producers. The boards presently do not have any statutory authority to pay dividends so that the characterisation of a payment to a producer as a dividend would occur only in respect of its income tax treatment. Where a board is authorised to make a payment to a producer, for example, in consideration for product purchased, it would elect to make all or part of the payment non-deductible for tax purposes. The amount of the payment to be treated as a dividend should be calculated on the basis that the dividend were fully credited. For tax purposes only, the non-deductible payment would then be treated as a fully credited dividend. The dividend would be assessable to a producer in the same way as any other dividend, but the producer would be able to use the attached credit to offset the tax payable. The additional tax payable by a board therefore results in an equal tax saving to its producers. The mechanism to give effect to this election will be included in an amendment to section 199 which is currently being drafted by the Inland Revenue Department. We have anticipated this amendment in our draft legislation.

9.5.6 In order that cash flow considerations do not constrain a company's ability to allocate credits to its shareholders, companies will be able to allocate credits to taxable bonus issues. These will be taxed in the same way as dividends in the hands of shareholders. The boards do not at present have share capital so that a bonus issue allocation mechanism cannot be

used. It is, however, desirable that the boards have a mechanism for allocating credits without having to pay out cash dividends. Hence, we propose that they should be able to allocate credits to notional dividends. As proposed for cash dividends paid by a board, the amount of a notional dividend should be computed by assuming that it is fully credited. In other words, the allocation of a credit of 28 cents would require the declaration of a notional dividend of 72 cents. Producers would be taxed on the sum of the notional dividend and the credit in the same way as if the dividends were actual dividends. Where a producer member is a company, the notional dividend would not be assessable but the credit would be added to its ICA or WPA.

9.5.7 This credit allocation mechanism is equivalent to allocating credits to taxable bonus shares. In the latter case, the amount capitalised by way of the taxable bonus issue is added to the paid-up capital of the company. The distribution of capital will be subject to marshalling rules which are outlined in section 9.8. The boards do not, however, have a share capital so that a return of capital cannot be made in substitution for dividends. Thus, we propose that the boards be able to maintain a record of notional capital for tax purposes. The amount allocated to notional capital would equal the amount of notional dividends declared by the board, net of any credits. Actual cash payments sourced from notional capital would be exempt in the hands of the recipient producers.

9.5.8 The boards should also be able to operate a withholding payment account (WPA) in order that credits for withholding payments made can be passed through to producers and a branch equivalent tax account (BETA) in order to relieve any double taxation of the income of a CFC in which a board has an income interest of 10 percent or more.

### Recommendations

9.5.9 Accordingly, the Committee recommends that:

a the producer boards be able to operate an ICA and WPA for the purposes of allocating credits to their constituent producers and a BETA for the purposes of relieving double taxation of income derived under the BE regime;

b a board be able to allocate credits to either payments made to producers, which would be non-deductible and treated as dividends for tax purposes, or to notional dividends and in either case the amount of the dividend be computed on the basis that it is fully credited;

c an allocation of credits by a board to its producers by way of cash and/or notional dividends be made only once in each income year;

d the credits allocated by a board to its producers be in proportion to the product payments made or payable by the board to its producers and/or in proportion to the levies paid or payable by producers to the board;

e the boards be able to maintain records for tax purposes in which to credit the net amount of notional dividends allocated (i.e. the gross notional dividends allocated less the amount of the credits attached to them);

f the notional capital of a board be able to be distributed tax free to producers.

## 9.6 Co-operative Companies

9.6.1 A number of co-operatives are in a similar position to the producer boards in that the return they provide to their members is in the form of reduced input prices or higher output prices rather than dividends. Co-operative companies do, however, have issued share capital and may pay dividends to members. The number of shares held may, however, be unimportant since the return members obtain usually depends primarily on their transactions with the co-operative rather than their shareholdings. We therefore propose that co-operative companies be treated in much the same way as we have recommended for the producer boards. Thus, they would have the option of electing to make a payment to members non-deductible to the co-operative for tax purposes in which case it would be treated as a dividend. Credits could then be allocated to the dividend. In the event that cash dividends were not available, the notional dividend allocation mechanism outlined for the producer boards could be used. In either case, the credits would be allocated to members on the basis of their transactions with the co-operative.

9.6.2 Since some co-operative companies do, however, have a share capital and pay dividends, they should be also be able to allocate credits to dividends or taxable bonus shares in the same way as other companies.

9.6.3 The present section 199 applies not only to co-operative companies but more generally to "mutual associations". An association is widely defined as "any body or association of persons, whether incorporated or not". The Committee is uncertain of the nature of any unincorporated mutual associations and of their tax treatment. We therefore refrain from making any recommendations on the way they should be treated under imputation. Our recommendations therefore apply only to co-operative companies.

### Recommendation

9.6.4 The Committee therefore recommends that co-operative companies be treated in the same way as the producer boards for the purposes of imputation except that they also have the option available to other companies of allocating credits to dividends or taxable bonus shares.

## 9.7 Sharemilking Arrangements

9.7.1 One of the issues outstanding from our first report was whether a special arrangement was needed for sharemilkers who receive product payments through members of co-operatives though they themselves are not members. This would be the case under some sharemilking agreements. Where payments by a dairy company for milk supplied are made directly to a sharemilker and the land-owner, dividends and attached credits paid on the basis of product supplied should be paid directly to both persons on the same basis that payments for milk supplied would be made. In other words, the sharemilker should receive dividends from the co-operative even though he may not be a shareholder.

9.7.2 Where some other contractual arrangement exists, we would be reluctant to prescribe a general remedy. The parties involved can be expected to amend their contractual arrangements if they wish to. Where both the sharemilker and the land-owner are members of the co-operative, each would receive dividends and credits directly from the co-operative.

### Recommendation

9.7.3 Accordingly, the Committee recommends that, where payments by a dairy company for milk supplied are made directly to a sharemilker and the land-owner, dividends or bonus shares and attached credits paid on the basis of product supplied should be paid directly to both persons on the same basis that payments for milk supplied would be made.

## 9.8 Capital Distributions

9.8.1 The CD proposed that all distributions should be taxable, other than distributions of paid-up capital (including share premiums paid) made on the winding up of a company or on the redemption of shares. You agreed that this proposal should be amended by retaining the present exemption of distributions of capital profits on winding up.

9.8.2 The remaining issue is the treatment of a return of capital other than on winding up. In principle, a return of capital should not be taxed if it is merely a return of the capital paid in on the subscription of shares. If it were to be taxed, equity would be treated very differently from debt and instruments such as redeemable shares would not be viable. A return of capital should not, however, be a substitute for dividends and, pending solution of this problem, the Committee reserved its position on this issue in paragraph 2.6.4 of its earlier report.

9.8.3 It is conceivable that a company might issue shares, either of the same class or of separate classes, which are to be redeemed at regular intervals in the future. The redemptions would then be made instead of dividends. For example, if a company with a single class of shares redeems a certain percentage of every shareholder's holding each year, the resulting capital payments should be treated as dividends. Similarly, if a company issues a certain class of shares to its shareholders and then redeems them on a pro rata basis over a period of years, the return of capital should be treated as a dividend.

9.8.4 While providing for circumstances where a return of capital is made in substitution for a dividend, the legislation should give companies as much flexibility as possible to issue

redeemable shares. We therefore propose that a return of capital made on the redemption of shares, other than on winding up, should be treated as capital, and hence non-assessable, provided that:

a the shares were issued on terms such that they are to be redeemed at a specified date or dates or within a specified period; and

b the capital returned is equal to the amount paid in, including any premium, on the subscription of the shares; and

c the shares redeemed were not issued pursuant to an arrangement under which they were to be redeemed in a regular or systematic way such that it may reasonably be concluded that the return of capital is made in lieu of a dividend.

