Reducing tax barriers to international recruitment to New Zealand

A government discussion document

Hon Dr Michael Cullen
Minister of Finance
Minister of Revenue

Hon David Cunliffe
Associate Minister of Revenue

First published in November 2003 by the Policy Advice Division of the Inland Revenue Department,
P O Box 2198, Wellington.

Reducing tax barriers to international recruitment to New Zealand – a government discussion document.
ISBN 0-478-27110-7

CONTENTS

FOREWORD

The government is committed to developing New Zealand's economy so that it becomes more innovative and flexible, able to compete successfully in international markets.

Two of the areas identified as essential for building effective innovation are:

- attracting people with exceptional skills;
- increasing global connectedness.

The skills needed for a thriving, knowledge-based economy are in demand throughout the world. The people with those skills are increasingly mobile, and New Zealand businesses need to be able to compete with businesses in other countries to attract them to work here.

Whether they are returning New Zealanders or citizens of other countries, people recruited from overseas bring with them links to other countries, knowledge of foreign markets and contacts with new ideas and developing technology. These connections are especially valuable for a country as remote as New Zealand. This importance justifies a review of New Zealand's international tax system to ensure that it does not unnecessarily discourage recruitment of overseas talent.

The proposal introduced in this discussion document is intended to reduce the tax-related costs to New Zealand business of recruiting internationally mobile labour. It will thereby promote global connectedness, the growth of a skilled workforce, and the development of an innovative, competitive economy.

Hon Dr Michael Cullen
Minister of Finance
Minister of Revenue

Hon David Cunliffe
Associate Minister of Revenue

Chapter 1

INTRODUCTION

1.1 Employees recruited from overseas may face extra tax costs in coming to New Zealand, compared with what they would face at home or in other countries. The result is that extra costs are imposed on New Zealand business, who recruit them. This occurs either because recruits negotiate a higher level of remuneration, to compensate explicitly or implicitly for the additional tax burden, or because some potential recruits are deterred from taking the job at all. New Zealand businesses may then have to accept a second-best candidate, with an ongoing cost to the efficiency of the business.

1.2 It is important that New Zealand business gets the overseas recruits it needs, at the best price. The skills needed to produce growth and innovation are in demand internationally. A country the size of New Zealand should be open to obtaining those skills from beyond its domestic labour market. New Zealand's isolation also means it is important to use employment opportunities to develop better connections with the rest of the world. In this way New Zealand can keep in touch with international expertise, especially in the rapidly changing fields of science, technology and commerce.

1.3 Employers are best placed to determine which skills are needed and where they can best be found. The government's role is to set a regulatory framework which does not unduly interfere with attempts by employers to recruit the people they need. The proposals described in this discussion document aim to reduce the obstacles to overseas recruitment that the tax system imposes.

1.4 Businesses are effectively paying many of these costs themselves, and the current system distorts the behaviour of both businesses and overseas recruits. A well-designed tax system can do better.

1.5 In its final report to the government, the Tax Review 2001 recommended that individuals with no previous connection to New Zealand who become residents for tax purposes should be taxed only on their New Zealand-sourced income for the first seven years.

1.6 We have developed the idea of a temporary exemption from tax on overseas income for people who are recruited from overseas, but with a focus on reducing costs for New Zealand businesses, and widening the idea to include returning New Zealanders. The result is the proposal set out here.

1.7 We propose that people who are recruited to New Zealand to work as employees should be exempt from some of New Zealand's international tax rules. The exemption would last for a limited period. It would apply to people who are coming to New Zealand for the first time, or who have not been resident in New Zealand for at least ten years. The exemption could cover all sources of overseas income (including, for example, rents from overseas properties and interest in foreign bank accounts). Alternatively, it could cover only those areas where New Zealand's tax rules are particularly comprehensive (such as income from overseas companies controlled by the taxpayer).

1.8 The proposed exemption is not about attracting capital by encouraging wealthy immigrants. Since the exemption is from tax on foreign-sourced income, it would be an unsuitable tool for encouraging people to invest in New Zealand. The focus is on reducing employment costs for New Zealand business.

1.9 Nor is the proposed exemption a suitable tool for encouraging self-employed entrepreneurs to come to New Zealand. Entrepreneurs do not have the same opportunity to pass their extra costs on directly to New Zealand businesses. For these reasons, the exemption is aimed at employees.

1.10 The primary benefit of the proposed exemption would be to make it cheaper for New Zealand business to recruit and retain skilled employees.

SUMMARY OF PROPOSALS

A temporary exemption from some of New Zealand's international tax rules would be given to people who are recruited to work here.

The exemption would apply to anyone who has been non-resident for New Zealand tax purposes for ten years before the current period of residence. It would apply regardless of nationality, so returning New Zealanders could be eligible, as long as they had been non-resident for long enough.

The exemption would be targeted at people coming to work as employees in New Zealand. It would not be available to people coming here to retire, or to start up their own business, because there are no analogous costs for New Zealand business associated with these groups. As well as passing the non-residence test, claimants would also have to pass a work test. They would have to earn a minimum amount of income from a New Zealand employment, or work full-time in such an employment, in any tax year for which the exemption was claimed. Income from employment might include income as a partner from a non-family partnership. The work test would apply to a whole household, so that where both spouses were eligible on non-residence grounds, only one partner need earn above the threshold.

The exemption could cover a selected group of rules where New Zealand's approach is particularly comprehensive, or it could be wider, including tax on all foreign, non-employment income. This document therefore proposes two options for discussion, one narrow and one broad.

The **narrow option** provides an exemption from New Zealand's tax rules, where the treatment of foreign transactions is more rigorous than international norms. In particular, they include rules that tax accrued, unrealised gains. Employees from overseas would be exempted from:

- the special rules applying to foreign investment funds, controlled foreign companies and financial arrangements; and
- non-resident withholding tax and approved issuer levy.

The narrow option might also include an exemption in relation to:

- employee share options earned overseas during a period of non-residence;
- trust tax liabilities arising because the employee is a settlor who has become resident.

An alternative, broad option would give an exemption from tax on all foreign-sourced income, including overseas rents, interest and other investment income but excluding employment income. It would also cover non-resident withholding tax, approved issuer levy and some trust tax liabilities.

