



# INTERNATIONAL TAX

*A discussion document*



Rt Hon Bill Birch  
*Minister of Finance*

Hon Wyatt Creech  
*Minister of Revenue*



# PREFACE

## INTERNATIONAL TAX - A DISCUSSION DOCUMENT

New Zealand's current high rate of economic growth is the result of an extensive structural reform of the economy, including major reforms in the area of taxation.

Critical to sustaining this growth is continued investment by business and increased participation in the world economy. Openness to foreign capital, ideas and goods and services is essential.

One of the fundamental principles driving the Government's economic policies is a commitment to a broad base, low rate tax environment. Such a tax environment is conducive to sound business decision making and encourages investment on merit. Such an environment is also good for the New Zealand economy.

The international tax has a history of being a contentious area of tax policy. This is due to the inherently complex nature of international tax and the role international tax plays as a back-stop to New Zealand's domestic tax regime. The complexity of reforms to international tax since 1988 and the lack of a comprehensive discussion of the underlying rationale for the policy, have hindered the development of a broader agreement on tax policy details.

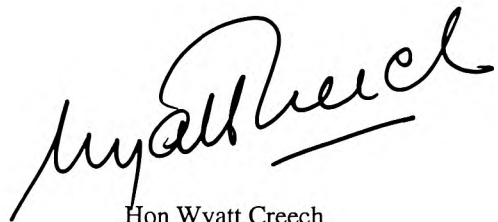
This document performs two roles:

- it presents a discussion of an economic framework which covers the whole field of international tax, allows evaluation of other regimes and demonstrates how the various elements of international tax rules interact. This discussion is intended to provide a basis for ongoing refinement of New Zealand's existing international tax rules; and
- it outlines specific reforms to the tax rules (covering foreign direct investment, transfer pricing and thin capitalisation) which the Government proposes to consider implementing this year. These reforms, together with existing rules, constitute the building blocks for a more coherent international tax regime consistent with the framework presented.

The Government welcomes comments on both parts of the document.



Rt Hon Bill Birch  
Minister of Finance



Hon Wyatt Creech  
Minister of Revenue



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# 1. AN OVERVIEW

## 1.1 INTRODUCTION

The past ten years have been characterised by major reforms within the New Zealand economy. Those reforms have included very significant changes to the New Zealand taxation system. Major new taxes have been introduced; for example, GST. Part of this overall tax reform process has been fundamental reform of the taxation laws as they affect income flows across international borders.

A deregulated international capital environment requires robust international tax rules to protect the New Zealand tax base. While providing that essential protection to the New Zealand tax base, the reforms of the international taxation regime have also been designed to underpin the development of the dynamic, open, internationally competitive economy that has been a key component of New Zealand's economic success in recent years.

Continued investment, necessary to support sustainable economic growth, demands that New Zealand businesses be able to satisfy their requirements for capital, either from New Zealand or overseas. Policies that give domestic producers access to capital at low cost will enhance the competitiveness of New Zealand business and are consistent with the Government's policy of repaying public debt to remove the risk premium for New Zealand.

### **New Zealand's recent economic performance**

**The average annual GDP growth over the past 20 years was 1.6%. In the year to June 1994, GDP growth was 6.3%.<sup>1</sup> New Zealand is now one of the fastest growing economies in the OECD. Forecast average GDP growth for 1994/95 is 5.8%.**

**Net public debt has fallen from 48% of GDP in 1992/93 to 43% in 1993/94. It is projected to fall to 26% by 1996/97 and 18% by 2003/04.**

**Underlying inflation has remained below 2% since 1991 and the fiscal balance moved into surplus in the 1993/94 year.**

**Exports of goods and services totalled 31% of GDP in 1993. Manufactured non-food exports rose from 19% of export earnings in 1980 to 30% in 1993, growing at 11% per annum in the two years to June 1993 (15% per annum for non-commodity manufacturing exports—on present trends, exports of this sort will double between 1993 and 1997).**

Foreign direct investment can bring with it the additional benefit of a transfer of technology and ideas to New Zealand. Openness to foreign capital, ideas and goods and services will aid the effort to build a dynamic, fast-growing enterprise economy that generates exports and jobs here in New Zealand.

At the same time, New Zealand businesses invest overseas to build infrastructures that support the sale of their New Zealand-made products and to pursue opportunities not available at home in the New Zealand economy.

A growing, dynamic economy that is raising the living standards of all New Zealanders will therefore see a combination of foreign investment in New Zealand and overseas investment by New Zealanders. The Government is committed to New Zealand's continuing full participation in the international economy.

As much as possible, investment decisions should be driven by the intrinsic quality of the investment rather than by tax considerations. The tax system should not make offshore investment more or less attractive than domestic investment for New Zealand investors. Inevitably, however, tax policy plays a role in business decisions, including those decisions which affect international capital and income flows both into and from New Zealand.

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<sup>1</sup> Source -Economic and Fiscal Update, 20 December 1994.

## **Openness**

**Openness and growth are strongly connected. Recent World Bank work on East Asia has confirmed this.**

**Foreign direct investment into New Zealand in the year to March 1994 alone was \$4.7 billion.**

**In legal terms, New Zealand is very open to foreign investment. Specific restrictions on foreign investment apply only to fishing quota and Air New Zealand. The Overseas Investment Commission oversees any proposal by non-residents to establish a business; acquire a 25% or greater share; increase an equity share; or acquire assets above \$10 million. From 1988 to 1992, the Commission declined only three out of more than 4,000 applications. Authorisation is also necessary for a non-resident to purchase rural land or offshore islands.**

**Capital flows world-wide already dwarf trade flows and are growing faster. Total world trade volume in 1992 was US\$10 billion per day, while foreign exchange turnover was US\$880 billion per day.**

**In July 1994 non-resident investors held about NZ\$4,671.5 million of New Zealand Government stock, 24.5% of the total and about NZ\$3,342.7 million of Treasury Bills, 55.9% of the total. In addition, foreign currency Government debt at 30 June 1994 was NZ\$16,864 million.**

**Foreign investors now hold substantial equity stakes in listed New Zealand companies, facilitated by dual listings on overseas markets.**

Any tax policy development involves achieving a mix of objectives. Clearly, protecting the New Zealand tax base and low compliance costs must be key goals.

Prior to Christmas 1994, the Government issued a discussion document giving significant weight to minimising the compliance costs associated with the taxation system. Obviously, ensuring the maximum economic benefit to New Zealand must also be given full and thorough consideration in tax policy formation.

The policy objective of minimising compliance costs has already been given effect in the international tax regime by the introduction of such features as the "grey list". Those investing in countries on the grey list are excused from complying with the rules of the international tax regime. The grey list countries have robust rules which are likely to ensure that any income-earning activity will be taxed at a similar rate to that which would apply under the New Zealand rules.

Over the last ten years, changes in international tax policy have led to the introduction of rules which allow the taxation of New Zealanders on their worldwide income, measured according to New Zealand tax rules. Both Controlled Foreign Companies (CFCs) and Foreign Investment Funds (FIFs) have been brought into and are now fully covered, by the international tax regime.

As part of the continuing reform process, in August 1993 the Government reformed the tax system as it affects non-resident portfolio investors by introducing a mechanism called the Foreign Investor Tax Credit (FITC).

The introduction of the FITC removed the double imposition of New Zealand taxes on dividends paid to foreign portfolio investors. Foreign portfolio investors are no longer required to pay full tax at the New Zealand company level as well as Non-Resident Withholding Tax. That puts a foreign investor in a similar position to a domestic investor as far as the maximum New Zealand tax payable is concerned. The change had an immediate positive effect on the New Zealand share market. (One large New Zealand business estimated that this one measure reduced its cost of capital by about 8%.)

At the time of those changes in August 1993, the Government announced that the next stage of the reform process would cover the areas of foreign direct investment, transfer-pricing and thin-capitalisation. These, together with existing rules, represent the remaining items in the current round of reforms of the international tax regime. The Government is of the view that, after the measures proposed in this package (foreign direct investment, transfer pricing and thin capitalisation)

have been given effect to, New Zealand will have an effective and comprehensive international tax regime. Although Ministers are always willing to listen to concerns, and obviously any part of the tax law must be the subject of continual refinement to address issues that arise (for example, base maintenance and other concerns), in the fundamental sense, what has been achieved by way of major reform in the last ten years is in the view of the Government settled. After such a protracted period of intense legislative activity, it is appropriate that there be a period of consolidation.

This discussion document is produced as part of the generic tax policy development process recommended by the Review Committee chaired by the Rt Hon Sir Ivor Richardson of the Court of Appeal. It outlines the Government's intentions for the next stage in the development of the international tax regime.

## ***1.2 BRIEF OVERVIEW OF THIS DISCUSSION DOCUMENT***

To assist understanding of the approach being taken to international tax policy, Part A of the document introduces a high-level discussion of the economic and tax policy considerations which the Government is working through to establish tax policy. This discussion is intended to indicate to interested parties the thinking on policy development in this area. It also offers an assessment, in the light of that discussion, of the current regime for taxing cross-border income. To assist the Government in its ongoing refinement of international tax rules, submissions are sought on the issues raised. The key issue here is the weighting to be placed on residence versus source tax bases.

Chapter 2 discusses the broad policy framework issues that underlie international tax policy.

Chapter 3 describes the current international tax regime and then assesses it in the light of the earlier discussion in Chapter 2 of the broad objectives of tax and economic policy.

Part B of the document then details the reform measures which the Government proposes to consider implementing this year. Submissions are sought from interested parties on these measures.

Chapter 4 discusses technical problems inherent in the existing rules for measuring cross-border income flows.

Chapter 5 covers the broad proposals for reform canvassed in this document, after which Chapters 6, 7 and 8 canvass in detail the options for reform. They introduce the Government's proposals for the tax treatment of foreign direct investment and put forward the Government's proposals to address the issues of transfer-pricing, source and thin-capitalisation rules.

## ***1.3 SUBMISSIONS***

Submissions on Part A, the Policy Framework, should be sent to:

The Manager  
International Tax  
The Treasury  
PO Box 3724  
WELLINGTON.

Interested parties can contact Treasury directly if they wish to discuss any issues raised in Part A.

Submissions on Part B, the Reform Proposals, should be sent to:

The Director  
Legislative Affairs  
Inland Revenue Department  
PO Box 2198  
WELLINGTON.

Submissions on either Part should be made by 12 April 1995.



## **PART A: POLICY FRAMEWORK**



## **2. POLICY MAKING CONSIDERATIONS**

*A general discussion on the broad framework for international tax*

### **2.1 INTRODUCTION**

Previous consultations on international tax reform have tended to focus directly on the proposed measures themselves. Although “Taxing Income across International Borders - A Policy Framework” introduced a comprehensive discussion of the rationale and issues underlying international tax policy, there was little feedback on that document at the time that it was published (July 1991). This lack of focus in the past has made it difficult to explain the underlying rationale for the Government’s international tax proposals.

To fill this gap, the Government has been working through the issues involved in the international tax regime identifying those factors that must be considered if the Government is to meet its economic and tax policy objectives. This will provide the context for discussion on international tax policy. In the process of developing this discussion document, the Government has undertaken preliminary consultations with overseas experts and members of the business community.

This chapter highlights these issues, many of which are based in economic theory and very technical in nature. To make the points while keeping the exposition as straightforward as possible, the economic aspects of the discussion simplify many of the real-world factors that influence business investment decisions.

It has already been pointed out that the Government, in determining its tax policy, endeavours to meet many objectives, some of which do not fit neatly with each other. Greater accuracy, for example, can often only be achieved at the cost of greater complexity and vice versa.

The design of an international tax regime involves many judgments about the economic effects of taxes, and the numerous trade-offs between the economic effects and the various practical issues. The following analysis focuses largely on the economic effects of tax policy rather than the related practical issues. As such, it is an illustrative guide to the economics of international tax rather than a definitive statement of the tax policy framework that must be rigorously followed.

### **2.2 OUTLINE OF THE CHAPTER**

This chapter first discusses economic considerations. It adopts a step-by-step approach to illustrate how the many important judgments fit into the analysis, and how they affect the design of the international tax regime. This approach should make it easy for readers to pinpoint any particular areas of concern about the economic analysis and the judgments made. Being able to identify their key concerns should enable parties to engage in a process of consultation on international tax which will be more constructive than in the past.

The economic discussion starts by canvassing the aims of international tax policy. It then looks at the factors, other than tax, that influence investment decisions. Analysing such influences is important, because an ideal tax system is one in which tax plays as small a role as possible in investment decision-making.

The discussion then considers the ways in which New Zealand taxes can influence the investment decisions of New Zealanders investing here and overseas, and of non-residents who are considering investing in New Zealand. This discussion includes comments on the influence of taxes imposed by other countries on the New Zealand Government’s tax policy.

Finally, the discussion outlines other important considerations that the Government must take into account when setting international tax policy, including the need to protect the domestic tax base, the need to reduce the costs of complying with and administering the tax system, and the desirability of sustainable policy.

### **2.3 THE BROAD AIM OF INTERNATIONAL TAX POLICY**

#### **2.3.1 Introduction**

Because New Zealand is an open economy, New Zealanders are free to invest either in New Zealand or offshore. Likewise, foreigners can invest in New Zealand or elsewhere.

For the purposes of this discussion, investment activity is divided into three separate forms. They are:

- investment undertaken outside New Zealand by New Zealanders. This sort of investment uses exported capital;
- investment undertaken in New Zealand by non-residents. This uses imported capital; and
- investment undertaken in New Zealand by New Zealanders. This uses domestic capital.

Although a discussion of domestic investment may seem out of place in a document dealing with international tax, taxes on cross-border income flows in fact have a marked impact on investment decisions, and the way that all three forms of investment interact is a key tax policy consideration.

### **2.3.2 Supporting efficient use of New Zealand's resources**

A fundamental aim of the Government's policy will always be, consistent with meeting other policy objectives, to ensure that, whatever the location of investment or the source of finance, all investment decisions make the most efficient use of New Zealand's resources. Policy that achieves this objective will make the greatest possible contribution to economic growth and consequentially improving living standards for all New Zealanders.

Investors use relative rates of return as a guide to choosing the most productive of alternative investments, both in New Zealand and overseas. For example, if relative rates of return are higher overseas than they are in New Zealand, the incentive on non-residents especially, but NZ residents as well, will be to invest offshore as opposed to in New Zealand.

It has to be taken as read that an unavoidable consequence of gathering government revenue through taxes is to reduce the actual direct return the investor achieves on the investment. To promote investment that benefits New Zealand, therefore, it is important to ensure the tax system does not have adverse effects on the relative rates of return available from onshore as opposed to offshore investments.

Less obvious, however, are the ways the tax system can affect patterns of investment. Deficiencies in the tax regime that result in different rates of New Zealand tax being applied to different types of investments will alter the relative rates of return investors can derive from those investments. This imposes a "deadweight cost" on the economy by potentially supporting inefficient patterns of investment.

If the international tax regime is to play its part in encouraging the efficient use of New Zealand's resources, the Government must aim for a regime that does not distort the relative rates of return from alternative investments both in New Zealand and offshore. When relative rates of return are not distorted by tax, investors will concentrate on those activities that make the most efficient use of New Zealand's resources, rather than those investments that take advantage of deficiencies in the tax system.

There is also an inescapable link between the world and the domestic rate of return on capital. If the return on domestic investment exceeds the cost of imported capital, then New Zealand can gain by increasing the level of investment financed by imported capital. Conversely, if the return on domestic capital is lower than the costs of foreign capital, then New Zealand loses money by financing domestic investment with foreign capital.

Hence, New Zealanders will gain where productive investment opportunities available to them give a return at least as high as the cost of foreign capital. And likewise, New Zealand benefits from making offshore investments only if the return to New Zealand is at least as high as the returns available domestically. To do otherwise would mean that New Zealanders would be investing offshore when better opportunities are available locally.

Combining these two factors means that New Zealanders should have an incentive to invest offshore only when the returns are at least as high as the cost of imported capital.



**These two factors can be summarised as follows:**

**FACTOR ONE:** New Zealanders should continue to take up domestic investment opportunities until the return to domestic capital falls to the level of the cost of imported capital, but not below it.

**FACTOR TWO:** New Zealanders should continue to take up offshore investment until the return to exported capital falls to the level of the cost of imported capital, but not below it.

If the international tax regime alters the relative rates of return available in New Zealand such that either of these two conditions, or both, are not met, then New Zealand will not be making the most efficient use of its resources.

#### **2.4 INFLUENCES ON INVESTMENT**

Cross-border investment occurs for a variety of reasons. Tax related issues are but a part of the overall picture. The impact of these differing influences varies depending on the type of investor.

Although the reasons for investment and types of investor are myriad and complex, there are two types of investors generally considered in a broad discussion such as this. They are portfolio and direct investors.

A portfolio investor is a shareholder with a non-controlling interest in a company. The level of shareholding is generally less than 10% of a company's shares or, alternatively, consists solely of debt instruments in a company. Usually the holdings are relatively liquid and small influences can see major changes in the content of a particular investor's portfolio.

In New Zealand, portfolio investors have a wide range of investment options to choose from. It is safe to assume that portfolio investors will, as a key motivation, seek the highest return on the funds at their disposal. The nature and location of specific investments are less of a factor in investment decision-making for portfolio investors. The motivation for investment will include the desire to diversify portfolio risk.

Direct investors, by contrast, are investors who take a significant stake in the company in which they invest. Factors other than immediate return on capital are important determinants of direct investors' investment decisions. These investors will tend to follow carefully the performance of the particular company concerned, and will often actively participate in the operations of the company. They will almost certainly have some influence over the affairs of a company, if not a controlling interest. Many direct investments will be wholly owned subsidiaries.

Direct investments are less liquid. They do not move out of a holding quickly or merely because the rate of return is temporarily lower than they expect. Factors such as the location of markets and production inputs, tariffs and other barriers to trade, and access to new technology and knowledge will concern direct investors. In the longer term, however, direct investors will still be influenced by the return on their investment.

The return that investors seek is an amalgamation of all the factors that influence investment.

#### **2.5 THE SOURCE OF CAPITAL - DOMESTIC OR FOREIGN**

The amount of capital imported into a country will be influenced by the extent to which foreign investors can switch from investments in one country to investments in other countries. The comparative rates of return available from investments between countries will be important in driving switching between countries. Obviously, political and economic stability also play a role in an investor's decision to go into a particular country, as do a variety of other features of a particular economy.

In a small open economy like New Zealand's, the supply of foreign capital is very sensitive to the rates of return available in New Zealand compared with rates of return available in other countries.

Further, because New Zealand is such a small part of the world capital markets, changes in the supply and demand for capital here have no discernible effect on those world market rates. It is the actions of international investors operating throughout the world's financial markets that set the return for imported capital.