9.8.5 In addition to returning capital on the redemption of shares, capital may be returned pursuant to reductions in the par or nominal value of shares. Such partial redemptions will, however, invariably be made on a pro rata basis and hence on the same basis that dividends would be paid. For this reason, we propose that a distribution made on a partial reduction of the nominal or par value of shares not be treated as a return of capital but be treated as a dividend. We also propose that debentures which fall within sections 192 or 195 of the Act which are issued after 30 September 1988 be treated as shares for the purposes of these rules.

9.8.6 Our proposals are significantly different from those proposed in the CD so that it is reasonable that taxpayers have some notice of them. The implementation date of the proposals should also be integrated with the change to the tax treatment of bonus shares which is to come into effect on 1 October 1988. We therefore propose that they come into effect on 1 October 1988.

### Recommendation

9.8.7 Accordingly, the Committee recommends that, with effect from 1 October 1988, a return of capital made by a company on the redemption of shares (including debentures issued on or after 1 October 1988 which come within sections 192 or 195 of the Act), other than on winding up, be exempt from tax in the hands of the recipient provided that:

a the shares are issued on terms such that they are to be redeemed at a specified date or dates or within a specified period;

b the capital returned is equal to the amount paid in, including any premium, on the subscription of the shares; and

c the shares redeemed were not issued pursuant to an arrangement under which they were to be redeemed in a regular or systematic way such that it may reasonably be concluded that the return of capital is made in lieu of a dividend.

## 9.9 Carry Forward of Credits by a Company

9.9.1 In our first report, we referred to the need for anti-streaming provisions to ensure that the revenue cost of the imputation regime is not different from that envisaged by the Government. The allocation rules and anti-stapling provisions have this objective. In paragraph 2.4.8 of our earlier report, we referred to the possible need for a specific anti-avoidance rule buttressed by disclosure requirements to counteract temporary transfers of interests aimed at avoiding the allocation rules. The effect of the allocation rules would also

be avoided by the accumulation of credits within companies which were then sold.

9.9.2 To limit the opportunity for such credit trapping and sale, we recommend in chapter 10 that excess retention tax be retained. This measure by itself is, however, not sufficient since, for example, the New Zealand holding company of a non-resident is not liable for ERT.

9.9.3 To supplement ERT with respect to companies owned by residents and as a measure effective in relation to non-residents, the Committee proposes that a 75 percent commonality of interests be required (using the same tests already used in section 188 of the Act with respect to the carry forward of losses, but extended to include fixed dividend shares) for a company to be able to carry forward the credit balance of its ICA, WPA or BETA. In the event that the 75 percent commonality is lost, a debit would arise in the relevant account equal to the credit balance of the account on the date that the required degree of commonality is lost. This measure will reduce trafficking in credits and is consistent with the integration principles underlying a full imputation system.

9.9.4 The compliance costs of a shareholding commonality rule are undoubtedly highest for listed companies because of normal trading of shares and the need to trace shareholdings through interposed companies. Moreover, listed companies and their subsidiaries are unlikely to be used as credit traps since their shareholders will generally be residents who are able to utilise the credits. Hence, we propose that there be an exception to the proposed commonality rule for companies listed on the New Zealand stock exchange and their wholly-owned subsidiaries.

### Recommendation

9.9.5 Accordingly, the Committee recommends that a 75 percent commonality of shareholding (using the tests presently

contained in section 188 of the Act but extended to include fixed dividend shares) be required for a company, other than a company listed on the New Zealand stock exchange or a wholly-owned subsidiary of such a company, to be able to carry forward the credit balance of its ICA, WPA or BETA.

## 9.10 Carry Forward of Unutilised Imputation Credits

9.10.1 Taxpayers in tax loss would be unable to utilise imputation credits (which are referred to in the draft legislation as "tax credits") so, in response to the Committee's recommendation, you agreed that they should be able to gross up the amount of any credit by dividing by a tax rate of 28 percent and adding the resulting amount to the amount of the tax loss to be carried forward. This was the mechanism that could at present be most easily accommodated within the Department's existing administrative and EDP systems. A better system would be to carry forward the amount of the unutilised credit but, according to the Department, it would be unable to implement this in the next year or so.

9.10.2 Since a system based on converting an unutilised credit to a loss carry forward is feasible, there seems no reason why it should not extend to all taxpayers. This would reduce the incentive for arbitrage amongst taxpayers aimed at utilising what would otherwise be wasted credits. Thus, we propose that all resident taxpayers, other than companies, be able to convert any imputation credits in excess of their tax liability in any income year, after taking into account all other tax reliefs, into a tax loss to be carried forward, where the amount of the loss is calculated as the amount of the unutilised credit divided by 0.28.

### Recommendation

9.10.3 Accordingly, we recommend that that all resident taxpayers, other than companies, be able to convert any imputation credits in excess of their tax liability in any income year into a tax loss to be carried forward, with the amount of the loss calculated as the total amount of the unutilised credit divided by 0.28.

## 9.11 Refunds of Dividend Withholding Payment

9.11.1 The dividend withholding payment will be levied on dividends received on or after 1 April 1988 by resident companies from non-resident companies. The amount of the payment is intended to approximate the income tax that a non-corporate shareholder would pay on a dividend from a non-resident company if the dividend passed directly to the person. Where the eventual recipient shareholder would not incur such a liability, such as a non-resident or tax-exempt shareholder, or where the amount withheld exceeds a resident shareholder's tax liability, the excess is to be refunded.

9.11.2 The withholding payment is to be paid quarterly. The Government Economic Statement proposed that refunds to non-resident companies be made by the resident company paying the dividend. In our first report, we proposed that the payer company should offset the refund paid to a non-resident against its withholding payment liability for the quarter in which the refund was made. If the refund paid exceeded the liability, the excess would be refunded by the Department. Refunds to tax-exempt shareholders were to be made quarterly by the Department. In our report, we proposed that excess withholding credits should also be refunded to other resident taxpayers at the end of the year in the same way as refunds of other tax.

9.11.3 We have given further consideration to the refund

mechanism. A problem with the proposed system is that the Department would be required to make reimbursing refunds to companies and refunds to tax-exempt shareholders before it had assessed withholding payment liabilities to verify, where necessary, that the withholding payment to be refunded had indeed been paid. One approach would be to have quarterly assessments but this would raise significantly the administrative and compliance costs involved. A more efficient system from an administrative point of view is to have annual assessments and annual refunds for all shareholders.

9.11.4 If an annual refund system were adopted, resident companies would face an unreasonable cash flow burden if they had to make not only the original withholding payment and pay that to the Department, but also refunds to non-resident shareholders that would be reimbursed only after the end of the year. We therefore consider that refunds to non-residents should be made by the Department on an end of year basis on application by a non-resident.

9.11.5 Withholding payment collected on behalf of non-resident shareholders can be viewed as an advance payment of some or all of their non-resident withholding tax (NRWT) liability on dividends paid. Thus, the withholding credit allocated to a dividend paid to a non-resident should be credited towards the NRWT payable on the dividend. Where the withholding credit was less than the NRWT payable, the payer company would be obliged to deduct the balance of the NRWT and pay it over to the Department as under the present system. Conversely, where the withholding credit exceeded the NRWT payable, the non-resident would claim a refund of the excess by making an application to the Department after the end of the income year in which the dividend was paid. Finally, if the withholding credit equalled the NRWT liability, no further payment or refund would be required.