The exemption would last for a limited number of years. Year for year, a broad option would be fiscally more expensive than a narrow option. We propose that a broad option could last for three years after the date of arrival, or the narrow option could last for seven years, at a roughly equal fiscal cost.

Potential claimants would establish their residence eligibility through a process of certification. This would allow them to claim the exemption through self-assessment, subject to passing the work test in each year.

Consultation process

1.11 Views are sought on the broad and narrow options, the detailed design of the exemption, and how it should be implemented.

1.12 Please send submissions, by 19 December, to:

Reducing tax barriers to international recruitment
C/- General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington
NEW ZEALAND

email: policy.webmaster@ird.govt.nz

1.13 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you feel there is any part of your submission which you consider could be properly withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.

Chapter 2

THE TAX COSTS OF INTERNATIONAL RECRUITMENT

2.1 Most people still live their whole lives in their country of birth, and have no plans to emigrate. An increasing number of people, however, are mobile and have a wide choice of potential destinations in which to work. One such group is people whose skills and experience are in demand internationally, who can choose where they want to work. For them, differences in tax systems are one factor to be taken into account when choosing where to work.

2.2 Tax on offshore income appears to be an especially important issue for these individuals. They may accept fluctuating tax levels on salary and wages, which can be thought of as payments for the broad array of services inextricably linked to the local quality of life and local pay standards. Their tolerance may be lower for taxes on income perceived as having a more tenuous connection with the country of destination.

2.3 People coming to New Zealand to work can find taxes on foreign-sourced income higher than in other countries. This is partly because some of New Zealand's tax rules relating to foreign-sourced income – such as the foreign investment fund rules and the controlled foreign companies rules – are more comprehensive than those of other countries. Moreover, some countries have wide exemptions from tax on foreign-sourced income for new migrants. They include the United Kingdom and Hong Kong, both of which are likely alternative destinations for skilled workers also considering a move to New Zealand. This means that prospective migrants with foreign-sourced income that is taxable in New Zealand, such as property rents and interest on bank deposits, may face higher tax bills here than they would in other countries.

2.4 Potential employees choosing between jobs in New Zealand and either Hong Kong or the United Kingdom are likely to be the most sensitive to tax differences. For any given country, though, the differences will be inconsequential for some potential employees and significant for others.

2.5 New Zealand businesses need to recruit certain numbers of overseas residents with skills and experience which are not available in New Zealand. The tax imposed by our laws on those potential recruits can be passed on to New Zealand business in various ways, including the following:

- Potential recruits may explicitly negotiate for the New Zealand employer to meet the extra cost of taxation. The tax is effectively borne by the business from its profits. In effect, it is not a tax on the income of the non-resident, but a tax on New Zealand business.

- In other cases employers may not know that they are bearing the cost of the extra tax. When naming their price recruits will recognise the extra tax that they will have to pay and simply start with a higher figure in salary negotiations. Some may request more compensation than the total extra tax bill, to compensate for compliance costs and the nuisance factor.

- If a business is not able to offer adequate compensation it may lose the best person for the job. It will have to employ the next best candidate, which gives rise to a cost to the efficiency of the business.

- Even before the negotiation stage, some potential recruits will decide not to come to New Zealand at all. They may decide that they are unlikely to negotiate adequate compensation. Others will realise that they could restructure their finances in a way to limit the extra tax burden, but will decide that they do not want to spend time doing this. The best candidates, those with good job offers elsewhere, may be especially likely to be swayed by these marginal considerations. These decisions reduce the pool of available talent. New Zealand business is less likely to be able to recruit and retain the best possible employees, and that costs New Zealand business in the long run.

2.6 It is often the case that New Zealand businesses cannot compete purely in terms of salary with similar businesses in other English-speaking OECD countries, although New Zealand has other attractions which can make up for some differences in remuneration. There is not an unlimited capacity to reduce salaries, however, and removing tax barriers would help employers to make the most of those attractions.

2.7 The proposed exemption aims to reduce the tax on foreign-sourced income which mobile, tax-sensitive workers can pass on to New Zealand business. Its purpose is to reduce the cost to New Zealand business of recruiting highly skilled workers, not to increase the number of overseas workers coming to New Zealand.

The justification for an exemption

2.8 Most taxes create costs for the economy, but those costs are balanced against the need to raise revenue. Any proposed exemption must be justified in the context of New Zealand's wider tax framework. Why this exemption and not another?

2.9 New Zealand has a broad-based tax system under which different types of income and expenditure are taxed equally, as far as possible. This reduces the extent to which tax considerations affect economic decisions and thus reduces the economic cost of taxation. In general, exemptions and special treatment for particular types of income or taxpayers are to be avoided.

2.10 In the context of international taxation, the residence principle is the basic economic framework of the New Zealand tax system. Within this framework, New Zealand residents are taxed on their worldwide income, which minimises tax incentives that would distort residents' decisions about whether to invest offshore or in New Zealand.

2.11 Conversely, the starting point for taxing non-residents is their New Zealand income, and overseas income is not taxed at all. But even their New Zealand income is generally taxed only when they bear the burden themselves. If the cost can be passed on to New Zealanders, it is better to remove or reduce the tax.

Example

Alex manages an overseas investment fund, and is considering where to invest $10 million. He is considering making loans in New Zealand, and in Atelia, a low-tax country. Atelian borrowers would pay interest of 6%, with no Atelian taxes. In New Zealand, interest would be subject to withholding tax of 15% to cover the investment fund's New Zealand tax liability. New Zealand borrowers would therefore have to pay 7.06% in order to produce a net return of 6%, if they are to compete for Alex's investment. This means that while the tax is collected from Alex, New Zealand borrowers would be required to pay him a higher return to compensate for that tax. New Zealand borrowers are effectively paying the tax on Alex's behalf or face losing his investment. New Zealand tax law recognises this problem, and the New Zealand borrowers can instead apply for a special status which enables them to pay tax at only 2% on their interest, a total of 6.12%.

2.12 A proposal to exempt overseas recruits from tax on foreign-sourced income is consistent with the logic of the residence principle. For the limited class of residents concerned, whose connection to the country is new and fragile, these taxes are inefficient.