From the New Zealand business perspective, demand for foreign investment funds will depend on a number of factors, including the rates New Zealand businesses must pay for domestically sourced capital and the extent to which New Zealand firms are willing to switch from domestically sourced capital to foreign capital.

If New Zealand businesses are in a position where they can readily switch between domestically sourced and foreign-sourced capital, their demand for domestic capital will be very sensitive to the rates of return paid to foreign investors.

Although levels and sources of investment are sensitive to many factors, the implication of this process is that the more freely business investment can move, the more investment decisions will be influenced by the world rate of return required by non-resident suppliers of such capital.

## 2.6 THE IMPACT OF TAXES

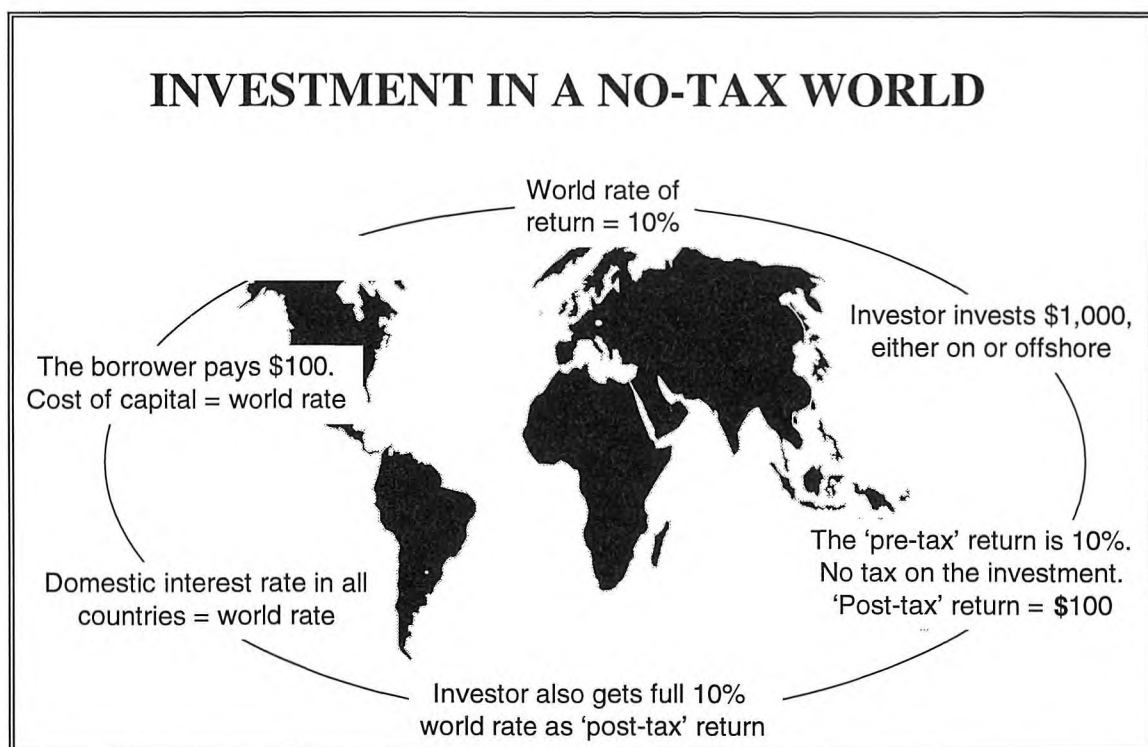
### 2.6.1 Introduction

To understand the impact of taxes, we have to first consider what would occur were there no taxes.

Theoretically, the real cost of foreign funds equals the pre-tax return accruing to non-residents minus the portion of that pre-tax return received by New Zealand as tax revenue. For the purposes of the following discussion, assume this figure is 10%.

Consider the case in which foreign investors are able to earn 10% by lending money to a number of prospective borrowers. In this example, foreign investors are indifferent as to where they earn their money. Given these assumptions, New Zealand businesses will have to pay non-resident investors 10% after tax to attract finance. If they paid less than 10%, foreign investors would simply shift their investments to jurisdictions in which they can earn 10% after tax.

Figure 1



In this simplified model of the world, because there are no taxes, there are no tax-driven distortions to economic behaviour. Funds move freely to the highest bidder. The world rate of return applies to all investments, whether they be imported, exported or domestic capital.

## 2.6.2 How taxes affect investment decisions

To the extent that taxes reduce equally the return to the investor from all potential investments, then the level of investment will be affected, but not the pattern of investment. If taxes alter the relative returns from different investment opportunities, then the pattern of investment will be altered, leading potentially (as explained in the section above on efficient use of New Zealand's resources) to a less efficient use of New Zealand's resources.

New Zealand tax policy will alter these impacts least when investment and production choices of individuals and firms are least affected by income taxes levied by New Zealand.

There are several ways New Zealand can tax the three bases referred to in this discussion; that is imported, exported or domestic capital. New Zealand could:

- tax residents only on their domestic income
- tax residents on their world-wide income
- tax non-residents on their New Zealand-sourced income

Each of these is now considered.

### a) New Zealand taxes only residents and only on their domestic income

The overall return to New Zealand equals the after-tax return to the New Zealand investor plus the tax revenue paid to the New Zealand Government. That is, the return on the investment is spread between the investor and the Government. The pre-tax return on domestic investment reflects the productivity of the investment for New Zealand.

Where there are no or lower foreign taxes (assuming all else is equal), imposing New Zealand tax on residents' domestic income, while exempting residents' foreign-sourced income from tax, would merely drive residents to invest offshore where there are no or lower taxes. In this case, to the extent of New Zealand taxes lost because the investment is not located in New Zealand, there would be a loss to New Zealand. Consider the following example:

Suppose a resident has \$1,000 to invest and that domestic income is subject to a 33% New Zealand tax rate but that offshore income is exempt from New Zealand tax. The investor can earn after-tax income of \$67 at home. The residents will invest in any offshore project yielding pre-tax returns as low as \$67, but only invest at home if the pre-tax return is at least \$100. Thus, an exemption for offshore income encourages New Zealanders to invest in offshore projects yielding less than the 10% rate of return. A New Zealand investor could borrow from foreigners at a 10% interest rate and on-lend it to other foreigners at a 6.7% interest rate and still have the same amount of cash in hand.

Therefore, to refrain from taxing the earnings of foreign investments of New Zealanders is obviously a bad policy from New Zealand's point of view. The following diagram explains this point. For the purposes of the diagram, we will assume there are no taxes offshore.

Figure 2

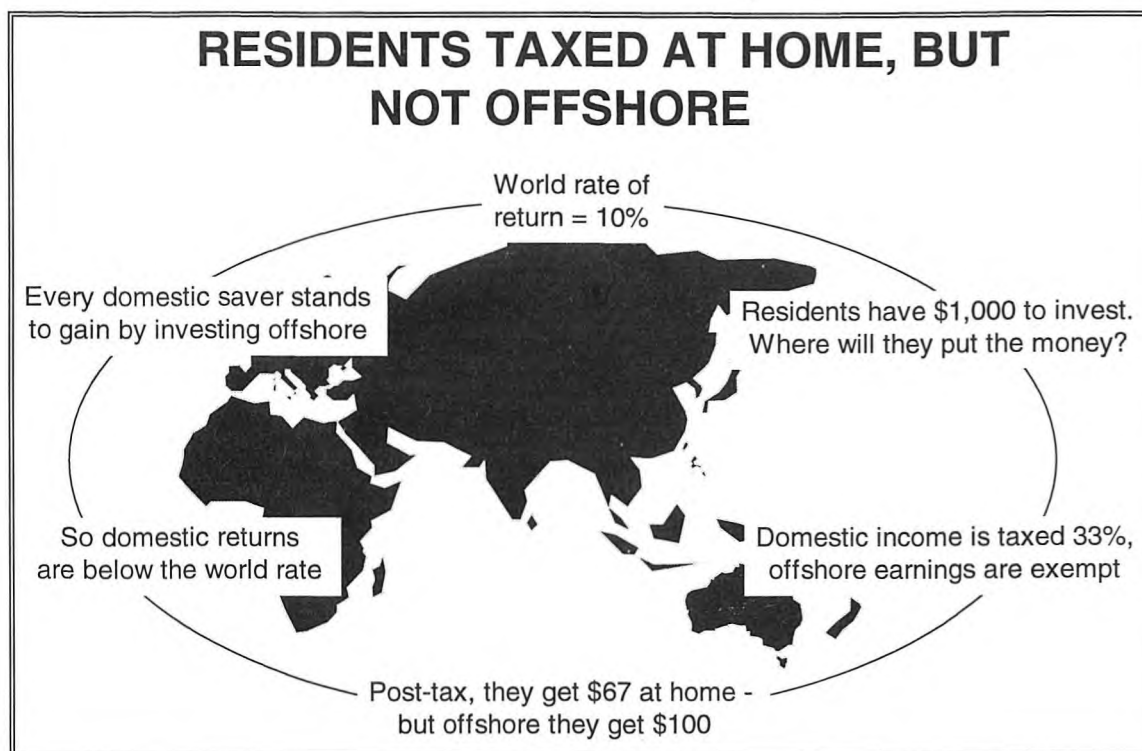


Figure 2 illustrates why it is inefficient to tax domestic investment but not exported investments. It is of course a stylised example. The extreme result is a tax system that collects no revenue, but encourages New Zealanders to hold tax-free investments offshore and non-residents to hold tax-free investments in New Zealand. Non-residents taking up the investment opportunities abandoned by residents will, however, still require the full 10% world rate of return to come to New Zealand.

#### b) New Zealand taxes only residents but on their world-wide income

Under this scenario, New Zealand would tax the offshore income of residents at the same rate that applies to residents' domestic income.

This approach is referred to as the residence basis for income taxation.

Under the residence basis of taxation the after-tax return to residents from both domestic and offshore investments is reduced by the same proportional amount. As a result, New Zealand investors will choose the investment yielding the highest pre-tax return because that also yields the highest post-tax return. Offshore investment under these circumstances will occur only when the investment returns justify the investment; that is, when the after-tax return is equal to or greater than that achievable in New Zealand.

In the example above, New Zealand residents will invest offshore only when they can earn more than the \$67 after-tax income available at home. If residents are subject to a 33% tax rate on both their domestic and offshore income, then they will invest only in offshore projects yielding pre-tax income equal to or greater than \$100: in the absence of foreign taxes investments benefit New Zealand because: (1) the overall return for New Zealand (i.e., the pre-tax income) equals or exceeds what they could have achieved at home; and (2) the overall return exceeds the cost of foreign capital to New Zealand. The latter condition means that any cross-hauling effects benefit New Zealand.

There are, however, situations where New Zealand cannot fully tax offshore income. Both practical and inter-jurisdictional difficulties arise. For example, some international agreements New Zealand has entered into limit our ability to tax New Zealanders in other jurisdictions. In particular, double tax agreements (DTAs) New Zealand has entered into (as well as practical considerations) generally prevent New Zealand from taxing foreign companies on offshore income they derive that accrues to New Zealand residents. Moreover, if a New Zealand resident makes a direct investment in a country with which we have entered into a DTA, New Zealand tax will generally be reduced by credits for any foreign tax paid.

As a result, the effective tax rate New Zealand imposes on foreign-sourced income can be lower than the rate applied to domestic-sourced income.

**c) New Zealand taxes residents only on their New Zealand-sourced income and non-residents**

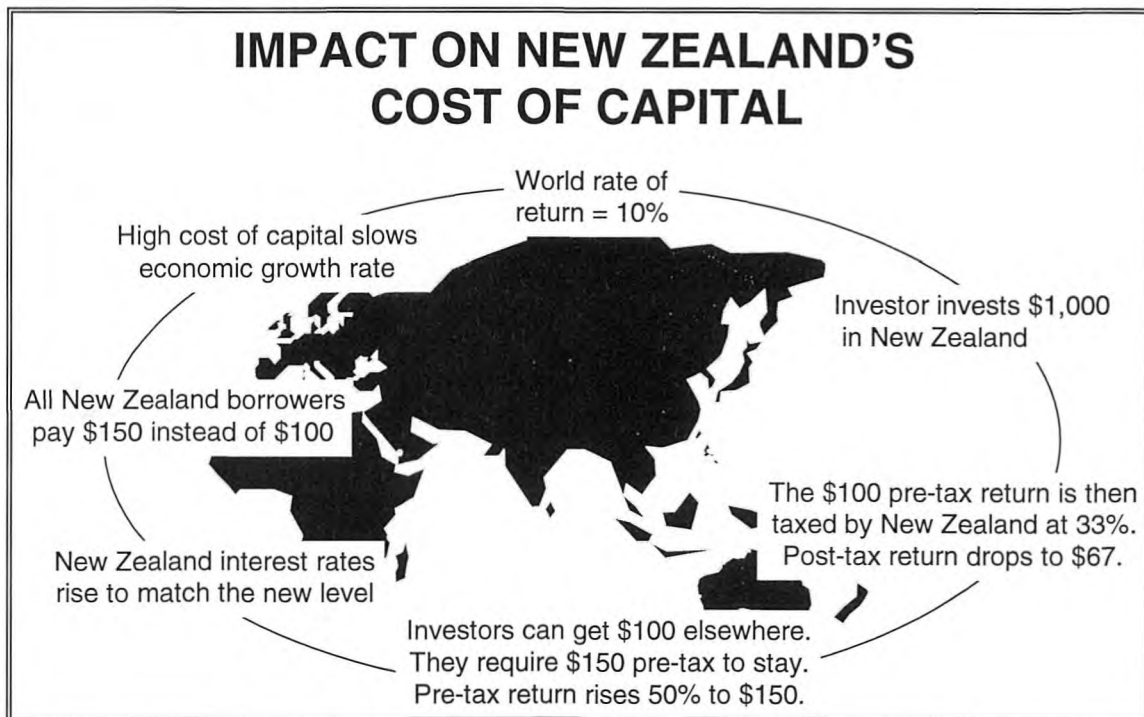
Applying the same rate of tax to both residents' and non residents' New Zealand income is referred to as the source basis for income taxation. Under the source basis taxation system, all income earned in New Zealand by both residents and non-residents would be fully taxed.

The source basis of taxation has the apparent advantage of seeming to be "fairer" than a residence basis. Under the residence basis New Zealand investors would be fully taxed on their domestic and foreign income whereas competing non-resident investors would be exempt from New Zealand tax even on New Zealand investments. However, such a conclusion loses its strength if the burden of any tax New Zealand levies on non-residents is in fact merely shifted on to New Zealand residents.

*Can non-residents shift the burden of New Zealand taxes?*

Again, the example begins with the world rate of return equal to 10% and a foreign investor having \$1,000 to invest in any offshore country including New Zealand. The return is, however, taxed by New Zealand at say 33%.

**Figure 3**



International capital markets will endeavour to respond to the imposition of such a tax. Investors with liquid funds can either transfer their funds to a country other than New Zealand where they can earn the required 10% post-tax rate of return or demand higher returns from New Zealand to compensate for the effect of its taxes on non-residents.

Returning to the earlier example, the initial impact of New Zealand's taxation of non-residents will be to reduce returns to non-residents from \$100 pre-tax to \$67 post-tax. Because investors can earn \$100 elsewhere, in these circumstances they will require \$150 pre-tax to continue to invest in this country. Therefore, pre-tax returns increase by 50% to \$150. Because of the operation of financial markets, interest rates in New Zealand would also rise to match the new level. This means that all New Zealand borrowers must pay \$150 instead of \$100 to borrow \$1,000 from any potential investor be they domestic or non-resident. This means that the cost of capital in New Zealand increases, slowing economic growth.

Care therefore has to be taken with the practical application of the source taxation method. To the extent that non-residents can shift the burden of New Zealand taxes back onto New Zealand businesses by covering the cost of any New Zealand taxes paid in the price they charge for the funds, taxing non-residents adds to New Zealand business costs and will not improve New Zealand's competitiveness.

If taxing non-residents leads to a higher domestic cost of capital, New Zealand firms will need to reduce their costs, including potentially the real wages of their workers so that they can pay the higher cost of capital and remain internationally competitive in product markets.

Taxing non-residents could therefore prove self-defeating for New Zealand businesses to the extent that it merely led to a rise in the domestic cost of capital. It follows therefore that an issue for international tax policy consideration is to assess to what extent taxes on non-residents impact on the domestic cost of capital.

### 2.7 THE PROBLEM OF DOUBLE TAXATION

In the above examples, other countries do not tax income. In practice this generally does not occur. The analysis is now extended to reflect the impacts of such taxes.

When other countries tax cross-border income, the potential for *juridical* double taxation arises. Juridical double taxation occurs when both the country where income is earned and the country where the investor resides tax the same income.

If there are no foreign taxes, taxing New Zealanders' domestic income while exempting New Zealanders' offshore income from tax will drive investment offshore (the section above on the source of capital discussed this point).

To see how foreign taxes alter this conclusion, consider the case of a world (including New Zealand) where there are no taxes. Assume a New Zealander has \$1000 to invest in three countries: New Zealand and two other countries, A and B. The interest rates in each country are as follows.

#### CASE 1

	Country A (zero tax)	Country B (zero tax)	New Zealand (zero tax)
Pre-tax Return	<b>11%</b>	9%	10%

In this case, the New Zealander investor would invest in country A, because that is where they can earn the highest return (the investor's choice is in bold).

Now consider what happens if Country A imposes a tax of, say, 20%, on all foreigners, including New Zealanders, investing there. The investor now earns the following rates of return:

#### CASE 2

	Country A (20% tax)	Country B (zero tax)	New Zealand (zero tax)
Returns after Foreign Tax	8.8%	9%	<b>10%</b>

In this case, the New Zealander would rather invest in New Zealand than in Country A or Country B.

Case 2 provides the benchmark from which to judge the imposition of taxes by New Zealand. If New Zealand had no taxes it would not try to offset the foreign tax with a subsidy to encourage New Zealanders to invest in Country A. Theoretically therefore the same result should apply when New Zealand taxes domestic and foreign-sourced income.

Now consider the case where New Zealand imposes a 33% tax rate on New Zealanders' domestic-sourced income, while their foreign-sourced income remains untaxed.

In this case, the incentives facing the New Zealand resident investor again change. They would now prefer to invest in Country B than in either New Zealand or Country A.

### CASE 3

	Country A (20% tax)	Country B (zero tax)	New Zealand (33% tax)
Returns after Tax	8.8%	<b>9%</b>	6.7%

However, from New Zealand's point of view the investment choices made in Case 2 remain preferable: the investor should invest in New Zealand, because that is where the overall return to New Zealand is highest.