9.11.6 The application for a refund by a non-resident or any

other shareholder would need to be supported by the dividend statement supplied by the payer company. The draft legislation details the information that we propose be required to be included in the statement.

### Recommendation

9.11.7 Accordingly, the Committee recommends that:

a refunds of dividend withholding payment to all shareholders, irrespective of their residence or tax status, be made by the Department after the end of the income year in which the corresponding withholding credit was received;

b where a withholding payment credit is allocated to a dividend paid to a non-resident, the non-resident withholding tax payable on the dividend be offset to the extent of the withholding payment credit.

## 9.12 Integration With BE Regime: Individuals

9.12.1 In our previous report, we recommended that individuals, like companies, should be able to operate a branch equivalent tax account ("BETA") for the purposes of avoiding double taxation of the income of a CFC, once as attributed income under the BE regime and again as a dividend when the income is distributed. The BETA would record the amount of tax paid by a person on attributed foreign income. The person could then offset tax payable on a dividend received from a CFC to the extent of the credit balance in the account. The computation of the tax payable on attributed income and the withholding payment liability on a dividend is straightforward for a company because of the flat rate of company and withholding tax. It is, however, more complicated for non-corporate taxpayers because of the

progressive rate scale.

9.12.2 The objective of avoiding double taxation in the case of non-corporate taxpayers can be achieved more simply by recording in BETA the amount of attributed income the person has derived, rather than the tax paid on such income. A dividend received from a CFC would then be non-assessable to the extent of the credit balance in the account. We therefore recommend this approach instead of that proposed in our previous report.

### Recommendation

9.12.3 Accordingly, the Committee recommends that, where a non-corporate taxpayer elects to establish a branch equivalent tax account, the amounts to be credited to the account be the attributed income derived by the person under the BE regime.

## 9.13 Group Investment Funds

9.13.1 Section 211A of the Act deals with group investment funds. The income of such funds is divided into two categories with "category A" income taxed as if it were derived by a company. The "category" B income of a fund is taxed as if it were derived by a trustee. A distribution of after-tax category A income is treated as dividend. As the trustees of such funds are taxed in the same way as companies in relation to category A income, it is appropriate that they be permitted to impute tax on distributions of category A income as if they were companies. The draft legislation gives effect to this.

# CHAPTER 10 – IMPUTATION: RELATED ISSUES

## 10.1 Introduction

10.1.1 This chapter outlines the Committee's recommendations on sundry other issues raised by the imputation reforms, including the definition of a dividend, the amendments to the fringe benefit tax regime and excess retention tax.

## 10.2 Dividend Definition

10.2.1 In paragraph 4.7.1 of our earlier report, we advised that we were considering amendments to the section 4 definition of a dividend. One possibility was the extension of the ambit of the present section 4(2) dealing with proprietary company dividends, to all companies. The desirability of doing so, however, is due more to the weaknesses of the proprietary company definition rather than to any perceived avoidance policies of non-proprietary companies. In section 10.6, we suggest that the proprietary company definition requires review and, pending that review, we do not propose that the present section 4(2) ambit be broadened.

10.2.2 One deficiency of the existing dividend definition is that the provision of benefits to shareholders other than by way of distributions or dispositions are not clearly within the definition. As benefits can be conferred upon shareholders in this way, we propose to include as dividends the making available of any company property for the benefit of any shareholder if in the opinion of the Commissioner the making available of the property is virtually a distribution of an amount which, if distributed other than in the course of winding-up of the company, would be a dividend. We also propose to extend

the dividend definition to include any excessive consideration provided by a company upon the acquisition of property from a shareholder. The taxable value of the dividend in the first case would be the amount by which the value of the benefit or property acquired by a shareholder exceeds any consideration provided by the shareholder. In the second case, the taxable value of the dividend would be the amount by which the consideration provided by the company exceeds the market value of the property acquired by the company.

10.2.3 Since these changes would extend the existing definition of a dividend, it is reasonable that taxpayers should have some notice of them before they come into effect. Accordingly, the Committee proposes that they take effect from 1 October 1988.

10.2.4 At present, section 4(2) deems to be a dividend any expenditure incurred by a proprietary company for the benefit of a shareholder, spouse of the shareholder, trust under which the shareholder or his or her spouse is a beneficiary or any other person associated with the shareholder. In order that we do not restrict the definition of a dividend with respect to a proprietary company, we propose that the extended definition of a dividend outlined in the previous paragraph apply where the person acquiring or disposing of the property in question is an associate of a shareholder of a proprietary company. By "associate", we mean any of the persons listed in the present section 4(2).

10.2.5 The CD proposed a definition of the term "paid up capital" meaning capital which could be returned free of tax upon winding-up or redemption. In our draft definition of dividend, we have adopted an alternative to this. A new section 4 defines widely the types of transactions which are initially considered to be dividends. A new section 4A contains exclusions from the section 4 net, so that no definition of "paid up capital" is required. Since our redrafted definition, apart from

the changes proposed in paragraph 10.2.2 (which we suggest come into effect from 1 October 1988), merely attempts to state more clearly the present definition, we consider that it should come into effect from the commencement of the present income year.

### Recommendation

10.2.6 The Committee therefore recommends that the definition of a dividend be extended with effect from 1 October 1988 to include, with respect to any person who is a shareholder of a company or, where the company is a proprietary company, an associate of a shareholder:

a the value of any benefit or property provided by the company to the person to the extent that it exceeds any consideration provided by the person for the provision of the benefit or property; and

b consideration provided by the company upon the acquisition of property from the person to the extent that it exceeds the market value of the property acquired by the company.

## 10.3 Section 190

10.3.1 Section 190 of the Act permits the Commissioner to disallow a deduction to a proprietary company for remuneration paid to a director, a shareholder or a relative of those persons if the remuneration is considered unreasonably high. The disallowed amount is deemed to be a dividend paid to the recipient. Such arrangements may appear more attractive in the light of the Committee's recommendation that, due to uncertainties in the application of the deemed dividend provisions, such dividends be excluded from the credit allocation rules. Hence, the Committee proposes that section 190

be retained in amended form.

10.3.2 The proviso to section 190 has the effect that the section does not apply where the recipient of the remuneration is an adult employed substantially full time in the business of the company and participating in its administration and management, and the remuneration is not influenced by the fact that the recipient is a relative of a shareholder or director. Because of the ease with which the proviso can be invoked and the possibility of streaming arrangements being entered into, the Committee proposes that, with effect from the commencement of the 1990 income year, the proviso exemption be limited to persons who are residents. This would have the dual effect of limiting the use of remuneration as a means of avoiding the allocation rules and reinforcing one of the few interjurisdictional allocation rules presently in the Act.

### Recommendation

10.3.3 Accordingly, the Committee recommends that the proviso to section 190 be amended, with effect from the commencement of the 1990 income year, to limit its application to resident recipients of remuneration.

## 10.4 Section 197

10.4.1 Section 197 relates to distributions of trading stock to shareholders as such, with distributions treated as a sale by the company and a purchase by the shareholder at market value. Section 197(3) makes it clear that the Commissioner's ability to deem the distribution to be a dividend under section 4 is not derogated by the deemed sale treatment under section 197(2).

