New Zealand's International Tax Review

Developing an active income exemption for controlled foreign companies

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An officials' issues paper

October 2007

Prepared by the Policy Advice Division of Inland Revenue and by the New Zealand Treasury

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Chapter 1

INTRODUCTION

1.1 In December 2006, the government released the discussion document *New Zealand's International Tax Review: a direction for change,* for public comment. It sought feedback on proposals for a major revamp of our international tax rules, to improve the competitiveness of New Zealand companies operating overseas. The main proposal was to relax the controlled foreign company tax rules by introducing a tax exemption for active income from the offshore operations of New Zealand businesses. Rather than make concrete proposals for the implementation of the exemption, it canvassed the various approaches taken in other countries and indicated the broad direction and approach of the proposed reform.

1.2 Officials then engaged in an extensive consultation process with businesses. Forty-eight written submissions on the ideas set out in the discussion document were received. This consultation and feedback has been invaluable in enabling the government to assemble a balanced package of reforms that is appropriate for New Zealand.

1.3 In May 2007, *New Zealand's International Tax Review: An Update,* was released to inform businesses about the government's in-principle policy decisions to date, setting out how the various components fit together.

1.4 This issues paper builds on the government's earlier discussion document and update to provide more detailed suggestions for the design of the new international tax rules for controlled foreign companies (CFCs). We are seeking the views of companies that have offshore operations or are contemplating offshore expansion on how these proposals may affect their business.

1.5 The next step will be to analyse submissions on the suggestions presented here and make formal recommendations to the government on how the proposed reform should be developed. The aim is to introduce next year a bill that gives effect to the reform.

1.6 This issues paper does not cover transitional and consequential matters associated with the planned reforms. Those matters, including issues related to the repeal of the conduit rules, the treatment of existing attributed CFC net losses and carried-forward foreign tax credits, and changes to the treatment of foreign dividends, will be covered in a separate issues paper due for release later this year. The treatment of non-portfolio foreign investment funds (FIFs) and branches will be the subject of further discussion and consultation next year.

SUMMARY OF SUGGESTED TAX TREATMENT

Active business test (chapter 3)

- No income will be attributable from controlled foreign companies (CFCs) that have passive income (including base company services income) of less than 5% of their total gross income. This is the active business test.
- Taxpayers may elect to calculate the percentage of passive income based on data from any one of the following three alternatives:
  - information from audited accounts that comply with NZ IFRS;
  - information from the CFC's audited accounts that comply with IFRS; or
  - New Zealand tax concepts of passive and total income.
- Taxpayers will be given the choice to apply the active business test to either the sub-consolidated income of wholly owned CFC interests within a particular jurisdiction, or to the income of individual CFC within the jurisdiction. They may choose to sub-consolidate only some of their wholly-owned CFCs in a jurisdiction.

Income from shares (chapter 4)

- Ordinary dividends[1] from shares held by CFCs in other CFCs or FIFs will be disregarded under the new CFC rules if they are tax-exempt under current law.
- Gains on disposals of shares by CFCs will be passive income if they are held on revenue account.
- Dividends from shares held by CFCs in New Zealand-resident companies are subject to attribution under current rules. These dividends will be disregarded under the new CFC rules to the extent they are imputed.

Interest (chapter 5)

- Interest and interest substitutes will be treated as passive income, subject to the rules about related-party payments discussed in chapter 7.
- Income brought to tax under the current financial arrangement rules provides a starting point for defining passive interest income. Exceptions will be provided for:
  - derivative instruments that qualify as hedges under NZ IFRS and are not hedging passive income/transactions;
  - foreign exchange gains or losses that arise from transactions carried out as part of an active business; and
  - interest from trade credits, deferred payment sales and hire purchases if the sales are carried out in the ordinary course of the business or the property is produced or used in the business.

[1] Ordinary dividends are all those that qualify for an underlying foreign tax credit. Dividends that do **not** qualify for an underlying tax credit are those whose recipient does not have a sufficient interest in the CFC; or when the share is a fixed rate share; or when the CFC is allowed a deduction for the dividend in calculating its liability for tax.

Royalties and rents (chapter 6)

- Related-party royalty payments will be passive income, subject to the rules about related-party payments discussed in chapter 7.
- Third-party royalty payments may be treated as active income if the CFC created, developed or added substantial value to the intellectual property and is regularly engaged in such activity, provided the intellectual property did not originate in New Zealand.
- Rental income earned by the CFC will be treated as active if it relates to property in the same jurisdiction as the CFC. Other rental income will be passive, subject to the rules about related-party payments discussed in chapter 7.

Related-party payments (chapter 7)

Interest, royalties or rents received by a CFC (CFC A) from a related CFC (CFC B) will be disregarded under the new CFC rules if:

- CFC B passes the active business test; and
- both CFC A and CFC B are resident in the same jurisdiction.

Other passive income (chapter 8)

- Insurance premium income of a CFC will be passive income. Investment income derived by a CFC that is carrying on an offshore insurance business will be subject to the rules applying to other CFCs set out in previous chapters.
- Income from life insurance policies and net gains from the disposal of life insurance policies that are on revenue account will be passive income.
- Personal services income earned by a CFC will be attributed to the controlling New Zealand-shareholder if:
  - 80% of the CFC's income from services relates to services personally performed by the New Zealand shareholder; and
  - substantial business assets are not part of the business structure used to derive the income from services.
- Gains from the disposal of revenue account property used in an offshore active business will be treated as active income. Gains from the disposal of other revenue account property will be treated as passive income.

Base company rules (chapter 9)

- Base company rules will be introduced but they will not apply to income derived from the sale of goods and from the supply of services related to the sale of goods.
- They will also not apply to income earned by a CFC from services if the services are performed in the jurisdiction of the CFC.

- They will apply only to income from services that are performed outside the jurisdiction in which the CFC is resident and if the employees performing the services are not resident in the CFC's local jurisdiction. In that case the nominally active income will be treated as passive income.

Calculating and attributing CFC income or loss (chapter 10)

- As a general rule, non-interest expenditure will be deductible in calculating the branch equivalent profits of a CFC to the extent they are incurred in deriving passive income, or in the course of a business carried on for the purpose of deriving such income, and not incurred in deriving active/disregarded income. Similar rules are suggested for non-interest expenditure incurred by shareholders in deriving an attributed CFC income or loss.
- Interest deductions in the calculation of branch equivalent profits will be restricted. The preferred approach is to pro-rate apportionment on the basis of the ratio of passive assets to active/disregarded assets. Interest deductions by shareholders will be subject to the interest allocation rules described in chapter 11.
- Special rules may be needed to deal with expenditure that relates to passive income that is not attributable because a CFC satisfies the active business test. The preferred approach is to allow such expenditure only if it is incurred in a year when the CFC is subject to attribution on its passive income.
- Technical amendments will be required to ensure that foreign tax credits are available only for tax paid or payable by a CFC in respect of its passive income.

Interest allocation rules (chapter 11)

- Interest allocation rules will apply to a New Zealand company with controlled foreign companies unless it has:
  - 90% or more of its assets in New Zealand; or
  - less than $250,000 of interest deductions.
- Companies required to comply with interest allocation rules will apportion their interest deductions if their New Zealand group debt percentage ratio is greater than 75%. The apportionment is based on the 75% safe harbour, or 110% of the worldwide group debt percentage, whichever is higher.
- Existing rules will be used to measure debt and assets for the purpose of the interest allocation rules, except that:
  - fixed rate shares issued to New Zealand taxpayers will be treated as debt for the purpose of the interest allocation rules;
  - equity investment in CFCs will not be counted as assets; and
  - the definition of "worldwide debt" will exclude liabilities that do not provide funds and liabilities that do not give rise to deductions (except fixed rate shares, which will be treated as debt for this purpose).