New Zealand can restore the benchmark result in Case 2 by taxing its residents' foreign-sourced income in addition to any taxes imposed by foreign governments. If it does so, the investor faces the following returns:

### CASE 4

	Country A (20% tax) (33% NZ tax)	Country B (zero tax) (33% NZ tax)	New Zealand (33% NZ tax)
Returns after Tax	5.8%	6%	<b>6.7%</b>

In practice, however, a deduction system along these lines cannot be applied. There are a number of reasons for this including the costs that such an approach would add to the New Zealand economy.

Our DTAs require New Zealand to adopt either an exemption or foreign tax credit approach. Under an exemption approach foreign-sourced income is exempt from New Zealand taxes. Whereas, under the foreign tax credit approach, New Zealand gives a credit for foreign taxes paid by its residents on their foreign-sourced income.

Further, there is a concern that other countries would strongly object to a system that would be seen by them as a deliberate effort by New Zealand to place an extra tax cost on businesses investing in their country, thus deterring investment in their economy.

In addition, as a rule those involved in business activity do not regard tax cost as the same in character as other business costs. The business proprietor has no control over taxes. Intuitively therefore in principle, the general reaction would be that it is wrong to impose a layer of New Zealand tax on top of a layer of tax already paid overseas. The deduction approach would be seen by most people as imposing an unfair tax burden on New Zealanders investing offshore.

In line with this theoretical discussion though, this "double layer" of tax argument could be looked at another way. Namely, to the extent that taxes on non-residents adds to the domestic cost of capital, other countries that apply such taxes will give a compensatory lift in returns to non-residents, including New Zealanders, that invest in their country to compensate them for their tax charge.

This is illustrated by expanding on the above example.

### CASE 5

	Country A (20% tax) (33% NZ tax)	Country B (zero tax) (33% NZ tax)	New Zealand (33% NZ tax)
Returns after Tax	<b>7.4%</b>	6%	6.7%

Therefore, while New Zealanders investing offshore may legally pay taxes to two countries, they may only bear the economic incidence of the New Zealand tax. In economic terms, they only pay one layer of tax.

Second, if the pre-tax returns do not rise to offset the tax on non-resident investors, the foreign tax penalises New Zealand by reducing the overall returns to New Zealand from offshore investment. But there is nothing New Zealand can do to avoid that penalty. Lowering the tax rate applied to foreign-sourced income merely shifts the burden onto other New Zealanders.

## **2.8 THE ROLE OF TAX TREATIES AND TAX ADMINISTRATION CONSIDERATIONS**

There are considerations arising for the tax administration and in the negotiation of double taxation agreements with other competent authorities that must be considered in any tax policy developments. We must consider how other jurisdictions will view our actions.

As explained earlier in this document, New Zealand taxes residents on their worldwide income, and, since the early 1960's, has allowed a credit both unilaterally and in terms of tax treaties for foreign income tax paid on any foreign income derived by a resident. The tax credit is limited to the amount of the New Zealand tax that would otherwise be payable. The effect is the resident pays the higher of the two countries' rates.

Under the twenty four tax treaties we have with foreign countries our residents receive certain benefits. The major benefit that they receive is certainty of tax treatment in the foreign country, i.e., the treatment guaranteed by treaties which follow international norms. More specifically, they commonly receive the following benefits:

- exemption of foreign tax on foreign profits not attributable to a branch in the foreign country.
- reduced or nil rates on investment income earned in the foreign country.
- a guarantee of tax credits in New Zealand for any foreign tax paid in accordance with the treaty.
- procedures for corresponding adjustments in one country when transfer pricing adjustments are made in the other. In other words, if one country increases the returned profit of one affiliate, the other country may reduce the profits of the other affiliate).
- mutual agreement procedures between the tax authorities to deal with other cases of difficulties which might arise and render the taxpayer liable to double taxation. Examples are the clashing of residence rules and the clashing of source rules (For example, both countries may under their domestic tax laws treat a taxpayer as a resident and seek to tax that taxpayer on their worldwide income.).
- some protection against changes in legislation in the foreign country (where such legislation is contrary to the provisions of the treaty, the treaty normally prevails).

In contrast to residents, non-residents are taxed on New Zealand source income only. Full New Zealand tax rates are levied on net business income according to normal deductibility concepts. Lower rates are levied on investment income (dividends, interest and royalties) but the lower rates are applied to gross income with no deduction of expenses.

The underlying concept under our tax treaties is to reduce tax rates on non-residents on a reciprocal basis within the protection of a treaty and thus leave tax havens out in the cold.

From the point of view of the tax authorities the tax treaties have a number of benefits. The major one is the ability to obtain information from the other country. This is of crucial importance for our Inland Revenue Department in combating avoidance and evasion.

The overall policy direction for New Zealand over the last 20 years has been to follow the OECD recommendations to use such treaties to remove obstacles to the flow of capital and people, and to combat international evasion/avoidance through the exchange of information. In practical terms that means that we have reduced our tax rates on non-resident within the protection of a tax treaty while at the same time obtaining reciprocal benefits for New Zealand residents in relation to their tax exposure in those other countries. Benefits are granted to taxpayers on whom information and verification can be obtained in line with the exchange of information provisions of the treaty. By reducing domestic rates within the protection of treaties this has helped to combat international evasion and avoidance.



## 2.9 THE RELATIONSHIP BETWEEN DOMESTIC AND INTERNATIONAL TAX

The above discussion indicates that there is no one simple system for taxing cross border income flows that meets all objectives. Either system, that is, source or residence taxing, has advantages and disadvantages. The effect of not taxing residents on their worldwide income and the way taxes on non-residents can influence the relative rates of return between domestic and foreign-sourced income means that there is a connection between the two arms of international tax policy.

The aim of the Government must be to equalise as far as possible the rate of return on imported and exported capital by levying an appropriate net tax on income flowing from both sources.

The basic logic underlying this approach is as follows:

1. New Zealand taxes should not affect residents' decisions between investing locally or offshore, provided New Zealand applies the same tax treatment to both their domestic and offshore sources of income;
2. when New Zealand taxes the foreign-sourced income of New Zealanders at lower rates than domestic-sourced income, New Zealanders receive an implicit increase in the after-tax return on their offshore investments.
3. taxing non-residents can offset this implicit increase in the return, since it raises pre-tax rates of return in New Zealand relative to offshore and provides a further implicit incentive to invest onshore.

For the purposes of this discussion, we refer to this link between the taxes imposed on residents and non-residents as the "see-saw" relationship. In purely theoretical terms, the "see-saw" relationship would require the aggregate tax rate on cross-border income flows to sum to around the New Zealand corporate tax rate. Theoretically, under the "see-saw" the choice appears to be between explicitly double taxing residents on their foreign-sourced income or imposing a hidden additional cost through a higher domestic cost of capital. In practice the link is not so definite.

### **The "See-saw" Relationship**

In its simplest form, the "see-saw" relationship arises because to the extent that taxes on non-residents are recovered by the non-resident from the New Zealand business, they in effect raise the rates of return in New Zealand relative to the world non-taxed rate of return.

Further, if New Zealanders are taxed more lightly on their offshore investments than on their domestic investments, then the tax system encourages them to invest offshore. Taxing non-residents can offset this bias by this increase in the rate of return, thereby making New Zealand a more relatively attractive location for residents to invest.

Implementing a pure application of the see-saw relationship would impose other costs on New Zealand if it raises the domestic cost of capital facing businesses already producing and investing in New Zealand. The choice of tax rate on non-residents involves therefore a complex trade-off that takes into account and balances all these factors.

If New Zealand applied the deduction approach while other countries applied the exemption and credit approaches, New Zealand resident international investors would be competitively disadvantaged vis-à-vis their foreign rivals. The situation would be akin to New Zealand exporters that have to compete against subsidised producers from other countries.

There is nothing New Zealand can do to remove either implied or direct subsidies given by other countries. Offering competing subsidies to New Zealand exporters and offshore investors only serves to make New Zealand worse-off by making it more attractive for New Zealanders to invest offshore. Applying the same tax treatment to foreign-sourced income as other countries maintains the competitiveness of New Zealand based international investors, but potentially at the expense of the competitiveness of the New Zealand economy.

In practical terms, the realistic option for the Government is to have some combination of taxes on both residents and non-residents.

## **2.10 FOREIGN TAX CREDITS RECEIVED BY NON-RESIDENTS**

When non-resident investors receive full credits for taxes paid in New Zealand, each dollar of New Zealand tax is fully offset by a reduction in home country taxes. The non-resident's tax bill remains constant. Taxing non-residents in these situations transfers revenue from the foreign country to New Zealand. Under these circumstances, New Zealand is able to raise tax revenue without deterring foreign investors and without increasing domestic interest rates or the domestic cost of capital.

If all non-residents are taxed currently by their home country and receive credits for New Zealand taxes, then the best policy for New Zealand would be to tax non-residents at least up to the level of those credits. If non-residents received tax credits in their own country of residence for foreign-sourced income they earn through their New Zealand operations, New Zealand should also tax those earnings. However, most countries do not currently tax income earned by a New Zealand subsidiary, so New Zealand does not get "free" revenue from applying the company tax, even though those earnings may be eventually taxed by the home country, with a credit for New Zealand taxes, when the income is distributed via dividends. The value of the deferred tax credit reduces the cost of the New Zealand tax, but does not offset it completely.

Most countries do not provide full credits for taxes paid overseas or restrict when their credits can be used. To the extent that these limitations cause a double tax effect to arise, the advantages gained from taxing non-residents can be reduced.

## **2.11 OTHER IMPORTANT CONSIDERATIONS**

### **2.11.1 Compliance and administrative costs**

In the course of designing or evaluating an international tax regime, it is also important to incorporate the Government policy of minimising compliance costs, both the costs taxpayers incur when complying with their obligations under the regime and the costs that the Government incurs with the administration of the regime.

It is important to note, however, that there is a further trade-off in the compliance costs area. Simply put, the trade-off is between accuracy and simplicity. Improving the accuracy with which the income tax regime measures cross-border income flows or reduces the scope for tax planning opportunities tends to increase the compliance and administrative costs arising from the international tax regime. Balancing these trade-offs is not straightforward.

For instance, the company tax regime is of necessity more complex than the source deduction system on wages. For the first regime, full accrual accounting records with their supporting administration and analysis must be maintained. For the second regime, a more straightforward calculation to determine a specific deduction from a cash payment must be made. The additional work involved imposes higher compliance costs than the PAYE system, but the company regime is a key "backstop" to the effectiveness of the PAYE regime. Without the company regime, it would be very attractive for taxpayers to convert wage and salary income into company income and remain untaxed on that income until it is distributed to the ultimate shareholders. It would also be attractive for them to defer investment income taxation through the same mechanism.

Similarly, taxes on the foreign-sourced income of residents are a key "backstop" for the domestic income tax regime. They may be more costly to enforce and comply with than domestic taxes, but the regime plays an important role in protecting the integrity of the whole tax system as it applies to New Zealanders.

For the Government, considerable weight is given to compliance costs in the design of the policy and its day to day operation.

### **2.11.2 Minimising tax planning opportunities**

Some taxpayers develop complex arrangements to reduce their tax liabilities in a jurisdiction by exploiting differences in tax treatments across countries and different forms of income, by recharacterising in legal terms the source of their income, its type, or their place of residence.

Such activities can impose additional "deadweight costs" on New Zealand as a whole by:

- encouraging taxpayers to use resources to design legal and financial structures to reduce New Zealand tax. Such expenditure is socially wasteful as it is directed at "gaining a larger share of the pie" rather than at "making the pie larger";

- encouraging poor investment decisions by artificially altering the after-tax rates of return to alternative investments; and
- requiring the Government to impose costs on business by the complexity of the measures needed to address this activity and the higher rates of tax needed to raise the same amount of revenue (ie., to make up for the resultant erosion of the tax base).

Tax planning can best be countered by ensuring that, as far as practical, tax is levied on a broad income tax base at low rates. This broad base, low rate approach is reflected in the Government's international and domestic tax reform programme.

New Zealand can tax non-residents only on income sourced in this country. The non-resident base is best protected by, as far as practical:

- applying uniform rates of tax on different forms of New Zealand income; and
- having clear and robust rules determining when income is sourced in New Zealand.

The measures canvassed in this document relating to foreign direct investment, transfer pricing and thin capitalisation aim to meet these objectives.

### **2.11.3 Multinationals and International Tax**

As discussed above, applying the residence principle (that is levying equal tax on both the domestic and offshore income of New Zealand residents) reduces any tax incentives to invest offshore and protects the tax base. Strictly, this principle applies to New Zealand resident companies only to the extent they have New Zealand resident shareholders. Application of this principle to a New Zealand resident company owned fully or partially by non-residents would mean those non-residents are subject to New Zealand tax on their foreign income. This can make New Zealand an unattractive base for offshore investment by multinationals. Consideration needs to be given to whether this problem can be ameliorated without reintroducing artificial incentives for New Zealand shareholders to invest offshore and without exposing the tax base to avoidance problems.

### **2.11.4 Policy sustainability**

Investments are, by their nature, a "forward-looking" activity and once initiated they are often costly to reverse. Investment thrives in a world where the rules are understood and permanent. Tax changes that can be reversed at a later stage after investments have been made would be unwelcome. These concerns tend to be of greater importance to foreign investors who often feel more exposed to changes in policy.

To avoid deterring investment, it is important to have broad community support for major tax rules so that they are seen as sustainable in the future. To engender this support, the Government intends to consult widely before deciding on the direction and nature of policy initiatives.

In addition, adopting reforms based on a consistent framework will build credibility over time.

It is therefore very important that individual reforms to the international regime are consistent with an overall economic and policy framework for international tax policy and that the long-term direction of policy be signalled clearly and adhered to over time.

## **2.12 CONCLUSION**

In the course of gathering revenue, the income tax regime has a number of effects on economic behaviour.

Of particular concern is the ability of a poorly designed income tax system to:

- deter foreign investment and the associated benefits of new capital, skills and technology it embodies;
- increase the domestic cost of capital for New Zealand firms, thereby reducing their international competitiveness;

- encourage patterns of foreign and domestic investment that do not make the most efficient use of New Zealand's resources; and
- make New Zealand an unattractive base for foreign multinationals to invest offshore.

In principle, the international tax regime should be designed in such a manner as to reduce these "deadweight costs". However, the process of designing a practical international tax regime that meets the Government's economic policy objectives and international obligations is a complex process involving numerous trade-offs between various objectives.

Theoretically, the broad features that the international tax regime should possess to be consistent with the Government's economic policy objectives are in particular:

- the effective tax rates applying to the New Zealand-sourced income of non-residents should be as uniform as possible across alternative investments; and
- the effective rates of tax applying to the foreign-sourced income of residents should be as uniform as possible across investments.

In both cases, this requires accurate measurement of income and uniform statutory tax rates on each type of income.

The rates of New Zealand taxes imposed on inward and outward investment need to reflect the desirability of minimising the cost of capital to New Zealand and encouraging investment into New Zealand. So far as possible the rate structure should not provide an incentive for New Zealanders to invest offshore rather than here. The "see-saw" relationship is a theoretical framework for considering this issue. However, tax rules on investment flows also need to be practical and fair.

Consideration also needs to be given to:

- minimising opportunities for tax planning;
- the compliance and administrative costs of the regime. Reducing such costs inevitably involves some sort of trade-off between the accuracy of income measurement and the simplicity of the regime;
- ensuring the regime is sustainable in the longer term and sends clear signals to potential foreign investors about New Zealand tax structures;

noting that a well designed regime will leave business investment decisions the same as they would be in the absence of New Zealand taxes.

### 3. THE CURRENT TAX REGIME

*A description and assessment of the current regime in the light of the general discussion in Chapter 2*

#### **Summary**

##### **Residents:**

- **shareholders of New Zealand companies are taxed at their New Zealand rate with a credit for New Zealand taxes and a deduction only for foreign taxes;**
- **income received directly from offshore is taxed at the relevant tax rates (usually 33%) with a credit for foreign taxes;**
- **a dividend received by a New Zealand company is subject to Foreign Dividend Withholding Payment (FDWP) at 33%, with a credit for foreign Non-resident Withholding Tax (NRWT) and with a credit for underlying foreign company taxes if the New Zealand company owns at least 10% of the foreign company;**
- **income accrued within most forms of foreign entities is taxed on a current accrual basis with a credit for foreign taxes, unless the entity is resident in a "grey list" country in which case it is exempt from New Zealand tax on accrual.**

##### **Non-Residents:**

- **debt investment is generally subject to either NRWT or AIL;**
- **portfolio equity investment is subject to company tax and NRWT;**
- **direct equity investment through a branch is subject to 38% branch company tax;**
- **direct equity investment through a subsidiary is subject to company tax and NRWT.**

#### **3.1 CURRENT TAX TREATMENT OF FOREIGN-SOURCED INCOME OF NEW ZEALAND RESIDENTS**

##### **3.1.1 The general principle - New Zealand residents pay tax on their world wide income**

In principle, New Zealand residents are taxed on their world-wide income; that is, the income they derive from all foreign sources as well as the income that they derive from New Zealand. However, as explained below, credits are offered for taxes paid overseas.

New Zealand residents can engage in a wide range of economic activities offshore, directly or indirectly, through various mechanisms such as companies, partnerships and trusts.

##### **3.1.2 Credits for taxes paid overseas**

The amount of New Zealand tax collected from the foreign-sourced income of residents can vary greatly depending on the extent to which New Zealand grants the taxpayer a credit for taxes paid overseas to a foreign jurisdiction.

### 3.1.3 Income from foreign "portfolio" investment and distributions

Resident individuals or companies can receive distributions of income from offshore in a number of different forms, including:

- interest paid by a non-resident borrower;
- dividends paid by a non-resident company;
- royalties paid by a non-resident;
- payments for services performed offshore; and
- business income derived from an offshore branch.

Income earned by a New Zealand resident individual from foreign portfolio investments, such as interest, dividends and royalties, is subject to the resident's personal New Zealand tax rate, less a credit for foreign taxes paid by the individual (these are usually withholding taxes imposed by foreign governments).

The same types of income, other than dividends, earned by a New Zealand company are also taxed at 33% less a credit for foreign taxes paid by the New Zealand company.

A dividend received by a New Zealand company is subject to FDWP of 33%, less a credit for foreign taxes paid by the New Zealand company.

If the New Zealand company owns at least 10% of the foreign company paying the dividend, the New Zealand company may credit against its FDWP liability a proportionate share of the foreign company taxes borne by the foreign company which pays the dividend.

### 3.1.4 Income earned from investment in foreign companies

The CFC regime applies to investment in foreign companies controlled by the New Zealand shareholders. Broadly, that is the case where five or fewer residents own more than 50% of the foreign company or, in specified circumstances, where a single person owns 40% or more of the company.