2.13 At present, our tax system effectively collects such taxes from businesses, but distorts the behaviour of both businesses and overseas recruits. The distortion to the behaviour of recruits is avoidable. If it were determined that the revenue collected was needed for government spending, it could be collected directly from the domestic tax base instead, without the unnecessary distortion.

Chapter 3

SCOPE OF THE EXEMPTION

3.1 Rules about which taxes would be covered by the exemption, who could claim it, and how long it would apply for need to be considered carefully to ensure that the exemption is efficient. Ideally, the exemption would cover only those taxes which are passed on to New Zealand business, would apply only to recruits who are "sensitive" to New Zealand's tax system, and would last only as long as that relative sensitivity lasted. But for each person these thresholds will be different.

3.2 As far as possible, the proposed exemption should be designed to avoid the following side effects:

- distorting investment decisions, especially making overseas investments more attractive than New Zealand investments;
- making overseas recruits relatively cheaper to employ than New Zealand residents with equal skills and experience; and
- damaging efficiency and perceptions of equity in the New Zealand tax system.

The two options

3.3 A broad option would exempt eligible employees from paying New Zealand tax on any foreign-sourced income (apart from employment income). This would include income from all foreign investments, such as shares in foreign companies, interest on foreign savings and rental income from foreign properties. It would also cover the obligation to deduct tax from payments made to a foreign lender.

3.4 The narrow option would focus on those New Zealand tax rules which are more comprehensive than the international norm. Of special concern are the rules relating to controlled foreign companies and foreign investment funds. There may also be a case for including rules on financial arrangements in the exemption. A common feature of these rules is that they tax the investor on income and gains made by the investment vehicle even though these gains may not have been realised or distributed. The narrow option would also cover deductions from payments made to a foreign lender and could also cover overseas share options and certain trust income.

3.5 The main effect of the narrow option would be to reduce direct tax charges on people with significant interests in companies and unit trusts in foreign countries (other than Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States, for which an exemption already applies). It would also reduce the tax suffered by people owing money abroad, the most likely example of which is a foreign mortgage.

3.6 The broad option would cover the same ground as a narrow option and would also reduce tax bills for people with any form of income from low-tax jurisdictions. There would be less effect on income arising in countries with tax systems similar to New Zealand's, because the income would be taxed fully there, with or without the exemption, and a foreign tax credit would be available to set against any New Zealand tax. A broad exemption would have an effect on this type of income only to the extent that New Zealand's rules and rates currently produce a higher tax bill – for example where the other country does not tax a particular type of investment

Advantages of the broad option

3.7 The broad option is by definition more comprehensive than the narrow option, and more likely to be successful in reducing tax-related costs to New Zealand business. The broad option is more likely to be useful in helping businesses attract people who would otherwise consider migrating to Hong Kong or the United Kingdom. It would send a stronger signal to businesses and their potential overseas recruits. It would also be easier to understand and simpler to comply with.

Disadvantages of the broad option

3.8 The broad exemption is likely to distort people's decisions about where to invest, whether offshore or in New Zealand. There would be an incentive to retain and even increase their offshore, tax-free investment, at the expense of New Zealand investments. This option might be more likely to encourage investment into tax havens. This effect, however, would be curtailed by the time-limit placed on the exemption. Arguably, a person arriving in New Zealand to work is unlikely to invest in the country until connections have been made and knowledge acquired. By that time, the exemption would be coming to an end, so the distortionary effects of a wide exemption might not in fact be that great.

3.9 The broad exemption might be seen as less fair, especially as it would apply to some returning New Zealanders, as well as people from other countries. In fact, some of the relieved tax would have been borne by New Zealand employers anyway. But perceptions of equity are important for a tax system which depends on voluntary compliance. Furthermore, there would be some unfairness to the extent that the broad option would be less well targeted.

Advantages of the narrow option

3.10 Some people may perceive any exemption from tax as unfair. The reduced scope of the narrow option is likely, therefore, to be seen as fairer. It would give a series of carefully defined exemptions from some quite technical rules, instead of a blanket exemption for all foreign-sourced income. There would be less difference between the tax liabilities of overseas recruits and New Zealand residents having similar patterns of income.

3.11 Any exemption will produce distortionary incentives to restructure investments to take advantage of it. The distortions under the narrow exemption may be fewer, especially if some taxability is retained. For example, the special rules relating to the taxation of foreign investment funds would be relaxed, so that there would be no taxation of unrealised gains. This would remove the comprehensiveness of the rules, but income from a fund would still be treated like any other foreign investment income, with distributions taxed as they are made.

3.12 Similarly, under the narrow option controlled foreign companies would not be taxed on the current rigorous basis, but distributions would be taxed ordinarily. This would mean that there was no investment vehicle that was simply tax-free, to attract funds which would otherwise go elsewhere.

3.13 The narrow exemption would likely work best for people deciding between remaining at home and accepting a job in New Zealand. Such people, if they are without job prospects elsewhere, may be sensitive to the New Zealand tax system than to their domestic tax system, but oblivious to systems in other countries.

Disadvantages of the narrow option

3.14 The tax avoidance possibilities of foreign investment funds and controlled foreign companies, which the special rules are in part designed to foil, would be opened up by the exemption. There would be, therefore, some incentive to invest in these vehicles. The distortionary effects of the exemption would at least be confined to those people prepared to engage in tax planning at the avoidance end of the spectrum.

3.15 Although the distortionary effects of the narrow option might be limited in scope, they would last for longer if the narrow option were to cover a longer period than the broad option.

3.16 The narrow option would not necessarily cover all of the tax costs arising from a highly skilled recruit moving to New Zealand. Although it singles out the most obvious areas of difference, it does not address any of a wide range of smaller differences, which could result in the New Zealand tax charge exceeding any foreign tax credit available.

International comparisons

3.17 Since few countries offer a broad exemption from tax for the foreign-sourced income to employees from overseas, New Zealand should be cautious at this stage. The Australian government recently proposed a broad exemption but it has not passed into law. The United Kingdom's domicile rules (currently under review) give an indefinite exemption from tax on foreign-sourced income for many immigrants. Hong Kong does not seek to tax foreign-sourced income at all, but in other respects, its tax rates are also very low. Residents are taxed only on profits, salary, and property values arising in Hong Kong, and the tax rate is 15% across the board. Merely introducing a temporary exemption for foreign-sourced income would not come close to making New Zealand competitive with Hong Kong in terms of tax. On the other hand, at the margin it could make all the difference.