10.4.2 The Consultative Document proposed the repeal of section 197 from the commencement of the 1989 income year. In our first report, we advised we were still considering this issue. The objective of the Act in regard to such distributions

of trading stock is to place the company and the shareholder in the same position as each would be had the trading stock been sold to a third party and the profit distributed as a dividend.

10.4.3 Merely to treat the distribution as a dividend without deeming the distribution to be a sale does not achieve this result, as it leaves the company with a deduction by way of a lower closing stock figure. Hence it is necessary to deem the distribution to be a sale and for this reason we recommend the retention of section 197.

### Recommendation

10.3.5 The Committee recommends that section 197 be retained.

## 10.4 Winding Up Distribution Tax

10.4.1 Winding up distribution tax ("WUDT") is designed to encourage the winding-up of companies which have ceased trading by levying tax at a concessional rate on taxable reserves distributed before 1 April 1989 in the course of and for the purpose of winding up. Winding up for this purpose includes a dissolution procedure provided for in section 335A of the Companies Act 1955. In our earlier report, we proposed that this should be a final tax. This means that non-resident withholding tax should not be levied on such distributions to non-residents, nor should any withholding payment be levied on such distributions received by companies upon the winding up of a non-resident company.

### Recommendation

10.4.2 The Committee recommends that distributions which have been subject to the winding up distribution tax not be liable for either non-resident withholding tax or dividend withholding payment.

## 10.5 Fringe Benefits Received by "Major Shareholders"

10.5.1 The CD proposed that as from 1 April 1988 fringe benefits provided by a company to any shareholder/employee should be subject to fringe benefit tax. Fringe benefits received by "major shareholders" of private companies had previously been treated as dividends and were excluded from the fringe benefit tax regime.

10.5.2 The Committee accepts that retention of the major/minor shareholder employee distinction for FBT purposes is now redundant. We have become aware that, as we did not comment on this proposal in our first report, there is an expectation amongst many taxpayers and their advisers that we did not support the CD proposal. As this expectation can be attributed to an omission on our part to comment explicitly in our earlier report, we believe that a delay in the implementation date of the proposal is justified in respect of some but not all fringe benefits.

10.5.3 Most benefits, with the exception of loans at concessional rates, to major shareholders who are also employees are currently subject to a deemed dividend provision. In respect of such fringe benefits other than loans, we believe that taxpayers will not be prejudiced by a 1 April 1988 commencement date as proposed in the CD.

10.5.4 The existing provision applicable to loans at concessional rates to major shareholders who are also employees is not a very effective provision so that bringing such loans into the fringe benefit regime will be a substantial change of treatment. Ideally such change should have a prospective application date. Due to the confusion over whether the CD proposal was to be implemented, we propose that the application of FBT to concessional rate loans to major shareholders who are

also employees be postponed to 1 October 1988. Such loans should remain subject to the deemed dividend provision before that date.

### Recommendation

10.5.5 Accordingly, the Committee recommends that fringe benefits received by any shareholder who is an employee be subject to the FBT regime rather than the current deemed dividend provisions:

a in respect of fringe benefits other than loans, with effect from 1 April 1988; and

b in respect of loans, with effect from 1 October 1988.

## 10.6 Excess Retention Tax

10.6.1 The CD at paragraph 6.6 proposed the repeal of excess retention tax ("ERT") with effect from the commencement of the 1989 year. The CD noted that ERT has two objectives under the classical company tax system - first, to ensure that non-corporate taxpayers cannot defer personal tax liability on dividend income by holding shares through a company and, secondly, to reinforce the classical company tax system by requiring a minimum distribution of income each year. The CD suggested that, with the introduction of imputation,the reinforcement of the classical tax system was no longer relevant. In addition, it argued that there will be no incentive for a company to retain dividends which bear imputation credits and that, while privately controlled investment companies may still be used to defer shareholder tax liability on dividends without credits, that opportunity exists for all companies, not just privately controlled investment companies.

10.6.2 In our first imputation report, we noted at paragraph 2.4.8 that it might be necessary to retain ERT in order to ensure that credits are utilised by individual shareholders rather than held in a company which, together with the credits, is then sold. We believe that there would be a considerable incentive for credits to be trapped for this purpose. While our proposal, discussed in section 10.7, for a 75 percent commonality provision for carry-forward of credits goes some way to limit credit trap and sale opportunities, we believe it should be supplemented by retention of ERT. This will also limit the deferral opportunities such companies would provide in respect of uncredited dividends.

10.6.3 We noted in our first report that the ERT provisions have had little impact since the abolition of bonus issue tax and that they would need strengthening if ERT were to be retained. Accordingly, we recommend that non-taxable bonus issues made after 30 September 1988 be excluded from the calculation of dividends distributed by a privately controlled investment company for ERT purposes.

10.6.4 The Committee and the Inland Revenue Department have reservations about the effectiveness of the current definition of "privately controlled investment company" given the ease with which the definition of "proprietary company" may be avoided. This should be reviewed by the Department.

10.6.5 The Department has proposed that the current exemption from ERT for companies not having share capital should be repealed. We are not aware of the reason for the original exemption and, in the absence of any compelling reason for its retention, we recommend the repeal of the exemption with effect from the commencement of the 1990 income year.

### Recommendation

10.6.2 The Committee recommends that:

a excess retention tax be retained;

b non-taxable bonus issues made after 30 September 1988 be excluded from the calculation of dividends distributed by a privately controlled investment company for the purposes of excess retention tax calculation; and

c the exemption from ERT for companies without share capital be repealed with effect from the 1990 income year.

# CHAPTER 11 – SUMMARY AND CONCLUSION

## 11.1 Introduction

11.1.1 This chapter briefly summarises the main elements of the BE, FIF and trust regimes and draws together all of the Committee's recommendations and some concluding remarks.

## 11.2 BE Regime

11.2.1 The BE regime recommended by the Committee is set out in chapters 2, 3 and 4 and follows closely that outlined in our first report. The regime will apply when five or fewer New Zealand residents hold interests, either directly or indirectly, or through nominees or associated persons, which add up to 50 percent or more of the rights or powers of ownership of a foreign company. The rules for determining whether a company is controlled are necessarily wide in scope. The rules for attributing the income of a controlled foreign company (CFC) to individual residents are more circumscribed. Income or loss will be calculated according to New Zealand tax rules, with some necessary modifications.

11.2.2 Residents with an income interest of 10 percent or more in a CFC will be required to compute their share of its income or loss, which is then attributed to them with a credit for the corresponding share of the foreign tax paid by the CFC. Residents would be able to aggregate their attributed income or loss, and the foreign tax credits, in respect of CFCs resident in the same jurisdiction. We propose that excess tax credits should be able to be carried forward. The New Zealand shareholders of a CFC resident in a grey-list country (Australia, Canada, France, Japan, West Germany, United Kingdom, United States) will be exempt from the regime unless the CFC utilises a significant tax

preference. Where such a preference is used, the Committee recommends a simplified basis of income calculation.

11.2.3 In our first report, we suggested that a foreign company should be a CFC if it was controlled by 5 or fewer residents on any day of its accounting year. After further consideration, in light of the high compliance costs of monitoring control interests which in some cases could change, if not daily, relatively frequently, the Committee now recommends that a resident's control and income interests be measured on the last day of the calendar quarters that fall in the accounting year of a CFC. A foreign company would be a CFC if 5 or fewer residents have an aggregate control interest of 50 percent or more on any of the quarterly measurement days. This change necessitates more elaborate anti-avoidance measures than would be necessary if control and income interests on every day in the year were taken into account. A remaining problem is the circumvention of the BE regime by the disposal of shares for a capital gain, but this can be addressed comprehensively only by the general inclusion of capital gains within the income tax base.