The FIF regime applies when the CFC regime does not apply; that is, it applies to investment in foreign superannuation schemes, foreign life insurance policies and foreign companies that are not controlled by New Zealand shareholders.

Resident shareholders are allowed a credit for foreign withholding taxes paid by them. Additionally, under the CFC regime and in certain circumstances under the FIF regime, the resident shareholders are allowed a credit for the underlying foreign taxes paid by the foreign company that is earning the income on their behalf. In other circumstances, the FIF regime gives only a deduction for the foreign taxes.

The main exception to this treatment is the "grey list" exemption. If the foreign company is resident in a grey list country, neither the CFC nor the FIF regimes apply (unless the foreign company is subject to a low foreign tax rate due to a designated concession listed in the 16th Schedule to the Act).

Since New Zealand offers a credit for taxes paid to overseas countries, it is likely that little revenue, if any, would be collected by New Zealand from businesses operating in countries that apply taxes equal to or greater than those imposed under the CFC regime. Accordingly, to reduce unnecessary compliance costs, companies operating in grey list countries are exempted from the Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) regimes.

The tax regimes in overseas jurisdictions vary enormously. Certain countries have robust tax rules while others do not. A list of countries that meet certain robustness criteria are listed in the 15th Schedule to the Act and are referred to as the "grey list" countries. The list of countries included on the grey list is reviewed annually. As would be expected, given the benefit that inclusion confers, the criteria for inclusion on the grey list are rigorous.

There are currently six countries on the grey list (Australia, United Kingdom, Canada, United States, Germany and Japan). As a general rule, tax levied in a grey list country should equate to the level of New Zealand tax that would be payable if that income was sourced entirely from New Zealand. The grey list and the availability of tax credits mean that

New Zealand residents might pay nil New Zealand tax on profits earned overseas. At most, the payment of New Zealand tax on overseas earnings is no more than the corporate rate; that is, 33%.

The Government announced its policy on the “grey list” in the 1992 Budget. Under that policy, each year the schedule of countries on the “grey list” will be reviewed as part of the Budget consideration process. As other countries meet the criteria for inclusion laid out in the 1992 Budget documentation, they will be added to the “grey list”. Apart from this, the Government considers the current “grey list” criteria as settled.

As explained above, this exemption is given to save taxpayer compliance costs. It is presumed that companies resident in these countries pay foreign taxes sufficient to generate foreign tax credits that would offset all of the New Zealand tax otherwise due under the CFC or FIF regimes.

If the grey list exemption applies, the income will be taxed upon distribution to the shareholder rather than when it is earned. The grey list exemption applies to 70-80% of New Zealand’s foreign direct investment income.

If a taxpayer is subject to the CFC or FIF regimes on income earned through investment in a foreign entity, mechanisms are used to prevent the double application of New Zealand tax on the income when distributed to the shareholder. This means that income distributed to a shareholder is subject to total New Zealand tax equal to the shareholder’s total tax rate.

However, the mechanism does not apply to foreign taxes and therefore shareholders are effectively given a deduction for foreign taxes. In essence, foreign tax credits given for CFC, FIF or FDWP imposts are ‘clawed back’ at the shareholder level.

### **3.1.5 Income earned from trusts**

Income derived by a trustee of a trust in any income year is either ‘trustee income’ or ‘beneficiary income’.

Beneficiary income is that part of income that vests in or is distributed to a beneficiary in the year that it is derived by a trustee or within six months after the end of the year. A resident beneficiary can be taxed on beneficiary income and certain other distributions from trusts with foreign connections.

Trustee income of a trust that has a resident settlor at any time in an income year is taxable in New Zealand, even where the trustees are non-resident and the income has a foreign source. In the latter case, the resident settlor will be liable for the tax as agent for non-resident trustees.

Taxable distributions can be made by foreign trusts and non-qualifying trusts. A foreign trust is a trust in which no settlor has been a resident of New Zealand from 17 December 1987 (or when the trust was first settled, if later) to the time that the distribution is made. A non-qualifying trust is a trust which, at the time of a distribution, is neither a qualifying nor a foreign trust.<sup>2</sup>

### **3.1.6 Provision of credits for foreign taxes**

New Zealand provides foreign tax credits both unilaterally and through its Double Taxation Agreements (DTAs) with other countries.

The objective of foreign tax credits is to avoid double taxation of the foreign-sourced income of residents. If a resident derives foreign-sourced income and that income is subjected to foreign tax, New Zealand provides the resident with a foreign tax credit.

Calculating the foreign tax credit involves two steps:

1. determining, in accordance with s.293(2) of the Income Tax Act 1976 (the Act)<sup>3</sup>, the foreign income tax borne by the New Zealand resident; and

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<sup>2</sup> A qualifying trust is generally a trust that has always been subject to New Zealand tax from the time it has been settled.

<sup>3</sup> This document refers to the provisions of the Income Tax Act 1976, rather than to the recently passed Income Tax Act 1994, which will come into force on 1 April 1995.

- determining, in accordance with s.306(2) of the Act, the New Zealand tax that would have been payable on the foreign-sourced income if no foreign tax had been paid. This is the foreign tax credit limit. (The method of calculating the foreign tax limit is shown below.)

The foreign tax credit allowed is the lesser of the foreign tax borne by the New Zealand resident and the foreign tax credit limit.

### **3.1.7 Foreign tax credit gross-up**

If income is received net of foreign tax (for example, interest subject to foreign NRWT), then the income must be grossed-up by adding the amount of the foreign tax before determining the New Zealand tax.

### **3.1.8 Calculating the foreign tax credit limit**

The foreign tax credit limit is calculated by multiplying the amount of New Zealand tax payable on the taxpayer's world-wide income (determined after the gross-up and before the foreign tax credit) by the ratio of the foreign-sourced income subject to the foreign tax to the total assessable income of the taxpayer.

$$\text{Foreign Tax Credit Limit} = \text{New Zealand Tax} \times \frac{\text{Foreign Sourced Income}}{\text{Total Assessable Income}}$$

## **3.2 CURRENT TAX TREATMENT OF NON-RESIDENTS - GENERAL COMMENTS**

Non-residents can engage in a wide range of economic activities in New Zealand, directly or indirectly, through various mechanisms including companies, partnerships and trusts.

There are considerable differences - from 1.34% to 53% at the extreme ends of the range- in the rates of New Zealand tax applied to the income derived from these economic activities.

These differences arise not only because of differences in the statutory rates of tax that New Zealand applies to different forms of income (that is, interest or profit), but also from differences in the tax treatment of different entities and in the tax treatment of non-residents in different countries.

## **3.3 TAXATION OF INCOME TO NON-RESIDENTS FROM "PORTFOLIO" INVESTMENT**

### **3.3.1 Equity investment**

There are two distinct layers of New Zealand tax that can be imposed on the income that non-residents derive from equity invested in a New Zealand company:

- the New Zealand company pays 33% company tax on the profit made in New Zealand; and
- NRWT is applied to any dividends distributed offshore to the non-resident.

Dividends paid by a company, unlike interest, are not deductible in determining its New Zealand tax liability. Therefore, the income that non-residents derive from equity investments in New Zealand can be subject to both the rate of company tax when that income is derived by a New Zealand company in which they have invested and the rate of NRWT when that income is distributed in the form of dividends.

A New Zealand resident shareholder in a New Zealand company receives credit for company tax through the imputation system. For non-resident portfolio shareholders, partial relief for double taxation is provided through the foreign investor tax credit described below.

#### **3.3.1.1 NRWT on dividends**

The rate of NRWT applying to dividend income is 30%, except where the non-resident resides in a country with which New Zealand has negotiated a DTA.



The usual rate of NRWT on dividends set by DTAs is 15%.<sup>4</sup> This means that, except where the foreign investor tax credit (FITC) applies, the overall combined statutory tax rate on non-resident equity investment in New Zealand is 53% in cases where the 30% NRWT rate applies and 43% in cases where the 15% DTA NRWT rate applies.<sup>5</sup>

The amount of NRWT on dividends is reduced, however, by credits for foreign dividend withholding payments levied on foreign-sourced dividends derived by New Zealand resident companies.

### 3.3.1.2 Foreign investor tax credit

The FITC regime, enacted in September 1993 (s.308A), provides a credit of company tax to non-resident portfolio investors. The FITC is calculated as 0.5583 of the imputation credits attached to the dividends paid to non-resident portfolio investors (defined as non-resident shareholders owning a voting interest of less than 10% in the company). The credit is paid to companies, which are required to pass it on to eligible non-resident shareholders through the payment of a supplementary dividend.

With the FITC, the total New Zealand tax on non-resident portfolio investment in New Zealand is the standard New Zealand company tax rate of 33% when the DTA 15% NRWT on dividends applies and 45% when the dividend is paid to an investor from a country which does not benefit from a DTA and the statutory 30% NRWT on dividends applies.

### 3.3.1.3 Taxation of income from "direct" investment

Non-residents can engage in direct investment in New Zealand either through a branch (that is, an unincorporated "fixed establishment"), or a subsidiary (that is, an incorporated "fixed establishment").

#### 3.3.1.3.1 Branch investment

One common investment option for non-residents is to establish a branch of their business operations in New Zealand. For example, a non-resident individual can operate a branch factory in New Zealand. Similarly, a non-resident company can establish an office in New Zealand to administer its operations here.

Distributions from a branch to its head office are not separately taxed because no payment to another separate legal entity is made. For this reason, branches are subject to a 38% company tax rate instead of 33%.

#### 3.3.1.3.2 Subsidiary investment

Another common form of non-resident investment is the establishment by the foreign company of a subsidiary in New Zealand.

New Zealand tax law does not "look through" a company to its shareholders to determine where a company is resident. A subsidiary of a non-resident company is treated as a New Zealand resident and taxed by New Zealand on its world-wide income if:

- the subsidiary company is incorporated in New Zealand; or
- it has its head office in New Zealand; or
- it has its centre of management in New Zealand; or
- control of the company by its directors is exercised in New Zealand.

In addition, interest or dividends paid from a New Zealand-resident subsidiary to its offshore parent would generally be New Zealand-sourced income derived by the parent and subject to the tax treatment discussed in this Chapter.

#### 3.3.1.3.3 Summary

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<sup>4</sup> The exceptions are the Indian DTA that reduces NRWT on dividends to 20% and the Philippines DTA that reduces it to 15% if the shareholder is a company or 25% if the shareholder is not a company.

<sup>5</sup> In the remainder of this Chapter, tax rates refer to combined statutory (rather than effective) tax rates unless otherwise indicated.

Currently, the FITC does not apply to direct investment, although this document proposes that it should apply in future. Company tax is only one of the levels of tax imposed on the income that non-residents derive from direct investment in New Zealand. As distributions are also often taxed, the tax on the distribution must be considered as well. The combined effects of the company tax and tax on distributions of interest and dividends are summarised in the following table.

**Table 1**  
**TAXATION OF COMPANY DISTRIBUTIONS FOR A TREATY INVESTOR**

CASH FLOW	DEBT		EQUITY	
	Portfolio	Direct	Portfolio	Direct
Income	100	100	100	100
Company Tax	0 <sup>6</sup>	0 <sup>6</sup>	-21 <sup>7</sup>	-33
Distribution	100	100	79	67
AIL / NRWT	-1 <sup>8</sup>	-10 <sup>9</sup>	-12 <sup>10</sup>	-10 <sup>11</sup>
Net Received	99	90	67	57
Eff. Tax Rate	1%	10%	33%	43%

### 3.3.2 Debt investment

Generally, interest income derived by a non-resident from debt investment in New Zealand will be deemed to have a New Zealand source and therefore be subject to NRWT in cases where a non-resident<sup>12</sup>:

- lends money in New Zealand (s.243(2)(l) of the Act;
- lends money outside of New Zealand to a resident, except where the resident uses the money for the purposes of a business carried on outside New Zealand through a fixed establishment outside New Zealand (s.243(2)(m)(i)); or
- lends money outside of New Zealand to a non-resident, if the money is used for the purposes of a business carried on in New Zealand through a fixed establishment in New Zealand (s.243(2)(m)(ii)).

The rate of NRWT applying to such interest income is 15%,<sup>13</sup> except:

- where the non-resident resides in a country with which New Zealand has negotiated a DTA. Most of New Zealand's DTAs restrict, to 10% of the gross amount of the interest,<sup>14</sup> the rate of NRWT that New Zealand can apply to the interest income earned by a non-resident; or

<sup>6</sup> Because interest is deductible in determining company tax, there is no net company tax imposed on profits distributed as interest.

<sup>7</sup> 33% company tax less FITC credit which amounts to approximately 12% of distributed profits.

<sup>8</sup> 2% AIL less the effect from 0.66% company tax deduction for net 1.34% effective cost of AIL.

<sup>9</sup> Presumes 10% NRWT rate on interest applies under a DTA as a final tax. AIL not available on distribution to direct investor (associated person). When the 10% NRWT is not a final tax, the effective tax rate on debt supplied by direct investors will exceed 10%.

<sup>10</sup> 15% NRWT on the dividend and supplementary dividend which together amount to \$79 in this example. 15% DTA NRWT rate presumed to apply, otherwise 30% statutory NRWT rate may apply (or alternative DTA rate).

<sup>11</sup> 15% of \$67 distribution. 15% DTA NRWT rate presumed to apply, otherwise 30% statutory NRWT rate may apply (or alternative DTA rate).

<sup>12</sup> NRWT does not apply to interest derived by a non-resident who is engaged in business in New Zealand through a fixed establishment. Such interest income is subject to ordinary income tax.

<sup>13</sup> However, NRWT is a final tax only when the borrower and the issuer are not associated. If they are associated, NRWT represents a minimum tax, subject to DTA restrictions. The remainder of the discussion assumes that the borrower and the lender are not associated.

- where the borrower is an "approved issuer" for the purposes of the Approved Issuer Levy (AIL) under Part VIB of the Stamp and Cheque Duties Act 1971. If the borrower is an approved issuer and is not associated with the lender, the rate of NRWT is reduced to zero.

An approved issuer must pay a levy of 2% of any interest that is paid to unassociated persons. This levy can be deducted when calculating the borrower's New Zealand taxable income, so that the effective cost of the levy to a taxable borrower is 1.34% of the interest paid.

When a non-resident lends money to a New Zealand company engaging in a business activity that generates assessable income, interest paid on that debt can generally be deducted by the borrower in determining a New Zealand income tax liability.

Deductibility means that the interest income of the non-resident investor making a loan to a New Zealand company is not subject to the company tax as well as NRWT. Rather, the total New Zealand impost applying to such interest income is the rate of AIL payable by borrower, or the rate of NRWT imposed on that interest income.

### 3.4 CONCLUSION

Statutory imposts of New Zealand tax on cross-border income flows are quite disparate, ranging from very high to very low.

Residents are generally taxed on foreign-sourced income at the time when it is received by them. They are sometimes taxed on foreign-sourced income on a current basis as it is earned; for example, when the CFC or FIF regimes apply. In some cases, the grey list exemption and foreign tax credits reduce the effective New Zealand tax rate on foreign-sourced income to nil. As a result, the rate of New Zealand tax payable on offshore income can range from 0% to 33%.

For non-resident investors, combined statutory imposts range from 1.34% to 43% where a DTA applies and up to 53% otherwise. For treaty investors, some examples of imposts on non-resident investment in New Zealand are:

- portfolio debt investment is subject to an effective impost of approximately 1% when AIL applies;
- portfolio equity investment is taxed at approximately 33%;
- direct debt investment is taxed at approximately 10%; and
- direct equity investment is taxed at approximately 43%.

Given the wide range of tax rates applying to both arms of international tax policy, significant changes in either area need to be considered in conjunction with the other; for example, significant reductions in the high tax rates on non-residents would have to be considered together with measures to increase uniformity in tax rates and the level of New Zealand tax applied to offshore income of residents.

In practice, there are difficulties applying even rates and timing rules for New Zealand tax to cross-border income flows. In each case, the underlying logic of the particular regime covering a particular income flow drives the applicable New Zealand rate. For example, residents who own offshore entities that are not CFCs or FIFs are generally taxed on foreign-sourced income when it is received by them in New Zealand. For CFC and FIF income, the tax is applied to the income as it is earned. Foreign tax credits and the "grey list" can see the New Zealand impost reduced to zero, although those taxpayers will normally be meeting their tax impost in the overseas jurisdiction from which the income comes.

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<sup>14</sup> Most DTAs provide for 10% NRWT on interest, except those with India, Canada, Malaysia, the Philippines and Singapore, which provide for 15% NRWT on interest and the Japanese DTA, which does not cover interest, so the statutory 15% rate applies.

Any changes in these areas were it contemplated would have to be fully integrated taking into account all factors including the final determination as to the extent to which the theoretical considerations outlined in Chapter 2 should be drivers of policy in this area. Submissions are invited on that and other relevant issues raised in this chapter.

## **PART B: REFORM PROPOSALS**



## 4. PROBLEMS WITH THE EXISTING RULES MEASURING CROSS-BORDER INCOME

### Summary

**The ideal foundation for a set of rules for taxing cross-border income would be:**

- **source rules that allow income from each tax base to be measured accurately;**
- **uniform rates of tax applied to each tax base.**

**Current tax rules could be moved closer to this foundation by:**

- **clarifying New Zealand's source rules, including transfer pricing; and**
- **reducing disparities in the tax rates applying to the different forms of foreign investment.**

### 4.1 INTRODUCTION

The current tax regime, as outlined in Chapter 3, seeks to levy tax on all three income tax bases on which New Zealand could levy tax:

- New Zealand-sourced income of residents;
- foreign-sourced income of residents; and
- New Zealand-sourced income of non-residents.

As discussed in Chapter 2, an important policy issue is the weighting that should be placed on each of these bases so that the tax impost is appropriate given economic efficiency, fairness, practicality and compliance cost concerns and given New Zealand's international obligations. This is a matter requiring on-going dialogue.

A more immediate issue is to ensure that, as far as practical, New Zealand's existing rules provide a sound foundation for levying whatever is considered to be an appropriate tax impost on each base.

The theoretical ideal foundation would be source rules that allow income from each base to be measured accurately and the application of relatively uniform rates of tax on each base.

Current tax rules do not measure up to this theoretical ideal. Significant problems are:

- a lack of adequate statutory guidance for taxpayers to determine the source of income. Some of these deficiencies are technical, relating to the structure of the legislation. Others are more significant in policy terms; for example, the lack of adequate transfer-pricing rules;
- in contrast to the theoretical ideal, current rules can impose highly variable rates of tax within each source base. For example, foreign investment is subject to different tax rates according to whether it is debt or equity financed.