1.7 Submissions should be made by 30 November 2007 and be addressed to:

International Tax Review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Or e-mail: policy.webmaster@ird.govt.nz with "International Tax Review" in the subject line.

1.8 Submissions should include a brief summary of their major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

1.9 Submissions may be the source of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who feel there is any part of it that should properly be withheld under the Act should indicate this clearly.

Chapter 2

CONTEXT AND OVERVIEW

2.1 The government's review of New Zealand's international tax rules has resulted in proposed reforms that will bring New Zealand into line with international norms and remove tax disincentives for businesses to locate in New Zealand and expand into other countries from a New Zealand base. This issues paper builds on earlier analysis and consultation based around the government's December 2006 discussion document and the May 2007 update.

2.2 Where possible, the paper draws on the examples provided by rules in comparable jurisdictions. We have looked, in particular, to Australia and the United States, which have both adopted a transactional approach in the design of their active income exemption. Australia also exempts dividends paid by CFCs.

Background and context

2.3 It is important that New Zealand's tax system is not out of line with the systems of comparable jurisdictions, particularly that of Australia. Within an increasingly borderless global economy, New Zealand must be able to attract and retain capital, and our businesses must be able to compete effectively in foreign markets. The changes introduced by the review of our international tax rules will align them with the rules of comparable jurisdictions and reduce the barriers faced by New Zealand firms that are contemplating expanding offshore.

2.4 The December discussion document proposed the introduction of an exemption for offshore active income. Under New Zealand's current system of comprehensive controlled foreign company (CFC) taxation, it can be attractive for innovative, dynamic firms to migrate or establish offshore, or simply stay small and local. Other OECD countries either defer taxing offshore active income or exempt it altogether. Providing an exemption for offshore active income will put New Zealand-based businesses on an equal footing internationally by removing an additional tax cost not faced by firms based in other countries.

2.5 The May update set out three guiding principles informing the proposed reforms:

- The new rules should, as much as possible, allow firms to get on with their legitimate business activity. This means the rules should not discourage firms from undertaking expansion of business operations offshore to take advantage of market opportunities or gain production efficiencies. The new rules should also take into account the legitimate business arrangements and methods of operation that New Zealand businesses use in their offshore operations.

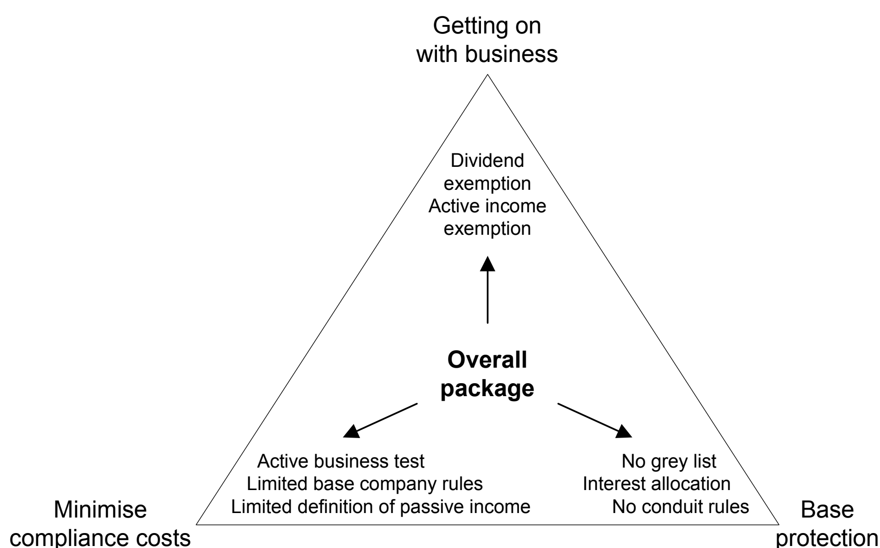
- The rules should, as much as possible, minimise compliance costs.
- The rules should maintain a level of protection for the domestic tax base.

2.6 Bearing those principles in mind, the government has made a series of in-principle policy decisions constituting a balanced package of reforms. Those decisions, also set out in the May update, were as follows:

- A tax exemption for the active income of CFCs will be introduced.
- Ordinary dividends from CFCs to the New Zealand parent will be exempt from domestic tax.
- A simple active business test will be developed to exempt all CFCs with less than 5% passive income, no matter where they do business. The test will replace the current eight-country grey list exemption.
- Even if a CFC does not meet the active business test, only its passive income will be taxed in New Zealand.
- A relatively limited definition of "passive income" that will include dividends, interest and certain rents and royalties will be developed.
- A limited set of base company rules for services will be developed.
- Once the exemption is in place, interest allocation rules will limit the extent to which New Zealand businesses can deduct interest costs relating to offshore investments.
- The conduit rules will be repealed.

2.7 The changes are represented in figure 1.

FIGURE 1: SUMMARY OF THE PACKAGE



Overall policy objectives

2.8 The government's commitment to economic transformation is at the heart of this package. In order to drive economic transformation, New Zealand must clearly distinguish itself in the global economy as a dynamic and competitive place in which to do business, improving incentives for businesses to invest and grow. The new tax exemption for offshore business activity will play an important role in delivering these policy objectives, helping to foster a competitive business environment.

2.9 Balancing this is the objective that New Zealand-sourced income should continue to be taxed here. To ensure that happens in the context of a reformed system, foreign income that is easily substitutable with domestic income must also remain subject to domestic taxation. It is mainly for this reason that offshore passive income will continue to be taxed in New Zealand, as it is under the rules of comparable jurisdictions. Passive assets tend to be highly mobile, having little or no connection with any particular location. Domestic income is therefore easily re-characterised as foreign income. Unless such income continues to be taxed as it is earned offshore, New Zealand's domestic tax base would be undermined.

2.10 Offshore portfolio investments are likewise readily substitutable for equivalent investments in New Zealand. Exempting offshore portfolio investments would create a tax bias favouring investment abroad over investment in New Zealand. It is therefore appropriate that portfolio interests in foreign investment funds (FIFs) should continue to be taxed in New Zealand. The applicable tax rules have recently been modified and updated with the introduction of the fair dividend rate method.

2.11 Non-portfolio FIF interests may be analogous with an interest in a CFC, particularly if the investor has sufficient information to apply the branch equivalent method for calculating income. The government has already acknowledged that, in principle, non-portfolio FIF interests should be eligible for the active income exemption. Similarly, it would be consistent with the overall policy direction to exempt income earned from offshore business activity conducted through a branch rather than a subsidiary. A number of practical considerations need to be resolved in relation to both non-portfolio FIFs and branches. This will be the subject of further discussion and consultation next year.

Policy design and implementation

2.12 This issues paper is concerned with the implementation of the active income exemption in relation to CFCs, and associated base maintenance reforms.

Getting on with business and protecting the base: nexus between location and source

2.13 A key aspect of the design of the new system is that the exemption should be available when there is a connection between the jurisdiction in which the CFC is located and the economic source of the income. This represents a practical outcome of allowing firms to get on with legitimate business activity while also providing a level of protection for the domestic tax base.