11.2.4 With respect to the grey list countries, the Committee recommends that only significant tax preferences should be listed and that it would be best not to list specific preferences until there has been some experience with the BE regime. The fundamental criterion for listing a preference should be that it is significant enough to attract New Zealand investment. Where a preference is listed, the listing should have prospective application.

11.2.5 We proposed a number of transitional provisions in our first report. The principal provision is the exclusion from the BE regime for a two year period (ie until 1 April 1990) of interests in CFCs, resident in countries other than listed low tax jurisdictions, that were acquired by taxpayers on or before 17 December 1987. We recommend one further transitional

measure in this report whereby residents with interests in CFCs on 17 December 1987 could elect to apply the regime for the two year period from 1 April 1988 until 31 March 1990 so that losses generated in that period would be available at the commencement of the regime on 1 April 1990 for offset against attributed income derived in the same jurisdiction.

## 11.3 Foreign Investment Fund (FIF) Regime

11.3.1 The FIF regime is set out in chapter 5 and section 245O of the draft legislation. The regime buttresses both the BE regime where tax deferral benefits do not depend on control and the proposed regime for superannuation where residents invest in foreign superannuation funds. It does this by taxing New Zealand residents on the income they derive through foreign companies, foreign unit trusts, or foreign superannuation funds ("foreign entities") which provide New Zealand residents with significant tax advantages.

11.3.2 The Committee has defined a FIF as any foreign entity which derives its income or value primarily or substantially from holding or trading portfolio investments in shares, investments in debt instruments, real property, commodities, etc, where the effect of the fiscal residence, the tax treatment applying to the entity in its country of residence and the distribution policy of the entity is to reduce the tax payable on the income of the entity to a level significantly below what it would have been had the income been taxed in New Zealand as it was derived.

11.3.3 We define an interest in a FIF in a similar way to an income interest under the BE regime, but this is extended to include life insurance or superannuation policies issued by a foreign entity. FIF income or loss is determined by reference to the change in value of the interest in the entity. We propose that there should be no credit for any foreign tax paid by the FIF because attributed FIF income or loss is effectively net of foreign tax. Attributed FIF income and losses of a taxpayer

should, however, be able to be aggregated without limitation and, in addition, attributed FIF losses should be able to be offset against other income up to the extent of the past attributed FIF income returned by the taxpayer.

## 11.4 Trusts

11.4.1 The trust regime recommended by the Committee is described in chapter 6 and is set out in Part F of the draft legislation. We propose a number of changes from the regime recommended in our first report but these are of form rather than of substance. The basic principles underlying the proposed regime can be summarised as follows:

a the taxation in New Zealand of the foreign-source income derived by a trust should not turn on the residence of the trustee. The material factor is the residence of the beneficiaries but since they are often not specified, recourse must be had to the settlor. In addition, a settlor will frequently have some influence, if not control, over the trustee so that the disposition of the income of the trust remains to some extent in the hands of the settlor. For these reasons, we consider that if the settlor is resident foreign-source trustee income should be taxable here;

b where there is a resident settlor of a trust in the year in which it derives foreign-source trustee income, the liability for New Zealand tax on that income should rest in the first instance with the trustee (whether that trustee is resident or not). If the trustee is not resident, the liability should fall to the resident settlor as agent of the trustee in the event that the trustee defaults;

c distributions from a trustee to a resident beneficiary should generally be taxable unless the trustee (or settlor, in the event of default) has been liable to tax in New Zealand.

11.4.2 We use the term "qualifying trust" to denote a trust in respect of which trustee income has been subject to tax in New Zealand in all income years since its settlement. Distributions from these trusts should be non-assessable to beneficiaries. "Foreign trusts", on the other hand, are trusts which have had, at no time after 17 December 1987, a settlor who is a New Zealand resident. We recommend that distributions from the trustee income of these trusts derived in income years commencing after 1 April 1987 should be assessable to a beneficiary, at his or her marginal tax rate, but other distributions from such trusts be exempt.

11.4.3 "Non-qualifying distributions" are distributions from trusts which are not qualifying or foreign trusts. We propose that these distributions, other than of the corpus of the trust, should be assessable to a beneficiary at a tax rate of 45 percent with no credit for any foreign tax, except withholding tax, paid by a trustee. The higher rate is intended as a proxy for an interest charge on tax deemed to have been deferred in respect of such distributions.

11.4.4 The Committee proposes that transitional provisions apply in respect of trusts settled by residents before 17 December 1987. These are that:

a the settlor would have no liability, as agent of the trustee, for tax on the trustee income of the trust;

b where such a trust winds up before 31 March 1989, all distributions other than of corpus and capital profits (which would be exempt) would be

subject to a final tax of 10 percent;

c where the settlor, trustee or a beneficiary of such a trust pays a tax equal to 10 percent of the net trust assets as at 31 March 1988, it would be treated as a qualifying trust provided that the trustee income of the trust is subject to tax in New Zealand in subsequent income years.

## 11.5 Disclosure

11.5.1 Disclosure of relevant information, with penalties for non-disclosure, and default methods where the taxpayer is not able to comply are critical to the effective operation of the regime. We outline our views on disclosure in chapter 7.

## 11.6 Imputation and Withholding Payment Systems

11.6.1 Our recommendations relating to the imputation and withholding payment systems cover details of the regimes which were left unsettled in our earlier report or which have emerged in the drafting of the legislation. There are no changes of substance or policy involved.

## 11.7 Summary of Recommendations

11.7.1 In summary, the Committee recommends that:

### Definition of "Company" and "Trustee"

a the definition of a "company" in section 2 of the Act be amended to include any entity which has a legal personality or existence separate from that of its members, which is created by way of incorporation or otherwise whether or not in New Zealand;

b the definition of a trustee of a trust in section 2 of the Act be clarified to mean that trustee only in his or her capacity as a trustee of that trust and includes all trustees of that trust;

### Residence: Individuals

c the residence test applying to natural persons be amended with effect from the income year commencing on 1 April 1988 so that a person is deemed to be resident in New Zealand if he or she:

i has a permanent place of abode in New Zealand; or

ii is personally present in New Zealand for at least 183 days of any 12 month period; and

d a person ceases to be resident in New Zealand only if he or she:

i is absent from New Zealand for 325 days of any 12 month period; and

ii has at no time during that period a permanent place of abode in New Zealand;

### Residence: Companies

e the residence test for companies be amended with effect from the income year commencing on 1 April 1988 so that a company, including a banking company, is resident in New Zealand if it:

i is incorporated in New Zealand; or

ii has its centre of director control in New Zealand; or

iii has the centre of its executive management in New Zealand; or

iv has its head office in New Zealand;

### Definition of "Nominee"

f for the purposes of the BE regime, a nominee of a person be defined to include:

i a child of the person under 18 years of age, unless the person can establish otherwise;

ii a bare trustee; and

iii a person who has entered into an arrangement or understanding with that person with respect to the holding or exercising of rights or powers;

### Definition of Associated Persons

g in relation to the BE regime only, the term associated persons mean:

i any 2 companies:

* which consist substantially of the same shareholders, as

presently defined in section 7; or

* which are under the control of the same person or persons, as defined in section 7; or
* where any group of persons holds income interests in each company totalling in aggregate 50 percent or more;

ii any person and a company if that person holds an income interest of 50 percent or more in that company;

iii two persons who are relatives if they are connected within the second degree of relationship;

iv a partnership and any person, where that person is a partner of the partnership;

v a partnership and any person, where that person and any partner are associated persons;

vi a trustee of a trust and any person where that person (or any person associated with that person) has derived a benefit from that trust or, being a person associated with the settlor of the trust, could derive a benefit from it (except where the trust is for the benefit of employees only and the person, or an associated person, does not manage or control the affairs

of the trust);

vii a trustee of a trust and any person where that person (or a person associated with that person) is a settlor of that trust (except where such an association exists as a result of an employer settling a trust, such as a superannuation fund, for the benefit of employees only and the employer or any associated person does not manage or control the affairs of the trust);

viii two persons who habitually act in concert with respect to the holding or exercising of interests in foreign companies, with respect to those interests;

### Definition of Interests In a Company

h residents' control and income interests in foreign companies be defined in terms of:

i paid-up capital;

ii nominal capital;

iii rights to vote or participate in any decision-making concerning distributions, the constitution of the company or variations in its capital (e.g. by the issuing, redemption, acquisition or cancellation of any shares);

iv income of the company which the person

would be beneficially entitled to receive or to have dealt with in his or her interest or behalf if it were distributed; and

v net assets of the company (or the proceeds from the realisation thereof) which the person would be beneficially entitled to receive or to have dealt with in his or her interest or behalf if they were distributed;

### Frequency of Measurement of Interests

i for the purposes of determining control and income interests in a foreign company, residents be required to measure their interests in the company in each category of interest listed in recommendation h on the last day of each calendar quarter;

j an interest held on a measurement day be deemed to have been held on every day of the previous quarter;

k provisions be included to reverse the effect of short term transactions and changes in the aggregate interests in foreign companies which have the effect of reducing the income attributed to residents or increasing an attributed loss;

l residents who have a control interest in a foreign company at any time during its accounting year equal to or higher than 10 percent be required to disclose the interests they hold in the company on its balance date and

any disposals of such interests made during its accounting year and where a resident has a control interest of 10 percent or more in a CFC at any time during its accounting year, the taxpayer be required to disclose the equivalent information in respect of the CFC;

### Calculation of Control Interests

m the control interest of a resident in a foreign company in any category of interest be defined as the aggregate of the person's direct and indirect control interests in that category and those of associated persons;

n as a general principle, interests in a foreign company held by a CFC or associated persons of the CFC be attributed to the group of residents with the highest aggregate control interest in the CFC and, where there is more than one such group, to the smallest one and, where there is more than one person in any such group, the interests of the CFC be apportioned among them according to their income interests in the CFC;

o any interests held by a nominee of a person be deemed to be held by that person;

p a foreign company be defined as a CFC in respect of any accounting year of the company if, on any of the measurement days that fall within that accounting year, there are five or fewer residents whose aggregate control interest in the company in any category of interest is 50 percent or more;

q where residents are directors of a foreign company and in aggregate have a control interest in the company in any category of interest of 50 percent or more, the company be deemed to be a CFC irrespective of the number of such directors;

r where shares in a foreign company (the "stapled" company) can be transferred only in conjunction with the shares of a New Zealand resident company or a controlled foreign company, shares in the stapled company be deemed to be held by the New Zealand resident company or the controlled foreign company;

### Calculation of Income Interests

s the income interest of a resident in a CFC for any calendar quarter be the highest of the sum of the resident's direct and indirect income interests in the CFC on the last day of that quarter in the five categories of interest defined in recommendation h;

t an entitlement to acquire an interest in a foreign company give rise to an income interest where:

i the consideration payable to exercise the entitlement is less than the market value of the interest to be acquired; or

ii the person holding the entitlement has given any form of financial assistance to the person holding the interest; or

iii the holding of the entitlement has the

effect of defeating the intent and application of the BE regime;

u the income interest of a resident in a foreign company held through a CFC be calculated by multiplying the resident's direct income interest in the CFC by the CFC's direct income interest in the other company, and so on where the interest is held through more than one CFC;

v the income interest of a person in a CFC for any accounting period of the CFC be calculated as the average of the person's income interests for the quarters which fall in that accounting period;

### Attribution of Income and Losses

w residents be exempt from the BE regime in respect of a CFC and an accounting year of the CFC where their income interest in the CFC for that year and that of any associated persons is less than 10 percent;

x the attributed income or loss of a resident with respect to a CFC and any accounting year of the CFC be calculated by multiplying the resident's income interest in the CFC for that year by the BE income or loss of the CFC for that year;

y an attributed loss of a resident not be recognised where the resident suffers little or no economic or financial loss;

z where the aggregate income interests of 10 percent or more of residents in a CFC in any accounting year would otherwise exceed 100

percent, the income interest of each resident be apportioned downward so that the aggregate income interest equals 100 percent;

### Adoption of CFC's Accounting Year

aa residents be required to report attributed income in respect of a CFC in any accounting year in the income year in which the balance date of the CFC falls;

ab where a foreign company changes its balance date, residents be required to obtain the Commissioner's consent to compute their control interests, income interests and attributed income or loss in respect of that company on the basis of its new accounting year and the Commissioner's decision apply to all residents with interests in the company;

ac where a CFC changes its balance date to a later date and the Commissioner consents to the residents using the new accounting year, any attributed income of a resident for the resulting long accounting period be brought to account in the income year in which the old balance date falls;

### Foreign Tax Credits

ad subject to recommendation ae, income and withholding tax paid by a CFC be creditable under the BE regime;

ae the proportion of the total income tax paid by a CFC that is creditable under the BE regime be the proportion of its total income that is

taxable in its country of residence or the country of source of the income;

af residents be able to aggregate their proportionate shares of the creditable taxes paid by CFCs resident in the same jurisdiction;

ag the maximum credit allowable to a resident in any income year in respect of his or her aggregate attributed income derived from interests in CFCs resident in the same jurisdiction be the New Zealand income tax payable on that income in that year;

ah residents be able to carry forward excess tax credits in respect of CFCs resident in the same jurisdiction for offset against New Zealand income tax payable in any future income year on attributed income in respect of CFCs resident in that jurisdiction;

ai the carry forward of an excess credit by a company be subject to a 40 percent shareholding continuity test equivalent to that in section 188;

aj a credit allowed to one company in a specified group of companies in respect of an income interest in a CFC be able to be transferred to another company in the specified group for offset against the New Zealand income tax payable by that company on attributed income derived from a CFC resident in the same jurisdiction as the first-mentioned CFC, subject to provisions equivalent to those in section 191;

ak foreign income tax paid by a CFC in respect of income attributable to another CFC be deemed to be paid by the latter CFC;

### Attributed Foreign Losses

al an attributed loss of a taxpayer derived from an income interest in a CFC be able to be offset only against attributed income derived from income interests in CFCs resident in the same jurisdiction as the first-mentioned CFC in the same or a future income year;

am the carry forward of an attributed loss by a company be subject to a 40 percent shareholding continuity test equivalent to that in section 188;

an companies in the same specified group be able to aggregate attributed income and losses in respect of income interests in CFCs resident in the same jurisdiction subject to provisions equivalent to those in section 191;