This document does not include proposals to change New Zealand's existing tax rules to bring them into line with the theoretical ideal. That would not be practical. However, improvements can be made. The remainder of this Chapter discusses various problems with existing rules. The next Chapter outlines a reform programme to deal with these problems and chapters 6 to 8 canvass details of that reform programme.

## 4.2 SOURCE RULES - TECHNICAL PROBLEMS

The main legislative source rule is found in s.243 of the Act. However, there are a number of other sections covering source issues, including ss. 245, 293 and 307. In addition, the general expenditure deduction provision (s 104) and the existing transfer-pricing provision (s 22), are important to the determination of net New Zealand-sourced income.

Technical problems with these rules tend to fall into one of four categories:

- insufficient statutory detail on where income is sourced;
- lack of explicit apportionment rules;
- structural problems regarding whether statutory apportionment rules apply to gross or net income;
- practical problems with the determination of source, leading to inconsistent rules and rules that are difficult to apply.

While some of these problems may seem to be relatively minor, at least when viewed in isolation, any weaknesses in the basic source rules are likely to flow through into the transfer-pricing rules. General income and expenditure source rules must be the basis upon which transfer-pricing rules are built, because transfer-pricing rules largely focus on the manipulation of prices to alter the source of net income.

### 4.2.1 Insufficient statutory detail as to where income is sourced.

The main statutory provision determining the source of income for New Zealand tax purposes, s.243(2), does not provide a general criterion for defining New Zealand-sourced income. Instead it merely lists some of the more common specific forms of such income. As a result, the section can provide insufficient guidance for determining the source of those forms of income which do not exactly match those listed and which therefore fall within the "catch-all" provision of paragraph (r). In those circumstances, it has been necessary to resort to common law rules to determine source. This can create uncertainty.

Problems in the definition of New Zealand-sourced income lead to uncertainties over whether income is foreign-sourced and, if foreign-sourced, from precisely where. The Act has no general definition of foreign-sourced income. It seems to work on the general presumption that income not sourced in New Zealand is foreign-sourced. The exception is dividend income. S 307 specifies that dividends paid by a company resident in a country which has a DTA with New Zealand are deemed to be derived from a source in that country. S 293(3) extends this source rule to dividend income from non-DTA countries.

As well as causing general uncertainty about the source of income, the above rules do not integrate well with New Zealand's foreign tax credit rules. Those rules limit tax credits to the level of New Zealand tax payable on the income from a specific source on which overseas tax is paid. Thus the absence of general rules determining foreign-sourced income creates problems.

### 4.2.2 Apportionment issues

The general source provision (s.243) implies that some forms of income with more than one source must be apportioned to determine the extent to which they have a New Zealand source. In addition, s.245 explicitly requires business and contract income to be apportioned. S.104 then requires expenditure to be apportioned between that which is used to derive New Zealand-sourced income and that which is not.

Despite these apportionment requirements, the legislation does not provide any explicit guidance on either the process or the methodologies that taxpayers should use to apportion their income and expenditure between different countries. This can create problems, not only for non-residents calculating their net New Zealand-sourced income, but also for residents calculating the proportion of their net income that they have derived from each foreign country.

A specific apportionment problem arises with expenditure incurred jointly in deriving New Zealand and foreign-sourced income. Joint costs incurred in one country can give rise to assessable income in more than one country. For example, research and development costs incurred by a parent company in one country may increase the profitability of its branches and subsidiaries in other countries. Similarly, head office management expenses incurred in one country can produce assessable income in a number of other countries. One approach to joint cost allocation is to allocate on a marginal cost basis. However, this has some practical limitations. Overall, the joint costing issue in the international



arena raises the same basic issues as in the domestic context. Joint costing in this context was considered by the Valabh Committee in their Tax Accounting Issues document.

#### **4.2.3 Structural problems**

In common with the rest of the income tax legislation, it can be unclear whether forms of income are intended to be expressed in gross or net terms. For example, it is not explicitly stated whether “business income” as used in s.243(2)(a) is intended to be net income (after deduction of expenses) or gross income (with expenses then deducted separately under provisions such as s.104). The Inland Revenue Department interprets s.243(2) as applying exclusively on a gross basis.

However, this can raise some other issues. For example, if non-New Zealand expenses are deductible under the normal provisions of the Act there seems to be no explicit requirement for those expenses to have a jurisdictional link with New Zealand. If a deduction is taken under s.104, that jurisdictional link is automatic. But that is not the case with some other deductibility provisions such as s.106(1)(h)(ii) where a jurisdictional link needs to be inferred.

Finally, while s.243(2) may best be interpreted as using concepts such as “income” in gross terms, it is schematically clear, though not explicitly stated, that the term “income” when used in reference to the foreign tax credit limit in s.293(2) should be interpreted as net income. Even in this case, there is no statutory guidance on the allocation of expenses in determining overseas net income; for example, whether an appropriate proportion of head office management expenses incurred in New Zealand should be deducted prior to calculating the net income on which foreign tax credits are allowed.

A clearer structuring of source rules would provide better guidance for taxpayers and better protection for the tax base.

#### **4.2.4 Practical problems with implementing source rules**

In principle, the economic source of income is the country in which the value-added activity leading to the generation of income takes place. In general, New Zealand’s source rules tend to follow this notion. However, the fungibility of money makes it difficult to apply the value-added principle to the determination of the source of income generated by debt or equity,

The interest source rule in s.243(2)(m) applying to money lent overseas seems in general to follow the value-added principle, but can be difficult to apply in practice. For example, New Zealand’s current rules deem interest on money lent overseas to a person living overseas (but resident in New Zealand for tax purposes) to have a New Zealand source (and thus be within the New Zealand tax net) if the funds are used for a non-business purpose. Clearly such a rule is difficult to administer.

New Zealand defines the source of dividend income as the residence of the paying company. This is an arbitrary rule. The global profits of a multi-national enterprise will be derived from the value-added activities in each country in which the company operates, not just the country in which it is tax resident. The dividend source rule is quite different from the interest source rule. This difference is difficult to defend on theoretical grounds, especially since New Zealand moved to an imputation system (as extended by FITC) which reduces the general differences in tax imposts on debt and equity.

New Zealand’s dividend source rule, when combined with the basic tax rule that a multi-national company resident in New Zealand is taxable on its worldwide profits irrespective of the ownership of that company, creates specific problems. It means that income which, in economic theory, is sourced overseas (where the value-added activity takes place) is subject to New Zealand company and dividend tax, even though the ultimate owners of the income are overseas resident shareholders. This imposes a tax penalty on multi-national companies operating out of New Zealand.

Other countries, such as the USA, have tried to mitigate this sort of problem by reducing tax levied on income derived offshore and then distributed to overseas owners. New Zealand should consider giving relief along similar lines if this can be done with reasonable compliance and administrative costs and without undermining the other desirable core features of New Zealand’s international tax regime.

### **4.3 ABSENCE OF ADEQUATE TRANSFER-PRICING RULES AND APPROVED METHODOLOGIES**

Another factor that complicates the calculation of net New Zealand-sourced and foreign-sourced income is the absence of adequate transfer-pricing rules incorporating approved transfer-pricing methodologies which multinational enterprises can use to value their transactions between New Zealand and overseas arms of their operations. This creates uncertainty

in the calculation of the net New Zealand income statistics and provides opportunities for multinational enterprises to manipulate prices on actual or deemed transactions in order to lower the New Zealand tax payable.

This area is now largely governed by s. 22 of the Act. This section empowers the Commissioner to readjust New Zealand income if a business carried on in New Zealand produces less income than the Commissioner might expect and when the business is:

- controlled by non-residents; or
- carried on by a non-resident company or a company controlled by non-residents or persons who have control of a non-resident company.

There are, however, a number of problems with this section, making it deficient as a key part of New Zealand's source provisions. In particular:

- the control tests which must be met before the provision comes into play are limited and therefore can be circumvented;
- insufficient guidance is provided about what is, in terms of the section, the appropriate level of net income to be sourced in New Zealand; and
- the relationship between s. 22 and other sections of the Act is not clear.

Clearer transfer-pricing rules, possibly buttressed by thin-capitalisation measures, would improve taxpayer certainty as well as base maintenance.

#### **4.4 VARIABILITY OF TAX RATES**

As outlined in Chapter 3, statutory imposts of New Zealand tax on cross-border income flows are quite disparate. While differences in the level of tax imposed on outbound as opposed to inbound investment can have an economic justification, it is particularly difficult to justify:

- direct inbound investment being subject to a statutory rate higher than the rate on domestic investment (33%). Under current rules, the tax rate on repatriated income from direct investment equity investment can be as high as 43% when the normal corporate tax rate plus NRWT on dividends (at the normal DTA tax rate) are combined;
- the large differences that exist between the tax rates applying to foreign debt versus equity investment. As outlined in Chapter 3, foreign debt investment can be taxed at rates as low as about 1% whereas foreign equity investment is subject to a statutory rate of at least 33%.

The latter feature provides an incentive for foreign investment to be financed with debt rather than equity. The high tax on direct equity investment exacerbates this problem. To the extent that some investors cannot substitute debt for equity, differential taxation of debt and equity will distort the pattern of foreign investment in New Zealand.

Reforms to reduce the very high statutory tax on direct foreign investors therefore seem justified. Such a measure would in itself reduce some of the pressure on the debt/equity distinction but further measures to reduce pressure on this boundary should also be considered.

#### **4.5 CONCLUSION**

The current statutory rules applying to cross-border income can be improved. This would involve clearer and more detailed rules for determining New Zealand-sourced and foreign-sourced income and apportionment rules for income that has more than one source (where apportionment is allowed) and expenditures incurred in producing both New Zealand-sourced and foreign-sourced income. Such rules should include approved methodologies for determining transfer prices.

Reforms along these lines would help both resident and non-resident taxpayers in their attempts to fulfill their obligations to accurately determine their New Zealand tax liabilities and help protect the New Zealand tax base.

In addition, a reduction in the variability of tax rates applying to different types of cross-border investment would improve the economic efficiency of current rules.



## 5. PROPOSED PROGRAMME FOR REFORM

### Summary

**The Government proposes a reform package consisting of three main, mutually-reinforcing elements:**

- **the extension of the Foreign Investor Tax Credit (FITC) regime to direct investors and, as a consequence, the reduction of the branch profits tax rate to 33%;**
- **new transfer-pricing rules applying to all cross-border transactions, using internationally accepted methodologies and compatible guidelines for the application of New Zealand's existing source rules;**
- **possibly, thin-capitalisation rules.**

### 5.1 INTRODUCTION

This Chapter outlines the Government's proposals for dealing with the problems associated with the international tax regime.

### 5.2 THE REFORM PACKAGE

When the FITC regime was introduced, the Government announced that it would consider the existing rules governing the taxation of direct investment by non-residents. These changes are proposed as part of a package of reforms to New Zealand's transfer-pricing, source and thin-capitalisation rules. The Government also proposes to implement an extended FITC regime. This package should be seen as a whole rather than as a set of separate proposals.

In particular, the Government considers that this package should be a continuation of and consistent with, the previous direction of the reform of international taxation. The proposed transfer-pricing rules and extended FITC regime are part of the strategy of imposing lower, but less variable, effective tax rates on non-residents. Further, the FITC extension for direct investors and the transfer-pricing proposals are mutually reinforcing. The FITC extension will reduce incentives for companies to transfer-price or thinly-capitalise, because New Zealand tax payments will have value to non-resident investors.

### 5.3 EXTENSION OF THE FITC REGIME

The Government proposes that the FITC regime be extended to all non-resident shareholders in New Zealand companies. Applying the regime to non-resident direct investors would involve a simple technical amendment, although some additional minor reforms may prove necessary in specialist areas such as life insurance.

The FITC is a particularly desirable mechanism for reducing tax-related distortions on cross-border capital flows because it applies only where and to the extent that, New Zealand company tax has actually been paid. This is because the FITC is a portion of the imputation credits attached to the dividend.

It is also proposed that the corporate tax rate on the New Zealand branch income of non-resident companies be reduced from 38% to 33%.

The extension of the FITC would apply from the date on which amending legislation is enacted, which is expected to be in the second half of 1995. It is proposed that the removal of the branch profits tax would take effect from the start of the 1996-97 income year.

#### 5.4 NEW TRANSFER-PRICING RULES

It is proposed that new transfer-pricing rules be implemented to improve the measurement of New Zealand-sourced income and to reduce the scope for manipulating cross-border transfer prices. The existing transfer-pricing rules contained in s.22 of the Act do not ensure that New Zealand-sourced profits are properly measured. The proposed regime is intended to be narrowly-focused, while protecting the tax base by being difficult to circumvent.

Transfer-pricing rules would require cross-border transactions to be recorded for tax purposes at arm's-length prices. They are intended to properly apportion income between New Zealand-sourced and foreign-sourced income and between New Zealand residents (within the New Zealand tax base) and non-residents (not within the New Zealand tax base). They are therefore a necessary part of New Zealand source and residence rules. Adequate source and residence rules, including transfer-pricing rules, are desirable for ensuring that the aggregate rate of New Zealand tax on income derived by non-residents is applied as accurately as possible.

The key elements of the proposed new transfer-pricing rules are that:

- the rules would apply to all cross-border transactions in which parties are not dealing with each other at arm's-length;
- the parties to a cross-border transaction would not be required to have a direct relationship such as common ownership;
- apportionment rules would apply to deemed transactions between a New Zealand branch and its head office, in order to treat the branch like a separate subsidiary of the head office;
- taxpayers would be required to report, for tax return purposes, all cross-border transactions at arm's-length terms;
- to ease compliance costs, however, submissions are sought on introducing a presumption that transactions by unrelated parties are at arm's-length;
- the internationally accepted range of arm's-length transfer-pricing methods would apply. These are transaction-based methods (comparable uncontrolled price, resale price, cost plus) and profits-based methods (comparable profits and profit split);
- the comparable uncontrolled-price method would be available to taxpayers as a safe-harbour. If taxpayers can apply this measure, the Commissioner could not apply any other method;
- outside this safe-harbour, a best method rule would apply to decide the specific method to be used to determine arm's-length prices in particular cases. Guidance on suitable approaches would be provided by some form of binding determination procedure;
- to reduce compliance costs, it is proposed that taxpayers be required to make only a reasonable estimate of an arm's-length price, rather than be within a statistically acceptable band of arm's-length prices; and
- to increase taxpayer certainty, advance pricing agreements would be available from Inland Revenue as part of the binding rulings regime.

The types of transactions to which the proposed rules would apply are those that deplete the New Zealand tax base. They include:

- a non-resident's sale of goods or services to a New Zealand taxpayer for greater than arm's-length consideration;
- a New Zealand taxpayer's sale of goods or services to a non-resident for less than arm's-length consideration.

Generally, the regime would not apply to wholly domestic transactions between residents, but if such transactions had an offshore connection resulting in a shift in income from a New Zealand resident to a non-resident, they would have to be subject to the regime, to limit abuse.

Like the reforms as a whole, the transfer-pricing regime is a package of measures designed to better measure New Zealand-sourced income and to limit avoidance while keeping compliance costs to a minimum. The elements of the regime should be considered not in isolation, but in terms of their overall effectiveness in meeting these objectives.

Submissions are invited on all aspects of the proposed regime, including:

- the absence of a de minimus rule. Whether compliance concerns are better met by taking a reasonably flexible approach to calculating the required arm's-length prices;
- whether taxpayers should be required to make only a reasonable estimate of an arm's-length price, or to use a price within a specified range produced by an acceptable arm's-length method; and
- the absence of a requirement for a direct relationship such as common ownership between parties to a cross-border transaction, to counter avoidance concerns and whether the breadth of this approach raises concerns about compliance costs and uncertainty that can not be adequately addressed by the introduction of a presumption similar to that referred to above.

It is proposed that the new transfer-pricing rules will apply from the start of the 1996-97 income year.

### **5.5 IMPROVED SOURCE RULES**

Detailed guidelines governing the application of the general apportionment provision (s.245) are proposed. These will follow the proposed transfer-pricing regime.

Clarification of the source rules and implications of the Valabh committee recommendations regarding apportionment of joint costs should be considered in parallel with the re-write of the Income Tax Act.

### **5.6 CONSIDERATION OF THIN-CAPITALISATION RULES**

Thin-capitalisation is the name given to the practice whereby a non-resident investor deliberately loads a New Zealand taxpaying entity with debt, so that large interest deductions will be attributed to the New Zealand tax base. This has the effect of reducing the New Zealand taxable income of the non-resident's New Zealand operations.

Like transfer-pricing, thin-capitalisation can be used by non-resident investors to artificially reduce New Zealand tax. Rules to counter thin-capitalisation may be required to act as a backstop to the proposed transfer-pricing regime.

The Government has not finally determined whether such rules are absolutely necessary. However, it has determined that, given the context of this discussion, the issue should be thoroughly canvassed. The Government does not want to implement an ineffective package. There is little point in introducing effective transfer-pricing rules if they are defeated in practice by thin-capitalisation. Therefore it has decided that rules to counter this practice should be considered.

The Government seeks submissions on this issue and on whether an effective thin-capitalisation regime is feasible and necessary.

### **5.7 CONCLUSION**

The reforms proposed above are an integrated package of measures designed to address particular concerns in the taxation regime as it affects non-resident investment in New Zealand. The key components of this package are:

- the extension of the FITC to direct investment;
- transfer-pricing and source rules; and
- consideration of thin-capitalisation rules.





## 6. EXTENSION OF TAX CREDITS TO FOREIGN DIRECT INVESTMENT

### Summary

**Extending the Foreign Investor Tax Credit (FITC) regime to direct investment will reduce the tax burden on such investment where New Zealand company tax is paid, thereby reducing the cost of capital for New Zealand businesses.**

**The extension will initially cost \$60 - \$70 million per annum.**

**The branch profits tax will be lowered from 38% to 33% to achieve consistency with the extended FITC regime.**

### 6.1 INTRODUCTION

This chapter covers:

- the objectives of extending the FITC to foreign direct investors;
- the fiscal cost of the extension; and
- the consequent change to the tax rate applying to branches of non-resident companies.

### 6.2 OBJECTIVE OF THE PROPOSED EXTENSION OF THE FITC REGIME

The FITC is a useful tool for reducing tax-related distortions in cross-border capital flows, consistent with the objectives in Chapter 2. This is because the FITC simultaneously:

- reduces the pre-tax rate of return required by foreign investors for them to place their capital in New Zealand;
- reduces the differential between the tax rates on foreign and domestic investment in New Zealand; and
- applies only where and to the extent that, the company actually pays New Zealand tax.