2.14 The concept of a nexus between location and source is reflected in the shape of the overall policy: as noted, passive assets generally lack any natural connection with a particular location. It also forms a consistent theme running through the detailed rules discussed in this paper, being central to the proposed treatment of different instruments and situations. For example, rents are normally passive, but will be treated as active when the leased property is situated in the same jurisdiction as the CFC. Likewise, royalties may be treated as active if there is a commercial reason for the intellectual property to be held offshore by a CFC. As the corollary to that, income from services not associated with goods will sometimes be treated as passive income under base company rules if the service is performed outside the jurisdiction of the CFC that provides it.

2.15 This approach is intended to ensure that New Zealand's active businesses are able to benefit from the exemption, while preventing domestic income from being artificially shifted to CFCs. It is also intended to inhibit the use of offshore profit traps. A profit trap can occur when a CFC in a low-tax jurisdiction is used to retain profits arising from a business in a third country – through the use of payments that can be deducted against that country's tax base, for example. It is sometimes argued that this practice occurs at the expense of the third country and should not, therefore, be of concern to New Zealand. In practice, however, it is often unclear whether all of the profits sheltered from tax represent foreign income rather than New Zealand income. Moreover, the existence of such traps creates opportunities for sheltering domestic income and creates incentives to over-allocate expenses against the domestic base. Finally, the effective double non-taxation of such income provides an unintended incentive to shift operations offshore.

Minimising compliance costs: the active business test

2.16 Another key design feature is the introduction of an active business test. A CFC that satisfies the active business test will be exempt from any requirement to attribute its income. The test has been designed to be as straightforward as possible.

2.17 International tax rules tend, by their nature, to be comprehensive and sometimes complex, and this issues paper is necessarily technical as a result. It sets out a series of detailed rules, in particular to ensure that passive income continues to be taxed in New Zealand as it is earned. However, the application of those detailed rules will be the exception. Most New Zealand firms with offshore operations are expected to satisfy the active business test and thereby benefit from a full exemption under the new rules.

2.18 Figures 2 and 3 show how the active income exemption and interest allocation rules would apply in practice.

FIGURE 2: ACTIVE INCOME EXEMPTION IN PRACTICE

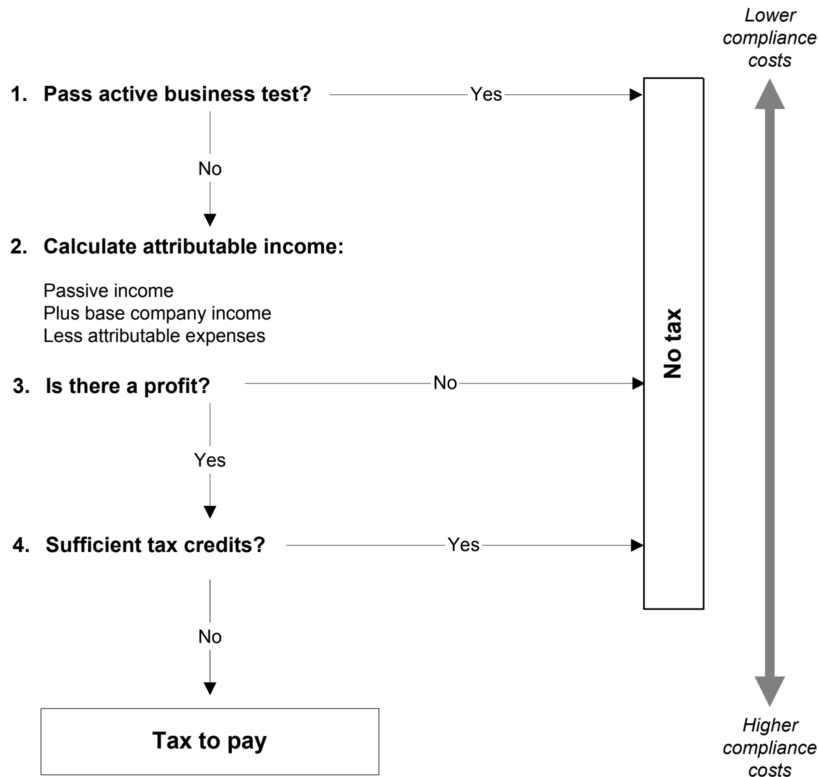
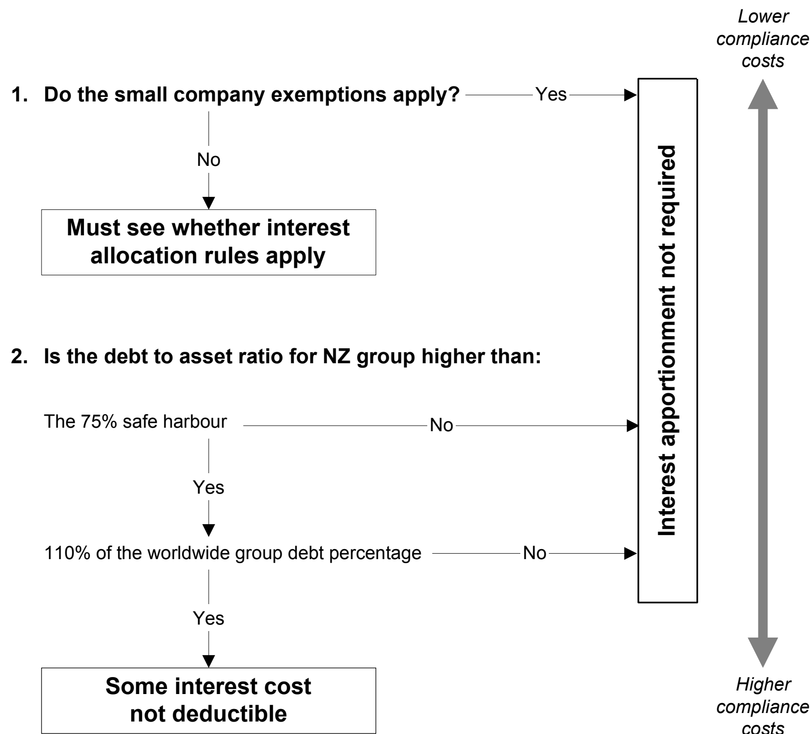


FIGURE 3: INTEREST ALLOCATION RULES



Chapter 3

ACTIVE BUSINESS TEST

Summary of suggested treatment

- No income will be attributable from controlled foreign companies (CFCs) that have passive income (including base company services income) of less than 5% of their total gross income. This is the active business test.
- Taxpayers may elect to calculate the percentage of passive income based on data from any one of the following three alternatives:
  - information from audited accounts that comply with NZ IFRS;
  - information from the CFC's audited accounts that comply with IFRS; or
  - New Zealand tax concepts of passive and total income.
- Taxpayers will be given the choice to apply the active business test to either the sub-consolidated income of wholly owned CFC interests within a particular jurisdiction, or to the income of individual CFC within the jurisdiction. They may choose to sub-consolidate only some of their wholly-owned CFCs in a jurisdiction.

3.1 A taxpayer with an interest in a CFC that passes the active business test will not have any income to attribute under the proposed CFC rules. A taxpayer with an interest in a CFC that fails the active business test will have to attribute only its passive income.

3.2 In the May update the government announced its intention to develop an exemption for active businesses, to replace the existing exemption for CFCs in eight grey list jurisdictions. This exemption will be available to CFCs in all jurisdictions, not just the grey list.

3.3 The active business test is intended to ensure that taxpayers are not required to attribute income from CFCs that are "primarily active". A CFC will be treated as primarily active if, in simple terms, its passive income (including base company services income) is less than 5% of its total gross income. This 5% threshold is consistent with that used in the United States and with the existing active income test in Australia.