### Application of BE Regime to CFCs Resident in "Grey List" Country

ao where a CFC resident in a grey list country utilises a listed significant preference in any accounting year, the BE regime apply as for CFCs resident in other jurisdictions except that the BE income or loss of the CFC be computed as its taxable income or loss for that year,

measured according to the tax law of its country of residence (before taking into account any losses of the CFC incurred in other years or losses incurred by any other company), adjusted for the effect of the listed preference;

### Definition of Foreign Investment Fund

ap the foreign investment fund regime apply to interests in foreign companies, foreign unit trusts and foreign superannuation funds that fall within the definition of a foreign investment fund and that the definition of an interest in a foreign investment fund include policies of life insurance or superannuation issued by a foreign investment fund;

### Treatment of FIF Losses

aq residents be able to aggregate their FIF income and losses derived in any income year from all FIFs in which they have an interest;

ar where a FIF loss derived by a resident in any income year exceeds his or her FIF income for that year, the excess loss be able to be deducted from other income of the resident derived in that year to the extent that the excess loss is less than an amount equal to the cumulative FIF income of the resident derived in earlier income years, less the sum of any excess losses set off against other income in those earlier years pursuant to this provision;

as to the extent that a FIF loss cannot be set off against FIF income or other income derived in

the same income year, it be carried forward for offset against FIF income derived in future income years;

at the carry forward of a FIF loss by a company be subject to a 40 percent shareholding continuity test similar to that in section 188;

au a FIF loss incurred by one company in a specified group of companies be able to be offset against FIF income derived by another company in the specified group subject to provisions equivalent to those in section 191;

### Entry and Exit From FIF Regime

av a deemed acquisition or disposal at market value occur when:

i a person becomes or ceases to be a resident;

ii a person disposes of an interest by way of gift or for a consideration which is less than its market value;

iii a person dies;

iv an interest in a FIF becomes an income interest in a CFC of not less than 10 percent; or

v an income interest in a CFC of not less than 10 percent ceases to be such an interest but is an interest in a FIF;

### Trusts

aw the present distinction between specified and non-specified trusts in sections 226 to 233 of the Act be removed from 1 April 1988;

### Trustee Income

ax a trustee be liable for tax on trustee income derived outside New Zealand in any income year in which the trust has a settlor who is resident in New Zealand at any time during the year;

ay subject to the recommendations bb, bc and bd, where a trust was settled after 17 December 1987, any resident settlor of the trust be liable for tax on trustee income as agent of the trustee except where the trust has a resident trustee who is a natural person or a trustee company within the meaning of the Trustee Act 1956;

az a settlor or trustee of a trust be permitted to elect to make foreign-source trustee income subject to tax in any income year by making a return of such income by the due date;

ba a trust in respect of which trustee income has been subject to tax in New Zealand, in the hands of either the trustee or the settlor, in every income year since the settlement of the trust be defined as a "qualifying trust";

### Settlor Liability: Superannuation Funds

bb a person who makes a settlement on a trust that is a superannuation fund, as that term is to be defined for the purposes of the new tax regime for superannuation, not be liable for tax on the trustee income of the trust;

### Settlor Liability: New Residents

bc persons who become resident in New Zealand after 17 December 1987 who have settled a trust before becoming resident not be liable for tax on trustee income in respect of that trust, provided that they have not previously been resident in New Zealand since 17 December 1987;

### Settlor Liability: Charitable Trusts

bd a person who makes a settlement on a charitable trust not be liable for tax on the trustee income of the trust;

### Beneficiary Income

be the beneficiary income of a beneficiary of a trust be defined as income derived by the trustee of the trust in any income year which:

i vests absolutely in interest in a beneficiary during the income year; or

ii is paid or applied by the trustee to or for the benefit of the beneficiary during the income year or within 6 months of the end of the income year

whether or not the beneficiary is an infant or is subject to any other legal incapacity;

bf the credit allowed to a beneficiary of a trust in respect of tax paid by the trustee of the trust in any income year be equal to the proportion of the total tax paid by the trustee in that income year that the beneficiary income of the beneficiary bears to the total income derived by the trustee in that income year;

bg the trustee of a trust continue to be liable for tax on beneficiary income as agent of the beneficiary;

bh the definition of a distribution encompass indirect distributions received from a trustee;

### Distributions From Qualifying Trusts

bi all distributions from the trustee of a qualifying trust (other than beneficiary income) be non-assessable in the hands of resident beneficiaries;

### Distributions From Foreign Trusts

bj distributions from a foreign trust be taxable to a resident beneficiary to the extent that they are made out of trustee income derived in any income year commencing after 1 April 1988 but all other distributions from a foreign trust, other than beneficiary income, be exempt;

bk distributions from a foreign trust be deemed to

be made first from the most recent income year of the trustee and, with respect to any income year, first, from taxable income derived by the trustee in that income year and, secondly, from non-taxable gains derived in that year;

bl distributions of capital profits realised in transactions directly or indirectly with associated persons be treated as taxable distributions;

bm corpus be defined as any property settled on a trust by natural persons valued at its market value at the time of settlement other than:

i property settled directly or indirectly, whether by one transaction or a series of transactions, by a trustee of another trust;

ii property that would have constituted assessable income of the settlor but for the fact that it is diverted to the trust; and

iii property in respect of which a deduction can be claimed by the settlor in calculating his or her assessable income;

bn where a distribution is deemed to be a taxable distribution other than beneficiary income, a credit for any foreign withholding tax be permitted such that the withholding credit does not exceed the proportion of the total withholding tax paid that the taxable distribution makes up of the total distribution;

bo the rate of tax applying to distributions from foreign trusts be the marginal tax rate of the recipient;

### Distributions From Trusts Settled By New Residents

bp where a trust is settled by a new resident before the person becomes resident in New Zealand and the trustee or the settlor of the trust meets the New Zealand tax liability for tax on the foreign- and New Zealand-source trustee income of the trust in every income year after the settlor becomes resident:

i distributions from the trust which are attributed to income years ending before the settlor becomes resident be treated as distributions from a foreign trust; and

ii distributions from the trust attributed to income years ending after the settlor becomes resident be treated as distributions from a qualifying trust;

### Non-Qualifying Distributions

bq distributions from a trust which are not distributions from a qualifying trust or a foreign trust ("non-qualifying distributions"), other than such distributions which are beneficiary income or distributions of corpus, be taxable at a rate of 45 percent;

br non-qualifying distributions be deemed to be made first from sources other than corpus;

bs a credit be permitted for foreign withholding tax paid on a non-qualifying distribution but not for any income tax paid by the trustee;

### Financial Assistance to Trusts

bt where a distribution from a trust would be a non-qualifying distribution and:

i a resident settlor of the trust has a loan outstanding to the trustee and the rate of interest is less than the prescribed interest rate applying for fringe benefit tax purposes, the settlor be assessed on interest on the loan outstanding computed at that rate, less any interest actually assessed to the settlor in respect of the loan; or

ii a resident settlor has a form of financial assistance, other than a loan, outstanding to the trustee of the trust, such as a guarantee, the settlor be assessed annually on an amount equal to the consideration that would have been payable in an arms length transaction, less any consideration returned as assessable income of the settlor;

### Residence of a Beneficiary

bu where a resident ceases to be a resident and within 5 years again becomes a resident, any taxable distributions received by the person during the period in which he or she was not resident, other than distributions from a

qualifying trust, be assessable in the income year in which the person commences to be resident;

### Disclosure: BE Regime

bv the Commissioner be given a general power to require the disclosure of sufficient information to establish the nature of any interest a taxpayer has in a foreign entity, whether or not the entity is a CFC, and to compute the taxpayer's attributed foreign income or loss;