As mentioned in the Overview, at the time of the introduction of the FITC, the Government decided that it should initially apply only to foreign portfolio investors (that is, those owning less than 10% of a company). The Government said it would consider later whether the FITC regime should cover foreign direct investors.

The deferral was to allow time for further consideration of the complex economic and taxation issues surrounding foreign direct investment. For example, direct investors are more likely to be able to claim credits for company tax against their home tax liabilities, which could mean that levying both company tax and NRWT in New Zealand does not increase their final tax liabilities. Such investors may also be able to reduce their tax liabilities through measures such as thin-capitalisation and abusive transfer-pricing. The current proposal is to extend the FITC in tandem with the other reforms in this package.

Overall, the Government believes that extending the FITC to foreign direct investment now will reduce the total tax burden on such investment. This benefit will flow through to a reduced cost of capital for New Zealand firms, thereby lowering costs to businesses operating in New Zealand and increasing investment and employment.

Accordingly, the Government proposes to extend the FITC mechanism to foreign direct investment. This will involve a straightforward amendment to s.308A of the Act to remove references to portfolio investor status.

### **6.3 COMPLIANCE COSTS OF THE EXTENSION**

Essentially, extending the FITC will have a neutral to positive effect on compliance costs for firms. Firms must already identify foreign investors for the purpose of withholding NRWT and foreign portfolio investors for the purpose of the existing FITC. If this proposal becomes law, firms would no longer have to separately identify direct investor shareholders (by the size of their shareholdings), thus saving that minimal compliance activity.

### **6.4 FISCAL COSTS OF THE EXTENSION**

Extending the FITC would have a direct effect on tax revenue. The estimated additional annual revenue cost would be \$60 - \$70 million. Most of this reduction would be expected to flow through to businesses by way of reductions in their cost of capital. The resulting additional activity and profits generated from that activity would be expected to generate revenue, although it is not possible to determine the extent of the gain.

### **6.5 IMPLICATIONS FOR THE BRANCH PROFITS TAX**

For DTA countries, the FITC will give portfolio and direct investors a maximum effective New Zealand tax rate of 33% on underlying company income. This is lower than the tax rate currently applying to branch operations of foreign companies.

Extending the FITC to foreign direct investors therefore also requires an adjustment to branch taxation. This is to restore equality in New Zealand taxation - the rationale for the current regime - between:

- the maximum rate for non-branch equity investment from DTA countries; and
- the single rate for branches.

When the FITC was introduced, it did not require any change to branch taxation because the branch structure is a substitute for direct, rather than portfolio, investment.

The Government therefore proposes to reduce the rate of tax on the New Zealand branch income of non-resident companies from 38% to 33%, coincident with the extension of the FITC. The estimated annual revenue loss is \$5 million.

### **6.6 CONCLUSION**

The Government proposes to:

- extend the FITC to cover all foreign investors; and
- correspondingly, reduce the tax rate on branch profits of non-resident companies from 38% to 33%.

This reform will involve simple technical changes to existing legislation, with minimal, if any, effects on compliance costs. It will benefit the New Zealand economy by increasing the attractiveness of New Zealand to foreign investors and reducing the cost of capital to New Zealand firms. This regime is consistent with the trend over the past decade toward eliminating differential tax treatments that are based on the type of investment or the nature of the investor.

The FITC mechanism also recognises that New Zealand is a small open economy, drawing on and investing in, a global economy. Any distortions the tax system introduces into interactions between New Zealand and the global economy can significantly affect New Zealand's overall economic performance.

The extension of the FITC regime would apply from the date on which amending legislation is enacted, which is expected to be in the second half of 1995. It is proposed that the removal of the branch profits tax would take effect from the start of the 1996-97 income year.

## 7. PROPOSED NEW TRANSFER-PRICING AND SOURCE RULES

### Summary

These reforms are aimed at improving the measurement of income by source and deterring taxpayers from manipulating transaction prices to decrease their taxes.

The proposed transfer-pricing rules will apply to:

- cross-border non-arm's-length transactions that deplete New Zealand's tax base;
- domestic arrangements that are part of a broader agreement involving non-residents;
- individuals and companies.

To further the Government's objective of minimising compliance costs, it is proposed at this stage to:

- require taxpayers to make only a reasonable estimate of an arm's-length price;
- include a presumption that unrelated parties transact at arm's-length prices;
- allow the comparable uncontrolled price method as a safe-harbour if taxpayers can apply that measure.

A binding statement will be made on approved transfer-pricing methodologies, requiring:

- use of the best method (outside the proposed safe-harbour); and
- reasonable accuracy.

To achieve integration with the rest of the Act:

- advanced pricing agreements will be available within the binding rulings process;
- self-assessment will apply;
- limited provision will be available for downward adjustments;
- the normal disputes resolution process will apply; and
- explicit apportionment rules will apply for income that is not sourced exclusively in New Zealand.

Detailed rules for apportioning cross-border income and expenditure that are consistent with the proposed transfer pricing regime are proposed.

Parallel with the re-write of the Act, the Government will consider apportionment rules for joint costs, foreign-sourced income and income without an explicit New Zealand source and clarification of the use of the net and gross concepts.

## **7.1 INTRODUCTION**

This Chapter outlines proposals to introduce a new transfer-pricing regime and explicit apportionment rules for income that is not exclusively New Zealand-sourced.

## **7.2 THE PROPOSED NEW TRANSFER-PRICING RULES**

### **7.2.1 Objectives**

The objectives of the proposed new transfer-pricing rules and improved source rules are to:

- improve the measurement of both the net New Zealand-sourced income of non-resident investors in New Zealand and the net foreign-sourced income of residents;
- deter taxpayers from attempting to decrease their New Zealand tax liabilities by manipulating the level of income they claim to be deriving from New Zealand and foreign sources; and
- to achieve these objectives in a manner consistent with the Government's policy of minimising compliance costs.

To achieve these objectives, the Government proposes to repeal the existing transfer-pricing rules in s.22 of the Act and replace them with a new set of rules. Explicit apportionment rules would also be introduced during the current process for income that is not deemed to be exclusively New Zealand-sourced.

### **7.2.2 Scope of the proposed transfer-pricing rules**

The proposed transfer-pricing regime is intended to be narrowly-focused, while protecting the tax base by being difficult to circumvent. It is therefore proposed to restrict the regime to cross-border transactions which are not at arm's-length and which deplete the New Zealand tax base.

The regime would not affect wholly domestic transactions nor ordinary cross-border transactions conducted on arm's-length terms.

The coverage of the regime will be considered carefully in the consultative process.

### **7.2.3 Only cross-border transactions covered**

The requirement to use arm's-length prices would be restricted to cross-border transactions. It is only in such transactions that the source of income can be transferred out of the New Zealand tax base.

The regime would apply where a cross-border transaction is not on arm's-length terms. The requirement to report income using arm's-length prices would therefore apply to transactions between:

- a New Zealand resident company and a non-resident company;
- two non-resident companies when at least one of those companies is taxable in New Zealand (to the extent of its New Zealand operations);
- a New Zealand company and a controlled foreign company; and
- two controlled foreign companies resident in different countries.

### **7.2.4 Restricted to where the New Zealand tax base could be depleted**

The requirement to use arm's-length prices should be restricted to cross-border transactions in which a New Zealand taxpayer depletes the New Zealand tax base by:

- supplying goods or services for inadequate consideration; or
- receiving goods or services for excessive consideration.

For example, if a New Zealand subsidiary purchases trading stock from its offshore parent for excessive consideration, the cost of sales of the New Zealand subsidiary is inflated and profit and taxable New Zealand income is depressed. On the other hand, where the New Zealand subsidiary receives goods or services for a lower-than-market price from its parent, the New Zealand taxable income of the subsidiary is augmented. There is no policy reason for New Zealand to have rules preventing the latter.

### 7.2.5 Application to branches

The arm's-length requirement should also apply to the rules apportioning income between branches and parent companies. Because they are not inter-entity transactions, such apportionments would not fall within any legal transactional definition. An arm's-length rule must therefore apply to deemed transactions between:

- a New Zealand branch of a non-resident company and its head office, or other branches or subsidiaries offshore;
- a resident company and its branch or subsidiary offshore; and
- the offshore branches of two resident companies where those offshore branches are in different countries.

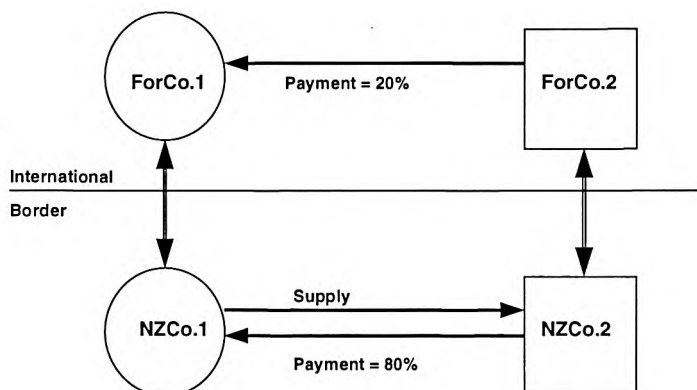
This objective seems to be best achieved by deeming transactions to occur between branches and parents and then applying an arm's-length standard to:

- the gross value of goods and services supplied by the parent company to its branch (that is, the proportion of gross revenue of the company attributable to the activities of its branch); and
- the gross value of goods and services acquired by the branch from its parent company (that is, the proportion of gross expenditure of the company that is attributable to the gross income generated by the activities of the branch).

### 7.2.6 The need to apply the arm's-length standard to arrangements that have a character similar to that of cross-border transactions.

As in Australia, it seems necessary to broaden the term cross-border transactions to cover arrangements that have a character similar to that of cross-border transactions.

For example, while the rules would not, in general, apply to transactions between two resident taxpayers, it seems necessary for them to apply if the transactions are part of a broader agreement involving non-residents. A stylised example of such a transaction is illustrated below. It has been adapted from an Australian Tax Office ruling:<sup>15</sup>



In this example, two unassociated company groups comprising NZCo.1 and ForCo.1 in one group and NZCo.2 and ForCo. 2 in the other group, have agreed that NZCo.1 will receive 80% of the arm's-length consideration from NZCo.2 in respect of the supply of property in New Zealand. NZCo.1's offshore associate, ForCo.1, will receive the balance of 20% of the arm's-length consideration from ForCo.2. While, at first glance, the transaction between the two New Zealand companies appears to be wholly domestic, the transactions represent a transfer of New Zealand-sourced income from NZCo.1 to ForCo.1. Applying the transfer-pricing rules in circumstances like these seems to be necessary to protect the New Zealand tax base.

<sup>15</sup> TR 94/14.

### 7.2.7 Application to non-related party transactions

At this stage, it is not proposed that the transfer-pricing regime would require any control or other specific relationship between the parties to a transaction. Instead, a general obligation that all cross-border transactions be at arm's-length prices is proposed.

Narrowing the regime to related party transactions would reduce uncertainty and compliance costs, particularly in day-to-day cross-border transactions. This would be consistent with the commercial reality that arm's-length parties normally conduct transactions at arm's-length prices.

However, when the Australians designed their transfer-pricing rules, they concluded that restricting them to related party transactions would enable people to circumvent them. Instead, they applied the rules to all transactions not conducted at arm's-length. In determining whether a transaction is at arm's-length, regard must be had to "any connection between any two or more of the parties to the agreement or to any other relevant circumstances."<sup>16</sup>

A recent ruling of the Australian Tax Office (ATO) shows that a primary concern was the tax avoidance that would occur if the transfer-pricing rules depended on the existence of control or share ownership.<sup>17</sup> The ruling, (and other ATO transfer-pricing commentaries) refers to a number of examples of this type of avoidance. For example:

"[Consider] a deal between a company in Australia that is a member of one group with a company overseas that is a member of another, quite unrelated group. The particular transaction could be one that results in the company in Australia receiving less for its exports than the relevant price on the open market. Why, it might be asked, should a company here do that. The answer could be that there are other, completely offshore, deals between members of the two company groups that, in one way or another, redress for each group as a whole the income imbalance resulting from the reduced export price to the company in Australia. There might, for example, be such an offshore agreement not to compete in a particular market.

Whatever might be said about the arm's-length nature of the set of deals between each of the two groups considered as a whole, the export transaction itself is not one carried out at arm's-length and [transfer-pricing rules] are there to redress the revenue imbalance for Australia that would otherwise exist."

This suggests that while a transfer-pricing regime restricted to related party transactions can increase certainty, there is a potential cost to its integrity. Alternatively, it could involve complex and detailed anti-avoidance rules.

New Zealand could adopt wording similar to that of the equivalent Australian legislation. However, this seems to do little to narrow the regime, while at the same time creating uncertainty about what is a "relevant circumstance" or "any connection".

Another way of narrowing the scope of the regime (the method favoured by Government) would be to incorporate a presumption that non-related parties have transacted at arm's-length unless there is any connection or relevant circumstance to suggest otherwise. This would put the onus on the Inland Revenue Department to demonstrate that transactions between non-related parties were not conducted on arm's-length terms before the transfer-pricing rules could be invoked.

At this stage, it is proposed that subject to the presumption, all cross-border transactions be valued at arm's-length prices. In the consultative process, consideration will be given to whether the regime can be more closely targeted without raising the concerns noted by the Australian authorities.

### 7.2.8 Application to individuals, trusts and partnerships

Transfer-pricing rules would have to apply to individuals on the same basis as they would apply to companies.

<sup>16</sup> See, for example, TR 94/14.

<sup>17</sup> See, for example, TR 94/14.

For the purpose of determining whether a transaction involving a trust is cross-border, a trust that would be a qualifying trust if it made a distribution (on the last day of its income year) should be treated as resident in New Zealand; any other trust should be treated as non-resident.

In the case of partnerships, the transaction should be regarded as cross-border if it would fall within that definition had it been with any member of the partnership. For example, the rules would be invoked if a partnership containing one non-resident member conducted a transaction with a resident. Where the transaction is not at an arm's-length price and the source of income is moved offshore, total New Zealand-sourced partnership income would be adjusted upwards. This should affect only non-resident partners, since resident partners are taxable on worldwide income. The adjustment should change the composition, but not the amount, of the resident partner's assessable income.

### **7.2.9 De minimus rules**

In general, overseas transfer-pricing rules avoid de minimus rules, which seem to be seen as arbitrary exemptions from what should be a general requirement that taxpayers transact at arm's-length. Arguably, the unsophisticated taxpayer at whom de minimus rules are aimed is unlikely to engage in significant transfer-pricing activity.

Moreover, while de minimus exemptions can reduce compliance costs, they can also increase uncertainty. Compliance concerns may be better met by applying a reasonably flexible approach to calculating the required arm's-length prices. Suggestions are given below for a comparable uncontrolled price safe-harbour rule and a reasonable estimate rule.

### **7.2.10 Determinations of arm's-length transfer-prices**

Taxpayers will need explicit guidance on the methodologies to use in determining arm's-length transfer-prices.

To assist them in this process, the Government proposes to issue a binding public statement on the question. This statement could be made in a number of different forms, including regulations or determinations issued by the Commissioner of Inland Revenue. Submissions are sought on the most appropriate form for the binding statement.

### **7.2.11 Methods of determining the arm's-length transfer-price**

Where feasible, the arm's-length price would be set using the comparable uncontrolled price method. Under this method, the arm's-length price would be set by reference to similar transactions in which adequate consideration was provided for the goods and services transferred, with adjustments for any minor differences in the nature of the transactions. Using the comparable uncontrolled price would, in effect, provide a safe-harbour rule for taxpayers. Taxpayers would have the assurance that, if they used this method, Inland Revenue would not impose a different methodology.

If a comparable uncontrolled price could not be identified, an appropriate proxy method for estimating the arm's-length price would be applied.

Possible proxies include:

#### *7.2.11.1 The resale price method*

This method could be applied where a New Zealand taxpayer (reseller) purchases goods or services from a related offshore supplier (supplier) which are then on-sold to an unrelated customer. To determine the transfer price for the controlled transaction (supplier to reseller), an arm's-length gross profit margin plus any relevant expenses is deducted from the price paid in the uncontrolled transaction (reseller to unrelated customer). The arm's-length gross profit margin would be obtained by reference to comparable uncontrolled sales of similar products.

#### *7.2.11.2 The cost plus method*

This method could be applied where a New Zealand taxpayer supplies goods or services to a related offshore party. The transfer price for this controlled transaction is determined by adding an arm's-length gross profit margin to the costs incurred by the New Zealand taxpayer in supplying the goods or services to the related offshore party. The arm's-length gross profit margin would be determined by reference to comparable uncontrolled profit margins in similar activities.

### 7.2.11.3 *The comparable profits method*

Under this method, it is presumed that the taxpayer earns a profit similar to comparable uncontrolled profits of similar persons in similar industries, measured as a return on assets, operating assets or equity; or as ratios of profit to sales, or some other financial ratio; or by some other appropriate measure. This method is most similar to s.22 of the Act.

### 7.2.11.4 *The profit split method*

Under this method, the profit of a group of persons engaging in a common activity is apportioned among the members of the group, using an apportionment system that would be agreed upon by unrelated persons acting at arm's-length. For example, the profit might be distributed in proportion to the capital contributed by each member, taking into account differing bargaining powers such as the ability to contribute intangibles or some other unique asset.

## 7.2.12 **Application of the best method**

It is proposed that if taxpayers cannot use the comparable uncontrolled price, they should use the method that provides the most accurate and practical measure of the arm's-length price.

This would give taxpayers and the Inland Revenue Department maximum flexibility in arriving at methods that best suit the very different circumstances in which arm's-length prices are required. For example, profit-based methods could be applied in circumstances where they yield a more accurate and practicable method of determining net New Zealand-sourced income than transactions-based methods would.

The approach outlined in the previous paragraph is similar to the "best method" rule used for the US transfer-pricing rules. The US regulations for determining the most reliable arm's-length method outline a range of factors that must be considered, including:

- the degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer;
- the completeness and accuracy of the underlying data;
- the reliability of the assumptions used; and
- the sensitivity of the results to possible deficiencies in the data and assumptions.

It seems appropriate to apply the same guidelines in New Zealand.

Generally, taxpayers would be expected to follow the same methodology for similar transactions and from one year to the next, unless the best-method rule called for a different one. This might occur because of a change in circumstances or the available data, or because a different method gave more accurate results.

Taxpayers will be able to agree with the Department in advance on the method that best suits their circumstances. One option would be to obtain either a binding or non-binding ruling. Obtaining such an upfront agreement can reduce uncertainties.

## 7.2.13 **Accuracy requirement**

Arm's-length price calculations are merely estimates of what the price would have been if the transaction had been conducted between arm's-length parties. Because of this, there is always room for disagreement about the exact arm's-length price that the taxpayer should adopt. This can create uncertainty for taxpayers and conflict with revenue authorities.