Breadth and length

3.18 A wide exemption would be more fiscally expensive than a narrow exemption over the same period of time. Thus, a broad exemption lasting three years would have approximately the same fiscal cost as a narrow option lasting seven years. On this basis, if the choice were between these two options, which would be more beneficial for New Zealand business?

3.19 Since the narrow option contains those elements most likely to be taken into account by employer and employee, it might be wisest to spend the money here. On the other hand, the longer period would exceed the likely period of sensitivity. Before seven years are over, employees might have moved investments to New Zealand, completed their employment contract and returned overseas, or simply failed to renegotiate compensation with an employer who now regards them as less mobile and not so sensitive to tax. In that case, it might be better to choose the shorter, wider option, which is likely to fall entirely within the period of sensitivity, although it may cover some tax to which some mobile workers are not sensitive.

Chapter 4

OPTION ONE: THE NARROW EXEMPTION

4.1 The narrow option would target the exemption at certain features of our tax laws. This would include relief from foreign investment fund and controlled foreign company rules, the non-residents withholding tax rules and the approved issuer levy rules. It could also include overseas share options, accruals and trusts. Although this chapter devotes more space to considering the narrow option than the next chapter to the broad option, this is only because the subject requires a more detailed discussion of what should be included.

Controlled foreign company income

4.2 When a foreign company is controlled by a small number of New Zealand residents, the controlled foreign company rules may apply.[1] Under these rules, the income of the company is attributed to its owners according to their interests. New Zealand owners are then taxed on their attributed shares of the company's income, regardless of any actual distributions. The company's income is calculated for this purpose as if it were a branch operating in New Zealand. Tax paid by the company in respect of the attributed income is usually allowed as a credit against the owner's tax bill.

4.3 The intention of these rules is to ensure that New Zealanders face similar tax liabilities, whether they invest in foreign or domestic enterprises.

4.4 The controlled foreign company rules do not require attribution of current income when the company is resident in Australia, Canada, Germany, Japan, Norway, the United Kingdom or the United States. Instead, the income is taxed only when it is distributed. These countries are considered to have tax systems that are equivalent to New Zealand's, so any tax due in New Zealand would be largely offset by a foreign tax credit.

4.5 The other main exception to the rules is that they do not apply where a person has less than a 10 percent income interest in the company, although the foreign investment fund rules may apply here instead.

4.6 New Zealand's controlled foreign company rules are broader than those of many other countries. In New Zealand, the rules do not distinguish between the active and the passive income of a business. In most other OECD countries, active income is exempt, and taxed only on distribution. Thus the New Zealand rules may impose a higher tax charge.

---

[1] The rules apply when five or fewer New Zealand residents hold 50 percent or more of the control interest in the company, or are able to control the exercise of shareholder decision-making rights. They also apply if a single New Zealand resident holds more than 40 percent of the control interest, unless a single non-resident holds an equal or greater amount.

4.7 The broader scope of New Zealand's rules can also cause relatively high compliance costs for taxpayers because of the need to prepare a second set of accounts. Company income is first calculated in accordance with the tax laws of the country of residence, and must then be recalculated in accordance with New Zealand tax law. Because active income is taxed, trading stock and depreciation have to be recalculated, thereby increasing the compliance costs.

4.8 The rules apply as soon as someone becomes resident in New Zealand. There is no transition period during which business interests can be rearranged.

Example

Helen is a South African computer engineer. She owns 20 percent of the shares in a family company based in Cape Town. The other shares are held by her parents. In South Africa, she is taxed on her income from the company as it is distributed. She moves to New Zealand to take up a job. She must now arrange for the family company's income to be recalculated in line with New Zealand tax law, and she must pay New Zealand tax on 20 percent of the company's total income, regardless of how much is distributed to her.

4.9 The higher tax and compliance costs associated with New Zealand's rules add to the cost of recruiting employees who have significant business interests overseas. We therefore propose to include them in any narrow exemption.

4.10 Under a narrow exemption, controlled foreign company income would not be attributed and taxed, but any distributions paid out would be taxed in the usual way, like any other company distribution. Once the exemption ended, the company income would begin to be taxed under the controlled foreign company rules, as if the taxpayer had become New Zealand resident on the day the exemption expired.

Foreign investment fund income

4.11 The foreign investment fund rules apply to certain interests held by a New Zealand resident in foreign companies, unit trusts, superannuation schemes and life insurance policies. Like the controlled foreign company rules, they are designed to tax residents on their shares of an overseas entity's income on a current year basis rather than when the income is distributed.

4.12 There are several exemptions from the rules, including:

- an interest in a company or unit trust in Australia, Canada, Germany, Japan, Norway, the United Kingdom or the United States;

- an interest in a foreign superannuation scheme or life insurance policy for the income tax year in which a person first becomes a New Zealand tax resident, and the next three years; and
- all of an individual's foreign investment fund interests if the aggregate acquisition cost was less than $50,000.

4.13 If an interest in a fund is not exempt, it must be disclosed to Inland Revenue, and the income must be calculated according to the rules and included in the tax return.

4.14 The intention of the foreign investment fund rules is to tax residents on their share of the income of the entity, regardless of distributions. Since many investors are not privy to the information needed to calculate the whole income of the entity in which they have invested, alternative calculation methods are permitted. In roughly descending order of accuracy, and ascending order of simplicity, these methods are:

- branch equivalent;
- accounting profits;
- deemed rate of return; and
- comparative value.

4.15 Only the branch equivalent method permits credit to be given for foreign tax paid.

4.16 The most commonly used is the comparative value method, which is simple and does not require a lot of information. This method calculates the income or loss based on the change in the market value of the shares over the year. Fluctuations in exchange rates will also be included. Consequently, investors will effectively be taxed on their unrealised capital gains, and with no credit for tax paid by the foreign entity on its profits.