3.4 The aim is for the active business test to be simple to apply. To this end, taxpayers will be able to elect to calculate the percentage of passive income based on data from any one of the following three alternatives (whichever is the easiest for them):

- information from audited accounts that comply with NZ IFRS;

- information from the CFC's audited accounts that comply with IFRS; or
- New Zealand tax concepts of passive and total income.

3.5 Compliance costs will be reduced by allowing companies to use their consolidated accounts for CFCs in a jurisdiction, thus reducing the number of tests to be performed, and through the use of data for the test that is readily available from the accounts. In some cases, a CFC may be required, or elect, to make certain adjustments to the data as outlined below. In general, elective adjustments will be necessary only when an active CFC is at the margin of the 5% threshold.

The 5% threshold

3.6 As the test is applied on a gross rather than a net basis, primarily active businesses should pass the test. This is because gross returns on active assets (such as manufacturing plants or distribution/sales facilities) are typically higher than those on passive assets (such as investments in securities). Active businesses that have a mixture of active and passive income will have to hold a significant proportion of passive assets to breach the 5% threshold.

3.7 Furthermore, the scope of what is included as passive income will be limited under the new rules. The relatively narrow definition of "passive income", particularly the absence of base company rules on goods, will simplify the test for most companies.

General approaches under the active business test

3.8 The active business test is intended as a gateway test to filter out primarily active businesses from the attribution rules. This is desirable because in most cases the compliance costs of attributing passive income outweigh the risks to the New Zealand tax base of incidental amounts of passive income accumulating in otherwise active offshore operations.

3.9 In designing this test several objectives are important:

- Application of the test should have low compliance costs.
- There should be a reasonable match between the concept of passive income used in the test and the concept of passive income for tax purposes.
- The information to which the test is applied should have a level of consistency across different entities to ensure the overall integrity and fairness of the new rules.

3.10 Taxpayers should therefore have an option to perform the test on the basis of:

- financial information from audited financial accounts prepared in compliance with New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS);[2] or
- audited financial accounts of the CFC if the accounts are in compliance with International Financial Reporting Standards (IFRS); or
- New Zealand tax rules for calculating total income and passive income (including base company services income) as described in the subsequent chapters.

3.11 Taxpayers should be required to use information from audited financial accounts under the first two options. The audit requirement enhances the integrity of the active business test. It provides a level of assurance that the financial information relied upon to test the percentage of passive income is in compliance with NZ IFRS or IFRS – as the case may be.

3.12 Taxpayers that are not required, at present, to have their accounts audited may incur additional compliance costs if they wish to rely on the active business test based on NZ IFRS or IFRS accounts.[3] We believe these additional costs are justified in terms of meeting the objectives identified in paragraph 3.9.

Active business test based on NZ IFRS

3.13 New Zealand businesses with foreign subsidiaries that are CFCs could apply the active business test using audited financial information that is in compliance with NZ IFRS. This requirement is not expected to impose additional costs on New Zealand businesses because it is consistent with the usual commercial approach to consolidation.

3.14 The Financial Reporting Act 1993 requires parent companies and non-company issuers to prepare consolidated financial statements for the group, and the applicable financial reporting standard is NZ IAS 27 *Consolidated and Separate Financial Statements*. The only exception to the requirement to prepare consolidated financial statements is when the parent is not an issuer and is a wholly owned subsidiary of another ultimate or intermediate parent company or its nominee. This exception should not give rise to any difficulty in terms of the effective operation of the active business test.

[2] "NZ IFRS" refers to the New Zealand adaptation of the complete set of standards and interpretations ("IFRS") issued by the International Accounting Standards Board (IASB). Individual standards are referred to as NZ IFRS XX or as NZ IAS XX if originally issued by the IASB's predecessor body. Any profit-oriented entity that complies with NZ IFRS will simultaneously comply with IFRS. More than 100 countries now require or permit the use of IFRS in the preparation of financial statements, and that number is steadily growing.

[3] Only companies and non-company issuers are subject to a legal requirement for audit. Companies that are not issuers or "overseas linked" companies (companies subject to section 196(3) of the Companies Act 1993) need not appoint an auditor if the company passes a unanimous resolution that no auditor be appointed.

3.15 Under NZ IAS 27,[4] an entity preparing consolidated financial statements must apply uniform accounting policies. When a member of the group uses a different set of policies – because of differences in accounting treatment in a foreign jurisdiction, for example – appropriate adjustments must be made to its financial statements in preparing the consolidated financial statements. Given this requirement, CFCs will be consolidated on the basis of the same accounting policies as applied by the parent – that is, policies that comply with NZ IFRS. We therefore expect that the requirement to apply the active business test based on NZ IFRS-compliant information will produce consistent results and yet have low compliance costs.

3.16 An issue for consideration is whether a parent that avails itself of differential reporting concessions should be able to apply the 5% threshold test on that basis. Our preliminary view is that, in the interests of the integrity of the threshold, the parent should apply the test using full NZ IFRS-based information.

3.17 For some CFCs, financial information that complies with NZ IFRS may not be available. This could happen when the taxpayer is not required to include the CFC in its group accounts because it does not control the CFC for accounting purposes. Also, a lower-tier CFC may be consolidated into another CFC before NZ IFRS adjustments are made. In this case, financial information that complies with NZ IFRS may not be readily available for the lower-tier CFC. In addition, the mandatory application of NZ IFRS has been postponed for some small businesses.[5]

3.18 Because reliance on NZ IFRS information will not always be possible, taxpayers will also be given the option to apply the active business test on the basis of a CFC's audited IFRS-compliant accounts or New Zealand's tax rules.

Active business test based on IFRS

3.19 As an alternative, the active business test could be performed using a CFC's financial accounts if the accounts have been audited and are in compliance with IFRS. Typically, such accounts would be stated as conforming to both the local accounting standards and IFRS, but it is conformity with IFRS that will be required for information to be used for the active business test.

3.20 We have considered whether it would be appropriate to allow the active business test to be based on the financial statements prepared for the CFC in its foreign jurisdiction that do not comply with IFRS but instead comply with a local adaptation of IFRS or, in the absence of a local IFRS equivalent, other local accounting standards. The difficulty is that the potential for variation in the financial information means this approach falls short of meeting the policy objectives referred to in paragraph 3.9.

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[4] NZ IAS 27, paragraphs 28 and 29.

[5] The option to delay the adoption of NZ IFRS is open to companies that are not issuers, not required to file financial statements with the Registrar of Companies, and not large. A company is large if it meets two of the three criteria: assets exceeding $10 million, turnover exceeding $20 million or 50 or more full-time equivalent employees.

Active business test based on tax rules

3.21 Taxpayers can also perform the active business test on the basis of New Zealand tax rules. If the passive income calculated under tax rules is less than 5% of total income (calculated for tax purposes) then the CFC will be exempt from attribution.

3.22 As noted, in some circumstances a New Zealand resident may hold an interest in a CFC yet not have NZ IFRS or IFRS-compliant information. In situations such as these, or when the financial accounts are not audited, taxpayers can use this option to perform the active business test.

3.23 The compliance costs will still be less than full attribution, as under the current rules, because taxpayers will be required only to calculate gross items of income – thus avoiding other steps in a full tax calculation, including the determination of deductible items of expenditure.

Foreign exchange gains and losses arising on translation of accounts into New Zealand dollars

3.24 In principle, the policy objective is to prevent the active business test being affected by foreign exchange gains and losses that arise from translating income amounts from the functional currency of the CFC into New Zealand dollars.