There are two ways to reduce this problem.

The first is the United States approach, which allows a range of arm's-length prices; the extent of the range is determined by the accuracy of the statistical data used. Under this approach, the taxpayer can use an actual transfer-price if it falls within the range. If the data-source used for the range is highly accurate (for example, comparable uncontrolled prices for the sales of the same products on similar terms), the acceptable range would be the entire range of arm's-length prices. If the data source is less accurate (for example, sales of similar, but not the same, products) the arm's-length range may be only a portion of the entire range of arm's-length prices.



An alternative is to require taxpayers merely to make a reasonable estimate of an arm's-length price. If the Inland Revenue Department challenges that price, it would have to establish, as a threshold issue, that the taxpayer's estimate was unreasonable.

The approach adopted may depend on the overall structure of the regime. For example, as noted above, a reasonable estimate rule could be adopted instead of de minimus exemptions. The current proposal is for a reasonable estimate rule, but the Government will consider submissions on this.

### **7.3 INTEGRATION WITH THE REST OF THE ACT**

#### **7.3.1 Binding rulings and advance pricing agreements**

It is proposed to incorporate provisions for issuing advanced pricing agreements under the binding rulings process, in order to:

- provide certainty to taxpayers who engage in transactions that are potentially subject to the new transfer-pricing rules, preventing possibly lengthy and costly transfer-price investigations later. An up-front investigation, with the taxpayer's co-operation, is likely to be easier than an adversarial ex-post investigation. In addition, if a multilateral agreement is used, the other countries' tax authorities may be able to help determine the arm's-length price; and
- reduce international disputes over source of income. It is important to note that countries that did not participate would not be bound, so such disputes could not be eliminated altogether.

To obtain an advance pricing agreement, taxpayers would have to disclose all relevant information. As with any other binding ruling, the agreement would bind the Commissioner of Inland Revenue only if this were done.

#### **7.3.2 Self-assessment process**

In order to be properly integrated into the way the modern New Zealand income tax system operates, the transfer-pricing regime has to operate within a self-assessment system. This means that taxpayers must use the transfer-pricing methodologies to determine their taxable income when engaging in transactions subject to the regime. The Commissioner of Inland Revenue should then be able to apply normal re-assessment procedures if he or she determines that the taxpayer did not comply with the regime. When reassessing taxpayers, the Commissioner would have to comply with the guidelines issued on the methods that taxpayers are expected to employ for calculating arm's-length prices.

#### **7.3.3 Provision for downward adjustments**

It is proposed that, in general, the transfer-pricing methodologies will supersede the actual terms of the transaction only where this would increase the taxpayer's taxable income, or reduce a loss. In certain circumstances, however, the new rules could allow taxpayers to adjust their actual transaction prices in a manner that would reduce their New Zealand taxable income. An example is where a New Zealand parent charges a subsidiary CFC an excess price for goods. If CFC income must be returned based on the lower arm's-length cost of its purchases, there is an argument that the parent should return income using the same arm's-length price.

A downward adjustment to taxable income may be appropriate when:

- it is to offset an adjustment to the other party to the transaction, when both parties are taxable by New Zealand; or
- the adjustment is required to comply with a multilateral competent authority adjustment.

Any provision for such downward adjustments must fit within a self-assessment system and be administratively manageable. A process that enabled taxpayers to dispute the outcome of a specific transfer-pricing adjustment by requesting a series of compensating adjustments to other, unrelated, transactions would probably be unworkable.

The proposed compromise is that taxpayers should be able to make downward adjustments that are the direct consequence of an upward adjustment to the same, or another, taxpayer. This provision must be subject to sufficient information being provided to the Inland Revenue Department - including identification of the downward adjustment sought and the other adjustment to which it directly relates. Provision would have to be made for later reassessments when a downward adjustment is sought following a reassessment including an upward adjustment, or an alteration to such an adjustment.

#### **7.3.4 Dispute resolution processes**

Unilateral transfer-price issues would proceed on the same basis as domestic tax disputes. For tax purposes, the taxpayer would report cross-border transactions at arm's-length terms on a self-assessment basis and the Commissioner could investigate transfer-price issues in an audit. Following re-assessment, the taxpayer could go through the objection process and, if necessary, dispute the tax liability through the court system.

If a transfer-price dispute involved allocation of income with a DTA partner, the taxpayer could invoke the competent authority provision of a treaty. In this case, the Inland Revenue Department would discuss the transfer-price issue with the competent authority of the other country and an agreement would be made among the competent authorities, as provided in the DTA.

#### **7.3.5 Penalties**

The new transfer-pricing rules do not seem to require any special penalty provisions. If a taxpayer failed to comply with the rules, the standard hierarchy of penalties, as finally determined following the completion of the Penalties and Compliance Review relating to taxpayer culpability, would apply - that is, negligence, lack of a reasonably arguable position and so on. It should be stressed that the Government has yet to make final decisions on the Penalties and Compliance Review.

#### **7.3.6 Reporting and record keeping requirements**

Taxpayers already report differences between their normal accounts and their accounts for tax purposes. For administrative purposes, there will have to be a specific requirement that where a taxpayer uses an arm's-length price for a particular transaction instead of the actual price paid, that transaction will be reported.

On a more general level, it is proposed that disclosure will be required whenever taxpayers use DTA provisions to override other specific provisions of the Income Tax Act. This new provision will apply to the Act generally, not just to the new transfer-pricing rules.

Taxpayers would be required to retain records supporting their cross-border transaction decisions for seven years, in line with the practice for all records relating to determining tax liabilities.

No other special record-keeping rules regarding transfer-pricing are proposed.

#### **7.3.7 Structure of the legislation**

It is proposed that the legislation be structured like that of Australia. Under this approach, the legislation itself would require only that transactions subject to the regime be reported at arm's-length. The legislation would also define arm's-length in a general way, using terminology similar to that used in OECD reports.

Guidance in determining arm's-length prices would be provided in regulations or determinations. The alternative, which the Government does not favour, would be to include the required methodologies in the legislation itself.

As already noted, it is anticipated that the regulations or determinations describing the methodologies outlined above would be published before the regime came into effect. Supplementary regulations or determinations could be published later, refining these methodologies or providing new ones reflecting experience with the regime.

It is proposed that the transfer-pricing rules be superior to all other Income Tax Act sections for the purpose of determining the price at which transactions occur. This means that the other sections, including s.99, would apply only after application of the transfer-pricing rules. However, it would always be open to the Commissioner of Inland Revenue to adjust transfer-prices under s.99 if that were necessary to restructure a tax avoidance arrangement. More generally, an appropriately calculated arm's-length price would be deemed, for all purposes of the Act, to have been the price at which the transaction occurred with respect to the taxpayer or taxpayers for which the arm's-length calculation was made.

The existing anti-abusive transfer-pricing rules outlined in s.22 of the Act would be replaced by the proposed new rules.

The transfer-pricing rules would work in conjunction with the deemed dividend rules contained in s.4. In this instance, the arm's-length price would be used to determine the market value. For example, if a New Zealand company purchased

inventory from its parent at more than the arm's-length price, the transfer-pricing rules would deem the purchase price to be the arm's-length price, thereby reducing deductions. In addition, s.4 would deem the amount paid in excess of the arm's-length price to be a dividend to the parent. The combined effect of transfer-pricing and deemed dividend rules would be to increase the company's profits from which a higher-than-declared dividend was paid.

If the taxpayer originally reported income using an arm's-length price, the adverse effect of such a rule should be mitigated by the extension of the FITC regime, because any dividends arising should, generally, be covered by imputation credits.

## **7.4 IMPROVED SOURCE RULES**

### **7.4.1 Proposed apportionment rules**

To measure their net New Zealand-sourced income and to comply with the proposed transfer-pricing rules, taxpayers need clear rules for apportioning, between countries, income that has more than one source (where such apportionment is allowed).

As discussed in Chapter 4, s.245 (the general apportionment provision) provides little guidance on how such an apportionment process should be carried out. Clearer apportionment guidelines would help taxpayers to comply with the requirement under s.245 to apportion, between countries, income that is not deemed to be exclusively New Zealand-sourced - for example, business profits derived by a non-resident with a branch in New Zealand.

It is proposed that the Inland Revenue Department remedy this position by providing more detailed cross-border apportionment guidelines which are consistent with the transfer pricing rules outlined in this document.

These rules could be set out in regulations issued in accordance with s.245 of the Act. Alternatively, the Commissioner of Inland Revenue could issue a policy statement (for example, a Technical Information Bulletin) clarifying the apportionment rules considered by the Commissioner to be "just and reasonable" for the purposes of s.245. Submissions are invited on which of these alternative approaches would be preferable. Draft guidelines will be released at a later date for consultation.

The gross income apportionment methodologies would outline common measures that taxpayers could use to apportion forms of gross income between countries. This would give taxpayers a clear indication of how to apportion, between countries, income that is not deemed to be exclusively New Zealand-sourced. In addition, it would ensure consistency in apportioning particular types of gross income.

### **7.4.2 Apportionment of joint costs**

As discussed in Chapter 4, a specific apportionment problem arises with expenditure which has been incurred jointly in deriving New Zealand-sourced and foreign-sourced income. Possible apportionment rules to apply to such joint costs were recommended by the Valabh Committee in their report on "Tax Accounting Issues". As a separate exercise the Government will be considering those recommendations.

Specifically, during consultations on this issue, consideration will be given to:

- introducing more targeted apportionment rules for non-interest joint expenditure (that is, expenditure incurred in producing assessable and non-assessable benefits);
- basing the apportionment of non-interest joint expenditure on a common measure that fairly and reasonably results in an objective allocation of the joint expenditure between the benefits produced by that expenditure; and
- where it is not practicable to use a common measure, basing the apportionment on the dominant purpose for which the joint expenditure was incurred.

Such apportionment rules for joint expenditure could be used to apportion joint expenditure not only between gross income derived from different countries, but also between activities that produce both taxable and non-taxable benefits.

## **7.5 OTHER POSSIBLE CHANGES TO THE SOURCE RULES TO BE CONSIDERED**

In addition to apportionment issues, Chapter 4 also identified a number of other problems with the existing source rules. These included structural problems arising from uncertainty over whether the rules relate to gross or net income and the

absence of general definitions of New Zealand-sourced and foreign-sourced income. As a result, in parallel with the re-write of the Income Tax Act, the Government also intends to consider possible amendments to the source rules in the Act, to:

- implement separate definitions of New Zealand-sourced income, foreign-sourced income and income that is not exclusively New Zealand-sourced; and
- clarify the use of the net and gross concepts in the definitions of New Zealand-sourced and foreign-sourced income.

#### ***7.6 EFFECTIVE DATE***

It is proposed that the transfer-pricing legislation be introduced by the middle of 1995. Provided that this timetable is met, the transfer-pricing regime and the guidelines would therefore be effective from the start of the 1996-97 income year.

## 8. THIN-CAPITALISATION CONSIDERED

### Summary

**Thin-capitalisation rules should aim to accurately determine interest expenses that are properly attributable to New Zealand, without interfering with normal commercial behaviour, at minimum compliance cost, within the self-assessment system.**

**The range of possible approaches include:**

- **a regime along the lines of that operating in Australia (which covers interest-bearing debt from foreign direct investors which exceeds equity from those investors by more than 3:1); or**
- **a more general regime which is designed to go beyond the most extreme cases of thin-capitalisation abuse and determine the proportion of interest that should properly be attributed to the host country; or**
- **a regime whose ambit falls between these two positions.**

**The Government is proposing, via this discussion document, to raise the issues surrounding thin-capitalisation and seeks submissions on the most appropriate approach; in particular on whether a thin-capitalisation regime is feasible and necessary.**

### 8.1 INTRODUCTION

Interest income derived from New Zealand by non-residents is subject to markedly lower aggregate New Zealand tax rates than is income from equity. Even after the proposed extension of the FITC regime, income from equity will face an aggregate tax rate of 33% compared with the 10% maximum that typically applies to interest income. The more generous tax treatment afforded debt in comparison with equity provides an incentive for non-residents to highly gear their New Zealand operations, thereby attributing high interest costs to New Zealand.

An effective thin-capitalisation regime would limit the ability of non-resident investors to artificially reduce their net New Zealand-sourced income by allocating excessive interest costs to New Zealand. Such a regime would need to apply equally to non-residents earning New Zealand-sourced income themselves and to non-residents operating in New Zealand through a subsidiary.

Other countries with transfer-pricing regimes similar to that proposed in this document have buttressed those regimes with measures to reduce the opportunity for thin-capitalisation, which allows non-residents to lower their net taxable income.

There is logic in this. However, if New Zealand were to follow this path, the Government would need to be satisfied that an effective and acceptable thin-capitalisation regime could be put in place that would not impose excessive compliance costs on businesses. The feasibility of this is addressed in this Chapter and submissions are invited. If submissions are negative, consideration should be given to how the underlying problem of variable tax on debt and equity should be tackled.

## 8.2 PARAMETERS OF AN EFFECTIVE THIN-CAPITALISATION REGIME

### 8.2.1 Objectives

An acceptable and effective thin-capitalisation regime should:

- determine the amount of interest expense properly attributable to New Zealand in a manner which is flexible enough to have regard to the normal variation of commercial finance, while nevertheless being effective when excessive debt finance is used;
- operate in the self-assessment system (that is, without the need for a Commissioner's discretion); and
- impose the minimum compliance costs necessary to achieve the above objectives.

### 8.2.2 Other countries' thin-capitalisation regimes

A number of other countries have already implemented thin-capitalisation measures. These countries include Australia, Canada, Japan, USA, Germany, Sweden and Norway, while the UK administers thin-capitalisation restrictions within the broad ambit of its transfer-pricing legislation.

These overseas precedents do not, however, appear to meet the objectives stated for an effective and acceptable thin-capitalisation regime. Australia is an example. Under the Australian regime, if interest-bearing debt finance from foreign direct investors (those owning 15% or more of the equity in an Australian company) exceeds equity finance from the same investors by more than 3:1, then interest paid on the excess debt to the foreign direct investors is disallowed as a deduction.

The Australian rules provide a look-through for back-to-back loans from the foreign direct investors, but do not treat debt finance from a third party that is guaranteed by a foreign direct investor as debt from a foreign direct investor.

While the Australian rules may capture extreme cases of thin-capitalisation, they do not appear to operate as a more general rule for determining the amount of interest properly attributable to the host country and deductible with respect to that country. This is because:

- the Australian rules operate with an arbitrary 3:1 debt:equity ratio only, which may be too high in some cases because the entire group operates with a lower ratio; and
- the Australian rules only regard debt from foreign direct investors, whereas given the fungibility of debt, all debt should ideally be considered for determining the amount of interest properly attributable to the host country.

The following example uses New Zealand as the host country to illustrate this point.

Consider a group that initially comprises a non-resident parent company. The company has shareholders' funds of \$100 and no debt. It proposes to set up a subsidiary company in New Zealand which will require total capital of \$100. The desired debt:equity ratio for the New Zealand operation is 4:1; that is, \$80 debt and \$20 equity. The group obviously needs to borrow money to finance its expansion into New Zealand and can do so either by:

1. the parent company borrowing \$100, which it uses to inject \$20 equity into the New Zealand subsidiary and to extend an \$80 loan to the subsidiary; or
2. the parent company borrowing \$20 for its equity injection and the subsidiary company borrowing the remaining \$80 from a third party.

In the first case, the New Zealand company's debt is to a related party; in the second, to a third party. In both cases, total group indebtedness is \$100.

The example is stylised, but this does not affect the validity of its basic argument: non-resident companies can use genuine third party debt<sup>18</sup> to thinly capitalise their New Zealand subsidiaries or branches. This means that, to be effective, thin-capitalisation rules must ideally cover third-party debt as well as related-party debt.

### 8.3 DESCRIPTION OF A POSSIBLE EFFECTIVE THIN-CAPITALISATION REGIME

The following broadly focused thin-capitalisation regime has been designed to be effective in limiting the excess allocation of interest expenses to New Zealand operations.

#### 8.3.1 Main features of the proposal

The regime has the following main features:

- it would apply only to entities or operations that are controlled by a single non-resident. That is because the policy concern is to restrict the ability of non-residents to exploit the debt/equity distinction to under-report net New Zealand-sourced income;
- it would have a safe-harbour debt:equity ratio set at a level that excluded most operations with a commercially-normal debt:equity ratio. The objective would be to reduce compliance costs and limit the extent to which the measures increase aggregate tax rates on non-resident investors operating with commercially-normal capital structures;
- entities whose debt:equity ratios exceeded the safe-harbour ratio would be subject to the regime only if their debt:equity ratios also exceeded 110% of the worldwide debt:equity ratio of the group to which that entity belonged; and
- entities which failed these two debt:equity ratio tests would not be permitted to deduct their excessive interest expense. Excessive interest expense would equal

$$\text{Total Interest Expense} \times \frac{\text{Actual debt} - \text{Threshold debt}}{\text{Actual debt}}$$

where threshold debt is the maximum amount of debt that would be consistent with the higher of the safe-harbour and 110% of the consolidated group debt:equity ratios.

#### 8.3.2 Entities

The regime would apply to any taxpaying entity, such as an individual, company or trust. The legal form of the taxpaying entity should not determine whether or not a substantive provision, such as a thin-capitalisation rule, should apply. The rules would need to apply individually to each partner of a partnership.

#### 8.3.3 Non-resident control

The regime would apply only to non-residents deriving New Zealand-sourced income (such as a branch of a non-resident company) and to New Zealand resident entities controlled by a single non-resident. Non-resident would include persons defined as resident under the Act, but treated as non-resident for purposes of a DTA. For the purposes of such a regime, a trust that would be a qualifying trust if it made a distribution on the last day of its income year would be treated as resident for that income year; other trusts would be treated as non-resident.

Non-resident control of a resident company would be defined as a single non-resident entity with ownership of 50% or more of the controlling interest in the resident company, as defined for the CFC regime. Attribution and look-through rules would apply to determine ownership of a controlling interest. These rules would be similar to ss.245B and 245C which are used to attribute control interests of foreign companies for the CFC regime.

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<sup>18</sup> Rather than disguised related-party debt.

## 8.4 DEBT: EQUITY RATIO

### 8.4.1 Safe-harbour ratio

A safe-harbour proposal would seem desirable in order to:

- reduce compliance costs by excluding most taxpayers from the ambit of the regime;
- target the regime at cases giving rise to the greatest tax-base concerns; and
- reduce the extent to which the regime would force non-resident investment to be heavily weighted towards highly taxed equity investment, thereby markedly increasing effective tax rates on such investors.