4.17 New Zealand's approach to foreign investment funds is more comprehensive than that of many other countries. It is based on the principle that residents should be taxed on their worldwide income as it accrues. Other countries have narrower rules, aimed at countering tax avoidance. As with controlled foreign companies, it is common for other countries to have an exemption for active business income. Thus in Australia, an interest in a foreign company which qualifies for the active business exemption is outside the foreign investment fund rules altogether.

4.18 Anecdotal evidence and submissions received by the Tax Review show that the foreign investment fund rules are often considered to be a deterrent to highly skilled people thinking of coming to New Zealand to work. It is therefore likely that the rules add to the cost of recruiting overseas employees.

Example

Paul works in Paris. He owns $70,000 worth of shares in French companies. He pays French income tax on his dividends. If he came to work in New Zealand, his shareholdings would be treated as foreign investment funds. He would adopt the comparative value method, and would have to pay tax on the annual change in value of the shares, including exchange rate fluctuations.

4.19 The narrow exemption would include foreign investment fund income , so only distributions from the fund would be taxed during the period of exemption. Once the exemption ended, the interest in the fund would begin to be taxed under the special rules, as if the taxpayer had become New Zealand resident on the day the exemption expired.

4.20 The government is considering possible options for reforming the taxation of offshore portfolio investment, which could eventually lead to further changes to the foreign investment fund rules. The application of the narrow exemption to funds would be reviewed in the light of any such changes.

Share options

4.21 New Zealand follows the international norm in taxing employee share options on the exercise spread, at the time they are exercised. The exercise spread is the difference between the value of the shares at the time they are acquired, and the price paid for them.

4.22 The tax liability on share options arises when the option is exercised. If the option is exercised by a New Zealand resident, it is taxable in New Zealand. This is the case even if the option is earned in overseas employment at a time when the employee was not a New Zealand resident. In this respect, New Zealand's tax rules are more comprehensive than those of many other countries.

4.23 For example, people who are resident in Australia, the United Kingdom, United States or Singapore are not taxed when they exercise share options if the options were earned overseas before they became resident. (In the United States, this depends on their not being US citizens). Some of these countries do charge capital gains tax on the ultimate sale of the shares, which in some circumstances reflects some of the pre-exercise gains.

4.24 Overseas recruits coming to New Zealand with unexercised share options from a previous jobs could, therefore, face a tax bill which would not have arisen had they decided to take up work in one of several other countries likely to compete for their skills and experience. This fact is likely to increase the recruitment cost for New Zealand business, at least in respect of highly mobile employees with several choices of location.

4.25 New Zealand business costs are less likely to rise in cases where employees are making a direct comparison between New Zealand and their long-term home country. Someone with share options from their current employment who was considering a move to New Zealand as an alternative to staying at home would face tax on the exercise of the option regardless of what choice they made.

4.26 On the other hand, the tax treatment in New Zealand may be a factor for an employee who compares the treatment with other alternative destinations, but not with the country of origin.

Example

Angela is a New Zealander who has worked abroad for fifteen years, mostly in Asia. She has acquired share options which are exercisable over the next three years, and she expects to make gains on exercise of between $200,000 and $300,000. If she goes to work in Australia, United Kingdom or United States she will pay little or no tax when she exercises the options. But if she comes to New Zealand, she will pay tax on the whole of the gains.

4.27 It could also be argued that New Zealand's taxation of share options is more severe than that of other countries because of its lack of exemptions and other favourable treatment. This comparison applies bilaterally, as well as multilaterally. For example, a share option earned in Britain might be exempt from United Kingdom tax because it met certain statutory criteria, but would be taxed in New Zealand. However, the range of treatment internationally is very wide. It ranges from deferral of payment of the tax (Ireland), to exemption for quite large amounts (United Kingdom), with some countries offering partial exemption for variously limited amounts (Canada and the United States). We are not aware of any OECD country which offers complete exemption for gains on employee share options earned in that country.

4.28 There is certainly a case for including overseas share options in the narrow exemption. Unfavourable comparisons with the United Kingdom, United States, Australia and Singapore could not then be drawn. On the other hand, such an exemption would increase the likelihood of double non-taxation (meaning no tax charged in the country of earning and the country of exercise), as it would make it easier for employees to plan their actions to take advantage of differences in the tax rules on share options. This is much less of a risk with other types of foreign-sourced income, which is likely to be subject to tax in the source country, in spite of any temporary exemption in New Zealand, and in relation to which the taxpayer has much less control over the timing of the income.

4.29 A particular risk is that overseas employees intending to retire to New Zealand might plan to maximise the proportion of their remuneration taken in the form of share options during their last years overseas, and then cash in the options, tax-free, in New Zealand. They would have to be employed in New Zealand only for as long as it took to exercise the options (but at least one year).

Non-resident withholding tax and approved issuer levy

4.30 New residents often retain a house in their home country, which may be mortgaged. The mortgage lender will not normally be resident in New Zealand, but the fact that the borrower is resident in New Zealand will be enough to give the lender a New Zealand source of income. This means that interest paid by the resident to the non-resident lender must be paid net of non-resident withholding tax. The rate of tax is 10% for countries with whom New Zealand has a double tax agreement and 15% for other countries.

4.31 Non-resident withholding tax is a tax on the interest received by the foreign lender, but because non-resident lenders usually charge an interest rate net of all New Zealand taxes, in practice, the burden of the tax is borne by the resident borrower. An alternative for the resident borrower is to apply for approved issuer status, register the security with Inland Revenue, and pay an approved issuer levy at 2% on the interest paid to the foreign lender. The liability for the approved issuer levy remains with the borrower.

Example

Anna leaves Germany and comes to work in New Zealand on a three-year contract. She owns a house in Frankfurt on which she makes mortgage payments of $4000 a month, mostly interest. She lets the house for $3500 a month, making a small loss. Because she is now resident in New Zealand, her German mortgage lender has a New Zealand source of income. Anna must deduct non-residents withholding tax at 10% from her mortgage payments, and pass it to Inland Revenue. In practice, she must pay that amount in addition to the mortgage payments, otherwise she will be in breach of the terms of her mortgage. Anna decides instead to elect for approved issuer status. She no longer has to pay the 10% withholding tax, but she does have to pay Inland Revenue a levy of 2% of her interest payments. Her housing costs have thus increased by about $800 a year.