3.25 This issue does not arise if the active business test is performed using NZ IFRS or IFRS-compliant financial information. Under NZ IFRS, such gains and losses would be recorded in the foreign currency translation account and would not materially affect the ratio of amounts on the income statement, which is the focus of the business active test. If the IFRS-compliant accounts of the CFC are used, then the test can be done on the basis of the amounts reported in these accounts. There is no translation into New Zealand dollars.

3.26 When income is calculated under New Zealand tax rules, however, it could include amounts arising from currency fluctuations between the functional currency of the CFC and the New Zealand dollar. To achieve consistency among the tests, appropriate adjustments should be made to the amounts calculated under the tax rules. For example, in Australia, the test can be calculated using functional currency of the CFC.

Use of sub-consolidated financial statements

3.27 We have considered whether the test could be applied on a country-by-country basis, to permit sub-consolidations of the CFCs located in the same jurisdiction. This would go further than the CFC rules in other countries, where comparable tests are applied to each CFC, rather than a group of CFCs on a country-consolidated basis.

3.28 Taxpayers should be given the choice to apply the active business test to either the sub-consolidated income of their wholly owned CFC interests within a particular jurisdiction or to the income of each individual CFC within the country. Taxpayers could choose to sub-consolidate only some of their wholly owned CFCs in a jurisdiction.

3.29 The effect of the sub-consolidated approach will be to eliminate intra-group transactions among the CFCs in the same jurisdiction and to aggregate the 5% threshold test across those CFCs.

3.30 For instance, the sub-consolidated approach will benefit taxpayers who have multiple CFCs within a jurisdiction, some of which are slightly above the 5% threshold, but together are below the threshold on a sub-consolidated basis because they have other CFCs in the jurisdiction with less than 5% passive income. Retaining an option to allow individual testing of CFCs will benefit taxpayers that exceed the 5% threshold on a sub-consolidated basis because they have one or more highly passive CFCs (for example, 100% passive) in the same jurisdiction as some of their active CFCs.

3.31 We expect that in situations where sub-consolidated information for a country is routinely prepared, the sub-consolidated option could reduce compliance costs by allowing a taxpayer to perform fewer active business tests and by automatically dealing with all intra-group transactions for CFCs within the same country.

Same jurisdiction condition

3.32 The sub-consolidated basis for the active business test would be limited to CFCs in the same jurisdiction. The same-jurisdiction restriction is necessary because it would be undesirable for a passive CFC located in a tax haven to be consolidated with an active CFC in, say, Europe.

Wholly owned group

3.33 Our view is that the sub-consolidated basis for the active business test should be permitted only if the set of CFCs is wholly owned. We recognise that part-ownership presents no barrier to preparation of sub-consolidated financial statements and, from a policy perspective, we have no objection to applying the active business test to partly owned sub-consolidated groups. However, the application of the test to partly owned groups could be permitted only if it was possible to determine the nature of income that should be attributed to minority interests in the partly owned subsidiaries. This seems problematic to us, and we invite submissions on how it could be achieved.

3.34 The active business test can, of course, be applied to an individual partly owned CFC.

Intra-group transactions

3.35 When the active business test is based on financial information of individual CFCs, intra-group transactions have the potential to inflate the amount of total income used in the active business test relative to that which would result if the test were performed on the results of the sub-consolidated group. This could increase the amount of passive income that a group of CFCs could earn while remaining under the 5% threshold.

3.36 Take an example of a group of two CFCs in the same jurisdiction: CFC A sells an intermediate product to CFC B (for $100) and CFC B adds value to the product and sells it to third parties (for $120). The sales revenue for the entire group is $120, and the 5% tolerance for passive income should be $6 for the entire consolidated group. If the active business test was conducted separately for individual CFCs, the sales revenue for CFC A would be $100, and the sales revenue for CFC B would be $120. The total tolerance for passive income of the entire group would be $11.

3.37 Other types of intra-group transactions, such as interest between a holding company and an active operating company, which would not be considered to be passive income, could also inflate the tolerance for passive income. In general, adjustments would need to be made to the amounts of total income to make it consistent with the amount that would be reported in sub-consolidated accounts.

3.38 In theory, similar problems could arise for transactions between related CFCs in different jurisdictions. A number of CFCs could be involved in a value-added chain before the final products are sold or the services are provided to third parties. Rather than proposing a mechanical rule for such transactions, we are examining a targeted anti-avoidance rule for dealing with transactions between related parties in different jurisdictions that are designed to increase the amount of passive income that could be earned without attribution.

Measurement issues in the active business test

3.39 In simple terms, a CFC will pass the active business test if its passive income is less than 5% of its total gross income. The passive income and total gross income of a CFC can be measured using NZ IFRS or IFRS-compliant financial information or New Zealand tax rules.

3.40 Example 1 shows how the active business test will be applied. The concepts used in the example are explained in the remainder of this section. The section describes the relevant standards that should be relied upon if the active business test is performed on the basis of NZ IFRS. We expect equivalent IFRS standards would be used if the test uses IFRS-compliant information. If the active business test relies on New Zealand tax rules, the rules described in the other chapters in this issues paper would be relevant.

Example 1: Active business test for CFC A

Gross income:

Gross revenue reported under NZ IAS 18	200
Plus other NZ IFRS items of passive income (if not already included above)	12
Total gross income for active business test	212

Passive income:

NZ IFRS items of passive income	12
Less permitted adjustments for income that is treated as active	(5)
Plus base company and other passive income	2
Total passive income for active business test	9
Passive income under active business test	**4.2%**

CFC A would pass the active business test and would be completely exempt from the CFC rules.

Total gross income of a CFC

3.41 The starting point for measuring a CFC's total gross income is to use NZ IFRS-based gross revenue reported under NZ IAS 18. This NZ IFRS notion of total revenue includes revenue from the sale of goods and rendering of services, as well as interest, royalties, dividends and rents arising in the course of the ordinary activities of an entity.

Adjustments to NZ IFRS "total revenue" quantification

3.42 Those categories of passive income that are not already included under NZ IAS 18 will need to be added to total income. In addition, active income that is not included under NZ IAS 18, such as active hedges, would need to be added to total income.

3.43 If the test is performed on a CFC-by-CFC basis, a number of adjustments would be needed to ensure that there was no effective double counting of revenues within a group of CFCs in the same jurisdiction. These adjustments would generally be to remove intra-group transactions that would be disregarded in the preparation of the sub-consolidated accounts of a group of CFCs in a jurisdiction. They would include:

- interest, rent and royalty payments from related active CFCs in the same jurisdiction; and
- an adjustment for intra-group sales and services income.

3.44 Adjustments would also be made to exclude from total income other types of income that are also excluded from passive income and that would not be taxable if earned in New Zealand. These include:

- ordinary dividends received from another CFC/FIF, which would be exempt if received by a New Zealand-resident company;
- dividends received from a New Zealand-resident company to the extent that they are imputed; and
- capital/unrealised gains and losses on equity investments that would be exempt for New Zealand tax purposes, as discussed below.

Passive income of a CFC

3.45 If the active business test is performed on the basis of NZ IFRS, the passive income of a CFC is measured, in the first instance, using NZ IFRS accounting standards. In some cases adjustments to this information may be needed, and these are discussed below.

NZ IFRS items of passive income

3.46 The following items will generally be included in passive income under the active business test:

- interest, dividend and royalties income and rental income, if any, under NZ IAS 18;
- foreign exchange gains and losses on non-derivative financial assets under NZ IAS 21;[6]
- gains and losses from fair value movements of non-derivative financial assets and derivatives (including derivatives held for trading purposes, but not including fair value movements on derivatives to the extent that the derivatives qualify for, and the entity has used, hedge accounting) under NZ IAS 39;
- gains and losses from derecognition of non-derivative financial assets under NZ IAS 39;
- finance lease income and operating lease income under NZ IAS 17; and
- premium revenue under NZ IFRS 4.