All three objectives would require a safe-harbour ratio set at a level that would exclude most entities. To keep compliance costs to the minimum, the regime must be targeted at levels of activity that would reasonably be seen as abusive. Business operating at a normal commercially acceptable gearing level should definitely be excluded by the safe-harbour rule.

Many overseas countries have a safe-harbour debt:equity ratio. Provided that this ratio is not breached, businesses are not affected by the thin-capitalisation rules. If this ratio is breached, interest deductions are generally denied. Under the general scenario proposed by this document, however, further provisions would still allow the interest payments to be deducted, even when the safe-harbour is breached.

In Australia, Canada, Japan and Germany the safe-harbour debt:equity is 3:1 (25% equity regime). In Spain it is 2:1 (33% equity regime). In USA it is 1.5:1 (40% equity regime). Because of significant differences in the regimes, it is difficult to use these as automatic precedents. The choice of the safe-harbour level is essentially a judgment. It has no basis in any hard taxation theory. The aim, as stated above, is to stop abuse.

It is envisaged that the New Zealand safe-harbour ratio would be within the range that other countries use. This should exclude most companies from the regime, for example, the average debt:equity ratio of the top 40 companies listed on the New Zealand Stock Exchange (November 1994) is about 1:1 (median 53% equity, mean 45% equity).

The Government seeks submissions on the most appropriate ratio for New Zealand.

### 8.4.2 Debt:Equity ratio defined

The New Zealand debt:equity ratio is the (related and third-party) debt on which New Zealand interest deductions are incurred, in relation to the equity of the New Zealand entity or branch.

Debt for the New Zealand taxpayer would need to be limited to debt giving rise to New Zealand tax deductions. Where no New Zealand tax deduction is taken, there is no issue of excessive interest costs being attributed to the New Zealand tax base. Thus, an interest-free loan from a non-resident parent to a New Zealand subsidiary should not be included in the debt of the New Zealand subsidiary. For example, a non-resident controlled company has assets of \$1,000 funded by an interest-free loan of \$500, interest-bearing debt of \$400 and shareholders' funds of \$100. Under the proposals, the debt:equity ratio of this company would be 2:3 (60% equity).

Debt would need to be defined widely enough to encompass all instruments and arrangements that are closely substitutable for debt. For example, it would need to include interest-bearing convertible notes. The definition of financial arrangements in the accrual rules covers all such arrangements. However, since the focus is on excessive interest and similar costs, the debt definition needs to be limited to financial arrangements for which a deduction is taken under s.106(1)(h) of the Act<sup>19</sup> or sections such as s.136, which allows a deduction for expenditure incurred by a taxpayer in borrowing money and employing it as capital in the production of assessable income. In other words, financial arrangements for which no interest deduction (or similar) is taken would not be considered as debt.

Equity for the non-resident, or non-resident controlled, New Zealand taxpayer would be the taxpayer's gross assets (for non-residents, gross assets located in New Zealand or employed in the production of New Zealand assessable income) less interest-bearing debt (using the above debt definition). To reduce compliance costs, assets should be able to be valued at either depreciated cost or market value. However, the valuation method would need to be consistent across all

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<sup>19</sup> The general interest deductibility provision.



assets unless different valuations are used for financial reporting in a way that is consistent with Generally Accepted Accounting Principles (GAAP).

#### **8.4.3 Determining when the debt:equity ratio should be measured**

The debt:equity ratio of the non-resident or non-resident controlled taxpayer would need to be calculated for an income year. For compliance cost reasons, the same ratio should be used for the entire income year. However, this leaves open the question of when debt and equity should be measured in order to calculate the annual ratio.

One way would be to measure debt and equity on the last day of the accounting year. The problem with such an approach is that companies could manipulate their debt and equity levels for that particular day.

Another option would be to take an average amount of debt and equity over the accounting period. Although this option is more equitable, it would have higher compliance costs as it requires taxpayers to perform detailed calculations.

A further option would be to take the highest debt level and lowest equity level during the year. However, that could be unfair. For example, a company requiring a high level of debt over a short period would be penalised. Since equity is a residual item that is calculated only after completing a full set of accounts, requiring the lowest level of equity to be calculated would impose excessive compliance costs.

A balance needs to be struck between preventing manipulation of debt levels to meet the safe-harbour ratio and the compliance costs involved in an averaging approach.

The best approach for debt may be to calculate debt as the highest amount of debt in the accounting year and allow an option for taxpayers to use the monthly (or possibly quarterly) average amount of debt for the accounting year, if this would give a fairer result. If such an option were provided, it would need to have associated anti-avoidance rules to prevent debt levels from being suppressed on the measurement dates.

Equity would always need to be measured on the last date of the accounting year, when accounts are prepared and this residual item is measurable. Measuring it on any other day would involve high compliance costs.

#### **8.4.4 Calculating debt:equity ratios on a consolidated basis**

In many cases, the New Zealand debt:equity ratio of a non-resident, or non-resident controlled New Zealand taxpayer, would flow mechanically once debt and equity were defined. However, in some cases the debt and equity of associated parties may need to be amalgamated to provide one debt:equity ratio for all associated parties. For non-corporates this would seem unnecessary and would incur unnecessary compliance costs.

If the New Zealand debt:equity ratio of a corporate group were not measured on a consolidated basis, it would be possible to meet any required debt:equity ratio simply by establishing a chain of companies, each meeting the required ratio. The problem arises because equity introduced into a corporate chain is counted as equity for each company down that chain. Thus, if company debt:equity ratios were measured separately, the same equity could cover the allowable debt level as many times as there are companies.

It would therefore be necessary to require the debt:equity ratio of a New Zealand group of companies to be calculated on a consolidated basis with the same debt:equity ratio applying to all companies in that group. Clearly, for these purposes the definition of a group should be limited to companies that are non-resident or non-resident controlled. For simplicity, the existing 66% common ownership company group definition in s.191(3) of the Act could be used - provided that each company in the group is non-resident or non-resident controlled. The alternative would be a wider rule such as a group of companies with a common non-resident controller.

In cases where group companies have different balance dates, calculating the debt:equity ratio on a group basis would raise the issue of which date should be used for calculating debt and equity. The obvious date would be the balance date of each company for which the thin-capitalisation rule applies. However, that could require several different debt:equity calculations. To reduce compliance costs there would need to be an option for all members of a company group to elect to use the balance date of one member.

For taxpayers other than companies (individuals and trusts), there would not seem to be the same need to calculate the debt:equity ratio on a consolidated basis.

The Annex at the end of this Chapter provides some examples of using a consolidated basis for calculating the New Zealand debt:equity ratio.

#### **8.4.5 Determining the world-wide debt:equity ratio**

After determining that the New Zealand debt:equity ratio exceeds the safe-harbour, it would be necessary to determine whether the New Zealand debt:equity ratio exceeds 110% of the consolidated world-wide debt:equity ratio for the group. This would be used to determine whether the interest incurred in New Zealand is excessive in comparison to the group's overall debt finance.

Where the controlling non-resident is a company that produces audited consolidated financial accounts in accordance with GAAP, the world-wide debt:equity ratio could be calculated from those accounts. There would need to be a provision allowing a taxpayer to use unaudited accounts if these could be shown to provide a true and fair view of the taxpayer's position.

Under these rules, the primary difference between calculating the debt:equity ratio of the New Zealand taxpayer and the ratio of the world-wide group is that the group's ratio would be calculated by treating all legal debt as debt, regardless of whether it is interest-bearing. The New Zealand taxpayer, in contrast, would treat only interest-bearing debt as debt for the purposes of calculating its ratio.

Therefore, the ratios used for comparison would not measure exactly the same types of debt. However, it would not be reasonable to require a multi-national company group to recalculate its debt:equity ratio using New Zealand tax debt concepts. Nor would it be reasonable to include in domestic debt, arrangements on which no interest deduction (or its equivalent) was provided. A compromise based on compliance-cost concerns is required.

There may, however, be circumstances when the non-resident controlling shareholder would prefer to calculate its debt:equity ratio using New Zealand tax concepts of debt and equity. There is no apparent reason to disallow this. In such cases, debt would need to be defined as all financial arrangements that would give rise to a deduction if the non-resident company group had been resident in New Zealand. Consolidated accounts would still be needed. A consolidated debt:equity ratio would be calculated for the non-resident controller and all persons associated with that non-resident, with an associated person test along the lines of s.245B.

Such an approach would be appropriate where the controlling non-resident does not have audited consolidated accounts, or where that person is not a company.

To add flexibility to the regime, taxpayers should be allowed to apply to the Commissioner for a ruling on variations to the above method for determining the debt:equity ratio of a controlling shareholder. The Commissioner would be authorised to provide such a ruling where a variation is in accordance with the principles of the regime. For example, this might be usefully applied where a world-wide diversified business with a low debt:equity ratio operates a bank in New Zealand with a high debt:equity ratio which is normal for such an operation.

There may also be other cases where strict application of the debt:equity ratio could lead to inequitable results. The Government seeks submissions on such cases and suggestions on how to identify them and provide relief without compromising the integrity of the regime.

In the unusual case where more than one non-resident entity or group is considered to control the New Zealand taxpayer, the taxpayer would have the option of choosing which non-resident controlling entity or group to use for determining the group debt:equity ratio.

For simplicity, the debt:equity ratio of the controlling entity would need to be determined on the last day of its preceding accounting year; that is, a year which ends before the New Zealand taxpayer's accounting year begins. That should be satisfactory for calculating the world-wide debt:equity ratio, since the opportunity to manipulate the amount of world-wide debt and equity is not likely to be significant.

Once the world-wide debt:equity ratio has been determined, it would be increased by 10%, to account for the different times of measurement of the ratios for the New Zealand taxpayer and the group and to allow for a reasonable amount of difference between the New Zealand debt and the world-wide debt. It would then be compared to the New Zealand ratio so that excess interest could be determined.

#### 8.4.6 Deduction disallowance for excess interest

If a non-resident or non-resident controlled entity has an excess level of debt, this would indicate that interest costs are being over-allocated to the New Zealand tax base. In such cases, an interest deduction relating to the excess debt would be denied. All interest and interest-type expenditures deductible under the Act, including the accruals rules (these include foreign exchange losses), would be subject to partial disallowance.

Under such a rule, a proportion of total interest expense, calculated according to the formula below, would be denied:

$$\text{Total Interest Expense} \times \frac{\text{Actual debt} - \text{Threshold debt}}{\text{Actual debt}}$$

where "threshold debt" is the higher of:

- a) the debt:equity ratio of the controlling entity (plus the 10% margin); and
- b) the safe-harbour ratio.

In calculating excess interest costs, it would seem inappropriate to net off interest income received by a taxpayer against the interest expense of that taxpayer. The rationale of such a regime would be to deny interest deductions when a taxpayer is excessively geared. The nature of the income received (interest, dividends or other) as a result of investing the borrowed funds would not be relevant. However, consideration would need to be given to the case where the recipient of an interest payment is also the payer; for example, current accounts moving between debit and credit balance. In such cases, netting off balances might be appropriate. Consideration should also be given to back-to-back loan arrangements with non-resident related companies.

If there is more than one New Zealand company in the consolidated group, excess interest would need to be disallowed in proportion to the interest claimed as a deduction by each company, up to the total amount of interest claimed by the New Zealand group of companies.

It would not be appropriate, under such a regime, to recharacterise as equity excessive debt for which interest deductions are denied, so that the interest payments would be regarded as dividends. For example, Australia adopts this approach of not recharacterising debt as equity when their thin-capitalisation rules apply.

#### 8.4.7 Anti-avoidance rules

A regime along the lines outlined above would need to include anti-avoidance rules to ensure that taxpayers do not:

- structure transactions to circumvent the control test; or
- temporarily or artificially inject or inflate equity to avoid an excess debt calculation.

#### 8.4.8 Reporting requirements and penalties

No special reporting requirements or penalty provisions would be necessary to operate the above thin-capitalisation proposals.

### 8.5 THIN-CAPITALISATION RULES - ISSUES FOR SUBMISSIONS

The Government invites submissions on all issues discussed in this Chapter and related matters. In particular, it solicits discussion on the necessity and feasibility of a thin-capitalisation regime and would also welcome submissions in the following areas.

#### 8.5.1 Ambit of the regime

A key issue is whether thin-capitalisation rules should be narrowly focused (as in the Australian regime) or more broadly focused (as in the regime outlined above). A narrowly focused regime has the advantage of being more closely targeted, but the disadvantage of being less effective. An intermediate position may be appropriate.

### **8.5.2 Safe-harbour ratio**

An appropriate safe-harbour, in line with international norms, needs to be set for a broad and effective thin-capitalisation regime.

### **8.5.3 Third-party debt**

The broad regime outlined includes third-party debt as well as related-party debt, both in determining the New Zealand taxpayer's debt:equity ratio and applying interest deduction disallowance. Some overseas regimes only refer to related-party debt for both purposes. The United States refers to all debt for determining the debt:equity ratio, but refers only to related-party debt for disallowing the interest expense deduction.

In some respects this proposal could be seen as an interest allocation rule rather than a thin-capitalisation rule. The Government in this circumstance faces a difficult issue. Referring to related-party debt only would focus the regime on those cases where debt finance is directly used in substitution for equity finance. However, with that focus, the regime could be avoided with back-to-back loans and related-party guarantees.

There is evidence from overseas that where a limited regime applies this is exactly what happens; that is, the regime is avoided. Unless the consultation process shows that such a concern is not relevant in New Zealand, only a wider rule would seem effective. Certainly, there seems little point in introducing a regime that we know in advance can easily be avoided.

Applying the regime to all debt would obviously avoid such a problem. It would allow the regime to operate effectively as a way of determining the appropriate amount of interest expense incurred in New Zealand. But it would, unless tightly contained, threaten the Government's goal of reducing compliance cost.

The wider rule would involve what some would see as a significant involvement, perhaps too significant an involvement, of tax rules in normal commercial decisions, made for normal commercial reasons, about the financial structure of a firm. For this reason, the Government has determined that such a regime needs to be focused in a way that addresses abuse only and it therefore seeks submissions on what the final shape of such a rule should be.

### **8.5.4 Consolidated groups**

The regime outlined above would require that New Zealand companies use consolidated accounts for the purpose of the calculations. This may impose additional compliance costs. However, if this is not done the regime could be avoided by multiple counting of equity that is flowed through a chain of companies. Again, submissions are sought on this point.

### **8.5.5 Inequitable results**

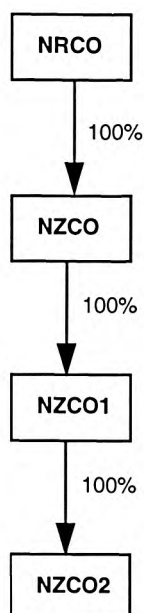
Taxpayers may wish to identify cases where they believe application of the rules would be inequitable and suggest a rule which will identify such cases and provide relief without compromising the integrity of the regime.

## **8.6 CONCLUSION**

This Chapter has outlined the elements of a thin-capitalisation regime intended to meet the objectives of being both flexible and effective. The Government seeks submissions not just on the issues discussed above, but on any other relevant issues relating to thin-capitalisation. The Government invites submissions on the extent to which attribution of excess deductions of interest expense to New Zealand is a problem and, if a significant problem, whether an effective thin-capitalisation regime is an appropriate response and if so what should be the ambit of the regime.

## ANNEX: CALCULATION OF DEBT: EQUITY RATIOS

This example assumes that the broad and effective thin-capitalisation regime outlined is applied. The structure to which the regime applies is as follows where NRCO is a non-resident company:



NZCO, NZCO1 and NZCO2 have the following balance sheets as at 31 December 1994:

### NZCO

Assets	\$	Liabilities	\$
Investment in NZCO1	100	Debt	100
Plant etc.	<u>100</u>	Equity	<u>100</u>
	200		200

### NZCO1

Assets	\$	Liabilities	\$
Investment in NZCO2	100	Debt	100
Plant etc.	<u>100</u>	Equity (NZCO1)	<u>100</u>
	200		200

### NZCO2

Assets	\$	Liabilities	\$
Plant etc.	200	Debt	100
	<u>200</u>	Equity (NZCO2)	<u>100</u>
			200

From the individual balance sheets, it would appear that all three companies have a debt:equity ratio of 1:1. However, in substance \$400 is being invested in plant, which is being funded by \$300 of debt. This is recognised on a consolidated accounting basis, where the debt:equity ratio of the corporate group consisting of NZCO, NZCO1 and NZCO2 is 3:1.

**Consolidated Balance Sheet of NZCO and Subsidiaries as at 31 December 1994**

<b>Assets</b>	<b>\$</b>	<b>Liabilities</b>	<b>\$</b>
Plant etc.	400	Debt	300
	<u>400</u>	Equity	<u>100</u>
			400

If the safe-harbour debt:equity ratio was set at 3:1, NZCO, NZCO1 and NZCO2 would not be denied an interest deduction. If the safe-harbour ratio was set at 2:1 NZCO, NZCO1 and NZCO2 would be subject to the proposed regime. This would mean a portion of their interest expense would be denied.

Conversely, under a non-consolidated approach, a chain of companies, where each company borrows from its parent, could result in each company breaching the proposed safe-harbour debt:equity ratio, even though the corporate group as a whole would not do so.

For example, consider again the example of NRCO, NZCO, NZCO1 and NZCO2. NZCO, NZCO1 and NZCO2 have the following balance sheets as at 31 December 1994:

**NZCO**

<b>Assets</b>	<b>\$</b>	<b>Liabilities</b>	<b>\$</b>
Inter-Co Advance	300	Debt	300
Plant etc.	<u>100</u>	Equity	<u>100</u>
	400		400

**NZCO1**

<b>Assets</b>	<b>\$</b>	<b>Liabilities</b>	<b>\$</b>
Inter-Co Advance	300	Debt	300
Plant etc.	<u>100</u>	Equity	<u>100</u>
	400		400

**NZCO2**

<b>Assets</b>	<b>\$</b>	<b>Liabilities</b>	<b>\$</b>
Plant etc.	400	Debt	300
	<u>400</u>	Equity	<u>100</u>
			400

The debt:equity ratios of NZCO, NZCO1 and NZCO2 are 3:1 and so would be within a 3:1 safe-harbour ratio but would breach a 2:1 safe-harbour ratio.

However, on an consolidated basis, NZCO and its subsidiaries have a debt:equity ratio of 1:1 and so would be within a safe-harbour ratio of either 2:1 or 3:1.

**Consolidated Balance Sheet of NZCO and Subsidiaries as at 31 December 1994**

<b>Assets</b>	<b>\$</b>	<b>Liabilities</b>	<b>\$</b>
Plant etc.	600	Debt	300
	<u>600</u>	Equity	<u>300</u>
			600