4.32 Many new residents are unaware of their liability to pay non-resident withholding tax, or of their opportunity to elect to pay the approved issuer levy instead. They may thus become exposed to shortfall penalties, as well as the non-resident withholding tax charge, which in many cases will be unrecoverable from the lender.

4.33 Non-resident withholding tax and approved issuer levy add to the direct tax and compliance costs of new residents with foreign debts. These costs are in some cases passed on to employers, increasing the cost of overseas recruitment. Non-resident withholding tax and approved issuer levy are therefore included in the narrow option.

Other possible areas for exemption

Financial arrangements

4.34 Like the foreign investment fund and controlled foreign companies rules, the financial arrangement rules (also known as the accrual or accruals rules) bring gains to charge for tax as they accrue, even though those gains may not be realised or received for some time. The rules apply to a wide range of financial instruments and transactions. They match income with the relevant expenditure, and they limit the scope for turning taxable income into non-taxable capital gains.

4.35 Many other countries do not have similar rules. The rules are therefore likely to cause extra tax costs for some people thinking of coming to work in New Zealand, and consequent costs to New Zealand business.

4.36 For example, money invested overseas in a deep discount or a zero coupon bond might produce no taxable income in that country until the bond matures. Under New Zealand's financial arrangement rules, the gain would be spread over the life of the bond, and tax would be payable each year.

4.37 A mortgage is a financial arrangement, and in the common situation of overseas employees retaining a mortgaged property in their home country, a tax liability could arise on foreign exchange fluctuations.

4.38 There may be a case for including the accrual rules in a narrow exemption, and it would be useful to hear of circumstances in which exposure to the accrual rules has been an issue for a prospective overseas recruit.

4.39 If the narrow option did provide some exemption for financial arrangements, it would not be enough to confine the exemption to foreign-sourced income, because money lent to a New Zealand resident gives rise to New Zealand-sourced income. Deemed income from foreign exchange fluctuations on a mortgage, for example, would, therefore, not be foreign-sourced income. One possibility would be to exempt all foreign-sourced income arising under the accrual rules, as well as New Zealand-sourced income arising under those rules if the financial arrangement was a loan made to the exempt person before he or she became resident. Alternatively, it might be necessary to extend the exemption to the accrual rules as a whole. In that case it would probably be desirable to limit the exemption to pre-residence arrangements, to reduce the scope for avoidance.

Trusts

4.40 The trust tax rules provide that New Zealand tax on trustee income arising overseas depends on the tax residence of the settlor. Trusts established overseas but with New Zealand resident settlors are taxable in New Zealand, and the tax can be recovered from the settlor. This prevents New Zealand resident settlors from avoiding or deferring New Zealand tax by establishing trusts overseas. It also means that trusts with little or no connection with New Zealand can become subject to New Zealand tax rules as a result of the settlor immigrating to New Zealand.

4.41 Settlors who migrate to New Zealand for the first time after settling a trust are already given some relief from the general rule. They need not pay the tax due on the trustee income. However, it may be advantageous for them to choose to do so if there are New Zealand beneficiaries. Otherwise, some distributions to those beneficiaries may be taxed at 45% instead of the beneficiary's marginal rate.

4.42 The current rules are more likely to create extra tax costs for settlors who are returning to New Zealand, having set up a trust while non-resident. If they have been resident in New Zealand at any time between 1987 and the making of a settlement, they will be liable to tax as agent of the trustee. However, this might be partly offset by foreign tax credits, relating to tax paid directly by the trustee on the same income.

4.43 If the settlor rules were included in the exemption, it might save some compliance costs and a possibility of an extra tax charge for some returning New Zealanders. We would welcome submissions on this point.

Other areas

4.44 We would like to hear of any other areas where New Zealand tax on foreign income or payments is unusually comprehensive and likely to be compensated by employers.

Chapter 5

OPTION TWO: HOW WOULD THE "BROAD" EXEMPTION WORK?

5.1 The broad exemption would remove New Zealand tax from all the foreign income of an eligible employee. This would have a greater effect in cases where the income is not taxed much in its country of source, and a lesser effect where the income arises in a country with a tax system similar to New Zealand's.

5.2 The effect of the broad exemption is also dependent on the choices available to a potential employee.

Examples

- Lee is a New Zealander currently working in South America. After 20 years of a career in international business, he has built up an investment portfolio based in a couple of low-tax jurisdictions. He is considering jobs in Australia, the United Kingdom, United States and New Zealand. If he goes to the United Kingdom he will not be taxed on his investment income as long as he leaves it offshore. If he goes to Australia or the United States he will be taxed. If he comes back to New Zealand, he will be taxed unless the broad exemption is introduced.
- Wendy is a teacher living in London, where she owns her own house. She has a small portfolio of United Kingdom shares. She takes up a temporary post in New Zealand and lets her London house. She pays United Kingdom income tax on her rental and dividend income. She is also liable for New Zealand tax on this income. Her New Zealand liability on the rental income is fully covered by the credit for the United Kingdom tax she has paid. But the New Zealand tax due on her dividend income is greater than the United Kingdom credit, because of the United Kingdom imputation and tax rate rules. Wendy therefore has some net tax to pay in New Zealand, which would be relieved under the broad exemption.

5.3 The starting point for a broad exemption would be an exemption for all foreign-sourced income arising during the period of the exemption. This could be achieved along the lines of section BD 1(2)(c) of the Income Tax Act 1994, which exempts from gross income any amount which is "a foreign-sourced amount and the taxpayer is a non-resident when it is derived". The exemption would be extended to include any amount which is foreign sourced income and the taxpayer qualifies for the exemption when it is derived.

5.4 Such an exemption would cover most sorts of foreign-sourced income, but it would not deal with everything. For example, liability to deduct non-resident withholding tax does not depend on the definition of gross income in the first place. Exemption from non-resident withholding tax for mortgage payments would have to be specified separately.

5.5 Are any other specific provisions needed, in the context of a broad exemption?

New investments

5.6 A broad exemption would create an incentive to increase overseas investments. One way of countering this distortion would be to provide that only sources of foreign income held at the time of entry to New Zealand qualify for the exemption. However, such a rule would increase the complexity of administering and complying with the exemption. "New sources" would have to be defined, including further investment in existing vehicles. This rule could create difficulties for ordinary investment planning.