3.47 We believe these categories of NZ IFRS income broadly match tax concepts of income from financial arrangements, dividends, royalties, insurance and rents. It is not expected that the NZ IFRS amounts for these categories of income would correspond exactly to what would be brought to tax under the attribution rules. For example, the derecognition rules under NZ IAS 39 are based on a substance-over-form approach that is different from the base price adjustments required under the tax rules.

[6] Excluding foreign exchange gains and losses discussed earlier in this chapter.

3.48 Certain of these categories may contain nominally passive income that is not subject to attribution. CFCs would be permitted to make adjustments to these amounts for purposes of the test, if necessary.

Adjustments to NZ IFRS "passive income" quantification

3.49 If a CFC is slightly over the 5% boundary, basing the active business test on the NZ IFRS passive income quantification may result in attribution of small amounts of passive income at a significant compliance cost. To prevent this outcome, adjustments will be permitted to exclude any items that are categorised as passive income under NZ IFRS, but considered active income under tax rules. These adjustments will be elective, so they will impose no compliance costs on taxpayers that already satisfied the active business test.

3.50 Two types of adjustments are envisaged here, in accordance with the tax rules discussed in chapters 4 to 9. The first type of adjustment is for categories of income that are active in substance, although they may be passive in form. These categories of income will be excluded from passive income, but will be included in total income for purposes of the test. They include:

- interest (including any foreign exchange gains and losses) that results from trade credits, deferred payment sales and hire purchase, if the sales are part of an active business;
- active rents; and
- active royalties.

3.51 The second type of adjustment is for certain passive income that will not be attributed and should be disregarded for the purpose of the active business test. It will be removed from both passive income and total income, which will include adjustments to exclude:

- ordinary dividends received from another CFC/FIF that would be exempt if received by a New Zealand-resident company;
- dividends received from a New Zealand-resident company to the extent that they are imputed;
- interest, rent and royalty payments from related active CFCs in the same jurisdiction; and
- capital/unrealised gains and losses on equity investments that would be exempt for New Zealand tax purposes, as discussed below.

Tax treatment of equity investments

3.52 An area where tax rules differ significantly from NZ IFRS is with respect to equity investments.

3.53 First, NZ IFRS does not make a distinction between investments that are on capital account and those on revenue account. As such, relying on the NZ IFRS accounts for the purpose of the active business test could include capital gains or losses that would not ordinarily be taxable. This could work to the benefit of taxpayers (if capital losses reduce the passive income) or against taxpayers (if capital gains increase passive income).

3.54 Second, there may be timing differences between when accrued gains and losses on equity investments are recognised in NZ IFRS accounts and when they are recognised for tax purposes. Equity investments are reported in the NZ IFRS financial statements at their fair values, with changes in fair value recognised either in the income statement or directly in equity, depending on the asset's classification in accordance with NZ IAS 39. In these cases, gains and losses will be recognised in NZ IFRS accounts on an accrual basis, rather than on a realisation basis, which is the case under the tax rules.

3.55 Again, this could work to the benefit of taxpayers (if unrealised losses reduce passive income) or against taxpayers (if unrealised gains increase passive income). Further, including unrealised gains and losses for the purposes of the active business test would create volatility in the results. The composition of active and passive income of a CFC would fluctuate from year to year as the share market fluctuated.

3.56 Overall, the mismatches between NZ IFRS and tax treatment of equity investments appear to be quite significant. Submissions are sought on whether it is preferable to follow NZ IFRS for equity investments or require taxpayers to make the relevant adjustments (which could not be optional).

Other passive income and base company services income

3.57 Other passive income and base company services income will need to be included in the amount of passive income for the purposes of applying the active business test. These are tax-specific concepts that have no corresponding rules under NZ IFRS. In addition, the revenue risks would be significant if these income groups are not captured under the active business test.

3.58 The types of income that should be included in the active business test include:

- for the holders of life insurance policies, income from life insurance policies and the disposal of life insurance policies that are on revenue account;
- income from personal services contracts;
- gains and losses from the disposal of passive revenue account property;
- gains and losses from hedges that are hedging transactions/assets that would produce passive income; and
- base company services income.

Chapter 4

INCOME FROM SHARES HELD BY CFCS

Summary of suggested treatment

Ordinary dividends[7] from shares held by CFCs in other CFCs or FIFs will be disregarded under the new CFC rules if they are tax-exempt under current law.

Gains on disposals of shares by CFCs will be passive income if they are held on revenue account.

Dividends from shares held by CFCs in New Zealand-resident companies are subject to attribution under current rules. These dividends will be disregarded under the new CFC rules to the extent they are imputed.

4.1 The current approach of directly attributing income from foreign shares owned by CFCs back to the New Zealand shareholder will continue. Accordingly, ordinary dividends from shares held by CFCs in other CFCs or FIFs will be disregarded under the new CFC rules if they are tax-exempt under current law. They will be excluded from passive income and total income for the purposes of the active business test (see chapter 3) and will not be treated as passive income for the purposes of attribution.

4.2 Dividends from shares held by CFCs in New Zealand-resident companies are subject to attribution under current rules. This treatment is to guard against concerns about untaxed profits being shifted out of New Zealand – subject only to non-resident withholding tax. These dividends will also be disregarded under the new CFC rules to the extent they are imputed. Again, this means they will be excluded from passive income and total income for the purposes of the active business test and will not be treated as passive income for the purposes of attribution.

4.3 The following sections outline how the following forms of income will be treated under the proposed active income exemption.

Income/dividends from shares held by CFCs in other CFCs or FIFs

4.4 Income from foreign shares owned by CFCs is generally attributed directly back to the New Zealand shareholder. In other words, our current practice is to look through CFCs holding CFC and FIF interests and attribute income from these holdings directly to the New Zealand taxpayer. That will not change under the new rules.

[7] Ordinary dividends are all those that qualify for an underlying foreign tax credit. Dividends that do **not** qualify for an underlying tax credit are those whose recipient does not have a sufficient interest in the CFC; or when the share is a fixed rate share; or when the CFC is allowed a deduction for the dividend in calculating its liability for tax.

4.5 Ordinary dividends received by CFCs from other CFCs or FIFs are exempt income under existing tax rules, to prevent double taxation. As noted, these dividends will be disregarded under the new CFC rules.

4.6 If a CFC has an interest of less than 10% in a foreign company[8] (that is, a portfolio FIF) income will be attributed directly to the New Zealand shareholders in the CFC, usually under the fair dividend rate (FDR) method. Any dividends paid by the portfolio FIF to the CFC or the New Zealand resident are exempt under current law and will be disregarded under the new CFC rules.

4.7 When a CFC holds a portfolio interest in a company (such as a listed Australian company) that, for whatever reason, is exempt from the FIF rules, dividends from that company will be treated as passive income.

4.8 If a CFC has an interest of between 10% and 50% in a foreign company[9] (that is, a non-portfolio FIF that is not a grey list company) income will be directly attributed back to the New Zealand shareholders under the FIF rules. Dividends paid by the non-portfolio FIF to the CFC are exempt under current law and will be disregarded under the new CFC rules.

4.9 The non-portfolio FIF rules (including the future application of the grey list to non-portfolio FIFs) are to be reviewed following the reform of the core aspects of the CFC rules. The treatment of dividends received by CFCs from FIFs will be considered as part of that review.