### Disclosure : Trusts

bw provision be included in the legislation to permit the Commissioner to require disclosure of information from residents who are settlors of trusts in existence on or after 1 April 1988;

### Default Methods

bx provision be included in the legislation for the calculation of the income or loss of a taxpayer where the taxpayer is unable to obtain sufficient information or where there is failure to disclose information;

### BE Regime Transition

by taxpayers be entitled to elect, in respect of all of their income interests held on 17 December 1987 in all CFCs resident in countries other than those on the transitional list, to apply the BE regime for the accounting years of such CFCs falling in whole or in part during

the period 1 April 1988 to 31 March 1990;

bz for the purposes of calculating the attributed loss of a taxpayer in respect of each such CFC in the transitional period, the taxpayer's income interest on any measurement day be taken as the lesser of the taxpayer's income interest on that day and the income interest he or she held at 17 December 1987;

### Trust Transition

ca where a trust has been settled on or before 17 December 1987, distributions from the trust, other than distributions of capital profits or corpus, be subject to a final tax in the hands of the beneficiary at a rate of 10 percent and distributions of capital profits and corpus be exempt provided that all of the property of the trust is distributed before 1 April 1989;

cb where a trust settled on or before 17 December 1987 is not a qualifying trust or a foreign trust and a beneficiary, settlor or trustee of the trust pays to the Commissioner no later than 7 February 1989 an amount equal to 10 percent of the net assets of the trust as at 31 March 1988, New Zealand income tax be deemed to have been paid on the trustee income of the trust in prior income years;

### Allocation Rules

cc where the credit ratio of a dividend applied by a company exceeds the maximum ratio, the excess credit not be allowed to shareholders, nor included in the definition of a dividend; and

cd a ratio change declaration be able to be made at any time before the first distribution at the changed ratio is distributed;

### Deemed Dividends: Allocation Rules

ce deemed dividends be excluded from the allocation rules where they arise in respect of benefits given to shareholders by way of the sale of company property to a shareholder at an inadequate consideration; the purchase of property from a shareholder by a company for excessive consideration; loans to shareholders other than bone fide loans at commercial interest rates; non-deductible expenditure enjoyed by proprietary company shareholders and associates; and excessive remuneration to directors or shareholders of proprietary companies, or their relatives;

### Producer Boards

cf the producer boards be able to operate an ICA and WPA for the purposes of allocating credits to their constituent producers and a BETA for the purposes of relieving double taxation of income derived under the BE regime;

cg a board be able to allocate credits to either payments made to producers, which would be non-deductible and treated as dividends for tax purposes, or to notional dividends and in either case the amount of the dividend be computed on the basis that it is fully credited;

ch an allocation of credits by a board to its

producers by way of cash and/or notional dividends be made only once in each income year;

ci the credits allocated by a board to its producers be in proportion to the product payments made or payable by the board to its producers and/or in proportion to the levies paid or payable by producers to the board;

cj the boards be able to maintain records for tax purposes in which to credit the net amount of notional dividends allocated (i.e. the gross notional dividends allocated less the amount of the credits attached to them);

ck the notional capital of a board be able to be distributed tax free to producers;

### Co-operative Companies

cl co-operative companies be treated in the same way as the producer boards for the purposes of imputation except that they also have the option available to other companies of allocating credits to dividends or taxable bonus shares;

### Sharemilking Arrangements

cm where payments by a dairy company for milk supplied are made directly to a sharemilker and the land-owner, dividends or bonus shares and attached credits paid on the basis of product supplied should be paid directly to both persons on the same basis that payments for milk supplied would be made;

### Capital Distributions

cn with effect from 1 October 1988, a return of capital made by a company on the redemption of shares (including debentures issued on or after 1 October 1988 which come within sections 192 or 195 of the Act), other than on winding up, be exempt from tax in the hands of the recipient provided that:

i the shares are issued on terms such that they are to be redeemed at a specified date or dates or within a specified period; and

ii the capital returned is equal to the amount paid in, including any premium, on the subscription of the shares; and

iii the shares redeemed were not issued pursuant to an arrangement under which they were to be redeemed in a regular or systematic way such that it may reasonably be concluded that the return of capital is made in lieu of a dividend;

### Carry Forward of Credits by a Company

co a 75 percent commonality of shareholding (using the tests presently contained in section 188 of the Act but extended to include fixed dividend shares) be required for a company, other than a company listed on the New Zealand stock exchange or a wholly-owned subsidiary of such a company, to be able to carry forward the credit balance of its ICA, WPA or BETA;

### Carry Forward of Unutilised Imputation Credits

cp all resident taxpayers, other than companies, be able to convert any imputation credits in excess of their tax liability in any income year into a tax loss to be carried forward, with the amount of the loss calculated as the total amount of the unutilised credit divided by 0.28;

### Refunds of Dividend Withholding Payment

cq refunds of dividend withholding payment to all shareholders, irrespective of their residence or tax status, be made by the Department after the end of the income year in which the corresponding withholding credit was received;

cr where a withholding payment credit is allocated to a dividend paid to a non-resident, the non-resident withholding tax payable on the dividend be offset to the extent of the withholding payment credit;

### Integration With BE Regime: Individuals

cs where a non-corporate taxpayer elects to establish a branch equivalent tax account, the amounts to be credited to the account be the attributed income derived by the person under the BE regime;

### Definition of Dividend

ct the definition of a dividend be extended with effect from 1 October 1988 to include, with respect to any person who is a shareholder of a

company or, where the company is a proprietary company, an associate of a shareholder:

i the value of any benefit or property provided by the company to the person to the extent that it exceeds any consideration provided by the person for the provision of the benefit or property; and

ii consideration provided by the company upon the acquisition of property from the person to the extent that it exceeds the market value of the property acquired by the company;

### Section 190

cu the proviso to section 190 be amended, with effect from the commencement of the 1990 income year, to limit its application to resident recipients of remuneration;

### Section 197

cv section 197 be retained;

### Winding Up Distribution Tax

cw distributions which have been subject to the winding up distribution tax not be liable for either non-resident withholding tax or dividend withholding payment;

### Fringe Benefits Received by "Major Shareholders"

cx fringe benefits received by any shareholder who is an employee be subject to the FBT regime rather than the current deemed dividend provisions:

i in respect of fringe benefits other than loans, with effect from 1 April 1988; and

ii in respect of loans, with effect from 1 October 1988;

### Excess Retention Tax

cy excess retention tax be retained;

cz non-taxable bonus issues made after 30 September 1988 be excluded from the calculation of dividends distributed by a privately controlled investment company for the purposes of excess retention tax calculation; and

da the exemption from ERT for companies without share capital be repealed with effect from the 1990 income year.

## 11.8 Conclusion

11.8.1 The Committee's recommendations outlined above are incorporated in the draft legislation contained in the accompanying annex. Further refinement of the draft will be needed as it is examined by parliamentary counsel and officials. Interested parties will then have an opportunity to comment at the select committee stage. The experience of other countries

has been that CFC regimes need relatively frequent amendment to meet changing business practices and no doubt that will be the case with the New Zealand regime. The increasing internationalisation of businesses and financial markets also makes it inevitable that tax legislation will become more complex, though this will affect only a small number of taxpayers.

11.8.2 The real test of the draft legislation will, however, come as it is applied. It is impossible to anticipate all of the circumstances that may arise. We are, however, confident that the basic framework of the regimes, as embodied in the draft legislation, is sound.