5.7 As noted earlier, the incentive to invest overseas would diminish as the exemption period drew to an end, which is when a decision to invest in New Zealand would become more likely in any case.

5.8 We therefore do not propose to distinguish between pre-migration and post-migration foreign-sourced income, except in the case of financial arrangements, for the reasons already given.

Employment income

5.9 Employment income and other income from the provision of the taxpayer's own services would be excluded from both the broad and narrow options. Since the exemption is aimed at people coming to New Zealand to work, this is unlikely to have any practical effect in most cases. Few eligible taxpayers would retain overseas employments or consultancies. Nevertheless, the exclusion would be made explicit, to reduce the scope for avoiding tax on New Zealand earnings by recharacterising them as foreign earnings (for example, by weighting the remuneration under employment contracts with New Zealand and overseas companies in the same group). The exclusion would extend to any benefit or income which related to services or employment carried out during the exemption period. This would probably have to include share option benefits if the benefit if dependent on continuing employment. Otherwise, it would be all too easy to arrange remuneration for the New Zealand employment through a share option arrangement set up before residence commenced.

Chapter 6

THE TEMPORARY NATURE OF THE EXEMPTION

6.1 The point of limiting the duration of the proposed exemption is to target mobile labour that is sensitive to tax. Some people who move to work in New Zealand may decide to put roots down and stay here permanently. Putting a time limit on the exemption is a way of identifying those people who have ceased to become sensitive to New Zealand tax by virtue of their decision to remain in New Zealand on a permanent basis.

6.2 A time limit also reduces any incentive for people to favour investment overseas. Removing the exemption after a period will encourage long-term stayers to consider taking advantage of investment opportunities in New Zealand.

6.3 We suggest that mobility and tax sensitivity are likely to be much lower for people who stay here to work after the end of their first contract. What is the length of a typical contract for skilled employees in the international labour market? State sector CEO contracts are for five years. The Tax Review suggested a seven year exemption. The maximum work permit is for three years, although in practice highly skilled employees with a definite job offer may be granted permanent residence by the New Zealand Immigration Service provided they meet other immigration requirements.

Chapter 7

ELIGIBILITY CRITERIA

7.1 The proposed exemption is designed to make it cheaper for New Zealand businesses to attract highly skilled and experienced employees to New Zealand. This chapter examines the eligibility criteria required in order to target the exemption at this group.

New residents

7.2 People coming to New Zealand for the first time are most likely to pass on extra tax costs to their employers. They would be eligible for the exemption, assuming they met the work test.

Returning New Zealanders

7.3 An important question is whether the exemption should apply to returning New Zealanders as well as to people who are tax resident for the first time. On the one hand, it could be argued that this gives to New Zealanders who have left the country a concession which is not granted to those who have stayed here and contributed to the economy. On the other hand, there is an argument that denying them the concession discriminates against New Zealanders who are in a very similar position to other mobile non-residents.

7.4 Some New Zealanders considering whether to return will be just as sensitive to tax as foreigners. If they have not been tax resident in New Zealand for a significant amount of time, and have skills which are internationally in demand, they are just as mobile as foreigners. If they have acquired sources of foreign income, it is likely that they, too, will pass on their increased tax costs to New Zealand employers.

7.5 Some returning New Zealanders will be less sensitive to tax, as the decision to return to New Zealand will be made for family reasons. Nonetheless, while other factors will entice expatriates back to New Zealand, this does not mean that tax will not be a decisive factor at the margin, especially in deciding whether to return sooner rather than later. Getting highly skilled New Zealanders to return during their working lives is more valuable to New Zealand than having them return in their retirement.

7.6 Immigration statistics suggest that there are fewer New Zealanders than non-New Zealanders in the group of highly skilled workers coming to New Zealand. The cost of extending the exemption to returning New Zealanders is unlikely to exceed one-third of the overall cost.[2]

7.7 If returning New Zealanders were excluded from the exemption, businesses could find it cheaper to choose nationalities other than returning New Zealand citizens. We have no desire to create such an incentive. If anything, returning New Zealanders are more likely to fit quickly back into New Zealand cultural and economic life.

7.8 Extending this exemption to returning New Zealanders recognises that New Zealand business benefits by hiring citizens who return after going overseas to gain skills, experience and contacts which are not available here.

Who will qualify as a returning New Zealander?

7.9 To confine the exemption to those who really are tax sensitive, we propose that New Zealanders must have been non-resident for tax purposes for a period of time in order to qualify. This means, for example, that they will have had no permanent place of abode in New Zealand for that period.

7.10 It is important that the period is long enough to deter New Zealanders with large offshore investments from simply going abroad for that period in order to qualify for the exemption upon their return. We propose that the period of non-residence be ten years, or twice the length of the exemption period if that is shorter. (If the exemption period is only four years, it seems unlikely that anyone would go abroad for more than eight years in order to qualify for it).

7.11 Non-residence for tax purposes would be defined in terms of domestic law, irrespective of double tax agreements. Someone who was deemed under a double tax agreement to be non-resident in New Zealand and resident somewhere else would not qualify for the exemption if under domestic law he or she remained a New Zealand tax resident.

7.12 An individual would be able to benefit from the exemption only once. Therefore an individual who received the exemption and then left New Zealand would not be able to receive the exemption again if he or she returned after the specified period of time. Otherwise, it might be possible for people to string together exemptions in several countries and repeat the pattern, never paying tax on foreign-sourced income at all.

[2] In 2002, 3887 New Zealand citizens aged between 25 to 50, in the category of managers, administrators and professionals, returned to New Zealand, compared with the arrival of 7242 non New Zealand citizens in the same category.

Previous tax residents

7.13 The exemption would apply to all returning previous tax residents who have been non-resident for the required period, and not just New Zealand citizens. People who have been in New Zealand previously as workers, students or children of people who came to work in New Zealand may now wish to return. They are just as likely as first-time residents to pass on their costs to their prospective employers. Given the rationale of the exemption, there is no reason why these people should be excluded. As with returning New Zealand citizens, a tax disincentive may be a decisive issue at the margin.