4.10 If a CFC has more than a 50% interest in a foreign company[10] (one that controls a second CFC) this would be equivalent to a situation where the New Zealand-resident shareholder controlled the second CFC directly. Therefore any ordinary dividends paid by the second CFC to the first CFC would be tax-exempt.

Treatment of revenue account gains

4.11 Most capital gains are not taxed in New Zealand, and they will also be disregarded under the new CFC rules. Gains on disposal of shares by CFCs that are revenue account property should be treated as passive income under the new rules. Because realisation of revenue gains from shares is an alternative means of extracting profits from companies, these gains should be taxed under the CFC rules. We recognise, however, that this proposal should be limited to gains that are held on revenue account.

4.12 Gains and losses on disposal of revenue account shares will be treated as passive income only at disposal. CFCs will not be required to accrue any unrealised gains on the shares as this is not required under New Zealand domestic tax rules generally.

[8] Calculated using income interests as defined in sections EX 8 to EX 13.
[9] Calculated using income interests as defined in sections EX 8 to EX 13.
[10] Calculated using control interests as defined in sections EX 2 to EX 7.

Income/dividends from shares held by CFCs in New Zealand-resident companies

4.13 Under existing tax rules, dividends paid by New Zealand-resident companies to CFCs are taxed on attribution, with a credit for New Zealand non-resident withholding tax (NRWT) unless the CFC operates in a grey list country, in which case there is no attribution generally.

4.14 The current rules were designed to guard against concerns about company profits being shifted out of New Zealand at a tax rate lower than the New Zealand corporate tax rate. Specifically, unimputed dividends could be distributed by a New Zealand company to a CFC and be subject to NRWT of a maximum of 15% for a treaty country. Taxing the dividend on attribution to the CFC (with a credit for the NRWT) preserves the New Zealand company tax on what are New Zealand-sourced dividends received by a New Zealand-owned entity. The existing avoidance concerns could be amplified by the proposed CFC changes, which mean that all dividends paid by CFCs to a New Zealand-resident company will become exempt from domestic tax.

4.15 The challenge is to design a rule that discourages artificial income shifting, but does not lead to double taxation. We suggest allowing dividends received by CFCs from New Zealand-resident companies to be disregarded under the new CFC rules to the extent imputation credits have been attached. An un-imputed dividend paid by a New Zealand company would be treated as passive income and taxed on accrual.

Chapter 5

INTEREST

Summary of suggested treatment

Interest and interest substitutes will be treated as passive income, subject to the rules about related-party payments discussed in chapter 7.

Income brought to tax under the current financial arrangement rules provides a starting point for defining passive interest income. Exceptions will be provided for:

- derivative instruments that qualify as hedges under NZ IFRS and are not hedging passive income/transactions;
- foreign exchange gains or losses that arise from transactions carried out as part of an active business; and
- interest from trade credits, deferred payment sales and hire purchases if the sales are carried out in the ordinary course of the business or the property is produced or used in the business.

General approach

5.1 Interest income is considered to be passive under the CFC rules of other countries, which generally distinguish between active and passive income. Further, a wide definition of "interest income" is typically used in these rules. Examples of interest income that is considered passive include interest as well as income from a finance lease or other financial arrangements. The May update listed other examples of passive interest income, such as interest that arises from investments or as part of the business of lending money, financial income such as guarantee fees, interest swap payments and the interest portion of sale and repurchase agreements.

5.2 Consistent with international norms, we suggest adopting a broad definition of "interest income" for the purpose of the new rules. All returns on financial arrangements that could be substitutes for interest will be treated as passive income. Doing otherwise would mean a substantial risk that domestic income could be re-characterised as income from mobile financial assets and escape New Zealand tax.

Income from financial arrangements

5.3 A wide definition of interest income is used in the existing tax rules for financial arrangements. These rules bring to tax all income from financial arrangements earned by New Zealand residents.

5.4 A financial arrangement includes debt and debt substitutes. All derivative contracts such as forward, futures and options are also within the scope of the financial arrangement rules.

5.5 Under the financial arrangement rules, income from a financial arrangement is calculated on an accrual basis and spread over the term of a financial arrangement. At the end of the term, or upon disposal of the financial arrangement, a base price adjustment is performed to "wash up" any untaxed gains (or losses) that should be brought to tax.

5.6 The financial arrangement rules are a good starting point for defining and measuring interest income that should be treated as passive, subject to the rules about related-party payments discussed in chapter 7. This approach is consistent with the definition of passive income under the CFC rules in other countries. Countries such as Australia that do not have comprehensive financial arrangement rules include interest as passive income and list separately the types of assets or income that might be considered passive. This list typically includes income and gains from other financial instruments such as derivative contracts.

Special consideration for active interest income

5.7 It is anticipated that most active offshore businesses will not have many passive assets in practice, and will be relieved from attribution under the active income test outlined in chapter 3. However, there may be cases where companies hold financial arrangements, which will generally be treated as passive, as part of their active businesses. Special rules are suggested to deal with income arising from such arrangements.

Derivative hedge instruments

5.8 Income from financial arrangements includes income from derivative instruments, such as forwards, futures and options, and these amounts will therefore generally be treated as passive income.

5.9 Active businesses do sometimes use derivative instruments to manage risks, however. This is particularly true of businesses that are exposed to foreign exchange risks, interest rate risks and price risks. For example, a CFC could be carrying out sale and distribution functions for the New Zealand parent. The offshore sales transactions might be denominated in a currency other than New Zealand dollars. To protect the New Zealand dollar value of these sales, the CFC could enter into a forward contract to fix the sales revenue in New Zealand dollars.

5.10 In principle, income from these active hedges should be treated as active. CFC rules in other countries often contain an exception along these lines.

5.11 It is not easy to separate derivative instruments that should be treated as active from those that should be treated as passive. However, it may be possible to rely on the special hedge accounting rules under New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), at least as a starting point.

5.12 Derivative instruments qualify for special accounting treatment under NZ IFRS if they are hedges. These derivative hedge instruments are classified into three categories:

- **fair value hedge**: a derivative instrument that hedges a particular risk associated with an existing asset or liability that could affect the value of that asset or liability and result in a profit or loss; or
- **cash flow hedge**: a derivative instrument that hedges the exposure to variability in cash flows that (i) are attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss; or
- **hedge of a net investment** in a foreign operation.

5.13 Relying on NZ IFRS to identify derivative instruments that may be active offers a degree of robustness because taxpayers will have to meet certain conditions to qualify for the NZ IFRS hedge treatment. For example, these derivative instruments have to be designated as hedges and will have to be highly effective.[11]

5.14 Some of these hedges may give rise to income that should be treated as passive. Therefore, rules will be needed to ensure that income from a hedge of an asset or transaction that produces passive income will likewise be treated as passive.

5.15 For example, a CFC may enter into a forward foreign currency contract to hedge the exchange rate risk on a fixed interest foreign currency bond held for investment purposes. The fixed interest foreign currency bond will generate interest income and foreign exchange gains and losses that will be treated as passive income under the new CFC rules. Gains or losses from the forward foreign currency contract should also be treated as passive.

Foreign exchange gains and losses

5.16 Foreign exchange gains and losses associated with a financial arrangement are covered by the financial arrangement rules because they could be seen as substitutes for interest income. For example, foreign exchange gains and losses could arise from financial assets (such as government bonds) denominated in a foreign currency.

[11] NZ IAS 39 contains detailed rules on the types of instruments that can qualify as hedging instrument (such as internal hedges cannot be treated as hedges), the requirements to designate a financial derivative as a hedging instrument, the types of items that can be hedged and the effectiveness of a hedging relationship.