Work test

7.14 The objective is to reduce the cost to business in attracting highly skilled people to work in New Zealand. To target the exemption at such individuals, it should be limited to those who actually work in New Zealand. In the absence of such requirement the exemption would potentially apply to retired people, students and long-term holiday makers.

7.15 The proposal does not aim at attracting wealthy people to New Zealand. Since it gives an exemption from tax on foreign-sourced income it does not provide any incentive to invest capital here and would be an unsuitable tool for such a purpose.

7.16 The exemption would be subject to a work test. To be eligible, people would either:

- earn a set level of New Zealand-sourced income from employment, the suggested level being $70,000, just over double the average income; or
- work full-time hours in employment for the whole year.

7.17 The full-time test would allow the exemption to apply to lower paid workers. Although they are less likely to have significant sources of foreign investment income, they could be affected by non-resident withholding tax and foreign investment fund rules, and even if the amounts are not large, the associated compliance costs and nuisance can be.

7.18 The qualifying income or hours must be from working for an employer who is not controlled by or associated with the taxpayer. This will prevent wealthy, non-working immigrants from obtaining the exemption by setting up a controlled company to pay themselves a salary.

7.19 A work test drafted in this way will not include the self-employed and entrepreneurs. This is because entrepreneurs and self-employed people do not have the opportunity to pass their extra tax costs on directly to New Zealand business.

7.20 A separate issue arises in respect of someone migrating to New Zealand to join a partnership. A partner is technically self-employed and for that reason will not be covered by the exemption. But a new partner negotiating the partnership agreement may ask to be compensated for extra tax duties at the expense of the New Zealand partnership, in much the same way as an employee. One option would be to extend the work test to include income from a partnership (excluding family partnerships).

Spouses

7.21 The work test also raises issues in relation to non-working spouses who may receive foreign sourced income. Not including them in the exemption would increase the overall tax burden on the family and might undermine the effectiveness of the exemption.

7.22 We therefore propose that the work test criteria would be met if either spouse worked full-time or earned at least $70,000, provided that both are either first time residents or eligible returners.

7.23 The work test would remain at the individual level if only one spouse met the residence test. So if a couple included one worker who was a long-term New Zealand resident and one new migrant who was not a worker, neither would qualify for the exemption.

Fluctuating work

7.24 If the level of New Zealand earnings fluctuated around the $70,000 mark, the individual would be able to claim the exemption for those years within the exemption period for which income was above the threshold. For example, low earnings in the second year of residence would not prevent entitlement to the exemption in the third year, if earnings were high enough. The exemption would expire by reference to the time when the person first became resident. The clock would not stop during a period when the work test was not met.

7.25 If someone was employed full-time, fluctuating income would not affect eligibility for the exemption. However, he or she would have to work full-time for the whole year for this alternative criterion to be met.

International comparisons

7.26 A number of other countries limit their incentives to highly skilled employees. For example, in Belgium non-resident status is granted to non-Belgian executives or specialists who temporarily work in Belgium for an international group. Non-residents are taxed only on their Belgian-sourced income. In Finland the expatriate rules provide for a flat tax rate of 35% for those foreign employees whose work requires special knowledge. Other conditions are that the monthly cash salary is at least EUR 5,800 and that the length of assignment is six to 24 months. The expatriate rules apply for a maximum 24 months from the start of the assignment and the employee must not have been resident in Finland any time during the five previous years. After that period the expatriate is taxed according to the normal rules.

Implementing the eligibility tests

7.27 In implementing such an exemption, there are a couple of important principles:

- If the exemption is to be effective in reducing business costs, those who are eligible must know that they are eligible at the time of agreeing their contract.
- The exemption should be simple to claim, and not distracting for those to whom it is irrelevant.

Self-assessment

7.28 The most obvious way to claim the exemption would be simply not to declare the exempt income. This approach is consistent with principles of self-assessment. There would be no formal claim, and no indication on the return that the exemption was being claimed. Use of the exemption by someone who was not eligible would be discovered only through audit.

7.29 On its own, this minimalist approach has a few drawbacks:

- The individual would be responsible for determining whether he or she met the eligibility criteria, and may be uncertain about that.
- Because the claim would be entirely in the hands of the individual, there is a risk that the exemption would not be used by all of those entitled to it. This could be dealt with by suitable notes in the return guide, but on their own such notes would be likely to stimulate mistaken claims.
- There would be no data with which to monitor the take-up of the exemption.

Certificate before arrival

7.30 The self-assessment approach could be enhanced by a certification requirement. Inland Revenue could issue a certificate confirming that a particular person met the residence criteria for the exemption. Final eligibility would then depend on meeting the work test, and individuals would need to decide this for themselves each year for the duration of their residence eligibility.

7.31 The exemption would apply only to someone who had actually received a certificate, and people could apply for a certificate before or after taking up residence. This requirement would make it easier to publicise the exemption in the return notes without encouraging mistaken claims. The certification process would also address the other two drawbacks of self-assessment alone:

- It would give the potential recruit comparative certainty about eligibility for the exemption. Final eligibility would still depend on annual income from earnings, but for most tax-sensitive, internationally mobile recruits this test would be easily and obviously passed. The difficult part is the residence qualification, and this would be settled by the certificate.
- Inland Revenue would be able to judge how many people are taking up the exemption.

7.32 The exemption could apply only to people arriving in New Zealand after it was introduced. Alternatively, it could apply to people already in New Zealand who would have met the residence criterion on arrival if the exemption had been in force at that time. In that case, the exemption would cover future foreign-sourced income arising in the remainder of the exemption period (treated as having begun when they arrived).

7.33 Backdating the residence criterion in this way so as to give some relief to people already in New Zealand would be justified if it relieved New Zealand business of cost. For that to happen, employers would have to renegotiate remuneration agreements, to remove those elements relating to tax. It seems rather unlikely that employers of highly skilled, mobile workers would seek to claw back a tax windfall from the employee in this way.

7.34 Nonetheless, denying the exemption to someone because they came here too soon might seem rather mean, and perhaps would harm perceptions of New Zealand's fairness. It would be a once only cost, and might encourage some people to stay for longer than they would otherwise.