5.17 These foreign exchange gains and losses are included as income or expenditure under the financial arrangement rules and brought to tax on an accrual basis or an expected value basis depending on the calculation methods used. These gains and losses will be treated as passive income.

5.18 Foreign exchange gains and losses could arise for a CFC in the conduct of its active business. For example, a sale transaction could be carried out in USD. Foreign exchange gains and losses that arise from this transaction are part of the active business income of the CFC. These gains and losses are not within the scope of the financial arrangements rules and will be treated as active income.

5.19 The financial arrangement rules also cover foreign exchange gains and losses that could arise from transactions that are carried out as part of the active business. For example, long-term trade credits and deferred property settlements when the property is used in the active business, can be denominated in a foreign currency. As noted directly below, interest on these transactions should not be passive income. Accordingly, any foreign exchange gains and losses on these same transactions should also be excluded from passive income.

Interest income from trade credits, deferred payment sales and hire purchase

5.20 Active businesses often generate interest income as part of their operations. For example, sales can be made on credit and interest charged on any overdue accounts. Trade credits, deferred payment sales and hire purchase arrangements that are integral to some businesses can also contain an interest element.

5.21 The interest components arising from some of these active transactions are excluded from the financial arrangement rules and will be treated as active income. For example, any interest related to short-term trade credits or deferred payment sales (that is, for a period less than 93 days) will not give rise to income under the financial arrangement rules.

5.22 The financial arrangement rules do cover trade credits or deferred payment sales that are longer than 93 days. Nevertheless, it would be consistent with the active income exemption to exempt these transactions because they are closely connected with the active business. Accordingly, interest income from trade credits, deferred property settlements and hire purchase agreements will be treated as active if the sales are carried out in the ordinary course of the business or the property is produced or used in the business.

Firms in the business of actively deriving interest income

5.23 Income arising from financial assets such as loans and receivables, securities and derivatives are generally treated as passive income. One of the consequences of this approach is that financial institutions that are in the business of generating these types of income are unlikely to qualify for the proposed active income exemption.

5.24 Some countries provide specific rules for financial institutions under their CFC rules. However, these rules tend to be complex as they are typically accompanied by a series of anti-avoidance rules to prevent domestic income from being shifted offshore.

5.25 Whether specific rules could be provided to extend the active income exemption to such companies would depend upon the resolution of a number of difficult problems:

- **Defining the borderline between active and passive.** Investments within a CFC could be passive in nature even if the business of the New Zealand parent company were active.
- **Allocating expenses and income between New Zealand and the CFC.** This is particularly difficult for any financial institution owing to the fungibility of money and its simple relocation.
- **Interest allocation rules.** These would need to be developed and extended (for example, to deal with the role of reserves of insurance companies).
- **Managing the risk to the New Zealand tax base.** For example, rules will be required to deal with vehicles such as captive insurance companies.

Chapter 6

ROYALTIES AND RENTS

Summary of suggested treatment

Related-party royalty payments will be passive income, subject to the rules about related-party payments discussed in chapter 7.

Third-party royalty payments may be treated as active income if the CFC created, developed or added substantial value to the intellectual property and is regularly engaged in such activity, provided the intellectual property did not originate in New Zealand.

Rental income earned by the CFC will be treated as active if it relates to property in the same jurisdiction as the CFC. Other rental income will be passive, subject to the rules about related-party payments discussed in chapter 7.

Royalties

Background

6.1 The December discussion document outlined the general approach of treating royalty income as passive because intellectual property is geographically mobile and there is a need to protect the domestic tax base.

6.2 The May update confirmed this general approach but raised the possibility of an exception for royalties derived in the active conduct of a business. Other countries make a distinction along these lines.

6.3 The update outlined a number of factors to consider in relation to the development of such an exception:

- the ability to transfer intellectual property out of New Zealand without incurring a New Zealand tax liability;
- the difficulty of separating royalty income from the value of related goods and services; and
- the difficulty of assigning royalty income to a jurisdiction with certainty.

6.4 The rules for the treatment of royalty income in New Zealand will need to balance a number of competing considerations. On the one hand, it is desirable to minimise the impact such rules will have on legitimate commercial activity, to foster the development of intellectual property in New Zealand and to maintain the competitiveness of New Zealand's tax system with those of comparable jurisdictions. On the other hand, there is a need to protect the domestic tax base and to design rules that take account of

the absence of a capital gains tax, a distinctive feature of New Zealand's tax system.

Royalties from a related CFC

6.5 Internationally, royalties received from related CFCs are generally treated as passive income. This is the position in Australia and the United States.

6.6 The concern is that the tax base may be eroded by shifting profits through the payment of deductible royalties. Given the scope for planning associated with related-party transactions and the inherent mobility of intangible property, there is also a material risk of CFCs being interposed to collect royalty income in a low-tax jurisdiction.

6.7 It is recognised that multinationals may concentrate their intellectual property in one CFC for legitimate commercial reasons. Accordingly, related-party royalties will be disregarded under the new CFC rules if paid by a CFC that has passed the active business test and is resident in the same jurisdiction as the recipient CFC. (See chapter 7 for details of the treatment of related-party payments.)

Royalties from unrelated parties

6.8 Internationally, royalties may be treated as active income if there are genuine commercial reasons for the intellectual property to be owned by a CFC, such as when the CFC has created, developed, substantially enhanced, or marketed the property.

CFC receiving the royalty has created the intellectual property

6.9 The United States treats royalties as active income if the CFC has created the property, is regularly engaged in such creation, and the royalties are received from a non-related party. The following examples from the United States Internal Revenue Service Final and Temporary Regulations (Sec. 1.954-2(d)) illustrate how the rule applies:

CFC creates the intellectual property[12]

Controlled foreign corporation A, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility, employees of Corporation A, who are scientists, engineers, and technicians, regularly perform experiments, tests, and other technical activities that ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation A for the privilege of using patented rights that it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A), but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind.

[12] The examples cited are numbered respectively 1, 4 and 3 in the United States' regulations.

CFC is not regularly engaged in the activity

Controlled foreign corporation C receives royalties for the use of a patent that it developed through its own staff of employees at its facility in country X. Corporation C has developed no other patents. It does not regularly employ a staff of scientists, engineers or technicians to create new products to be patented. Further, it does not purchase and license patents developed by others to which it has added substantial value. The royalties received by Corporation C are not derived from the active conduct of a trade or business for purposes of section 954(c)(2)(A).

6.10 Australia has a similar rule whereby royalties are active income when the "matter or thing" in respect of which the royalties are received originates with the CFC. The royalties must also be derived in the course of a business carried on by the CFC and received from an unrelated party.[13]

6.11 A similar rule to those used in the United States and Australia should apply in New Zealand. The United States' rule has some attraction, because the requirement that the CFC be regularly engaged in the activity goes some way towards achieving the underlying policy objective of ensuring the CFC is located in the jurisdiction for genuine commercial reasons.

CFC has developed or added substantial value to the intellectual property

6.12 Both the United States and Australia treat royalties as active income when the CFC has developed or added substantial value to the intellectual property. For instance, in the United States, royalties are active if the CFC has acquired and added substantial value to the property and the CFC is regularly engaged in such activity.

6.13 This further example from the United States' Regulations demonstrates how this rule works:

CFC acquires intellectual property and adds substantial value

Controlled foreign corporation B receives royalties for the use of patents that it acquires by purchase. The primary business of Corporation B, operated on a regular basis, consists of licensing patents that it has purchased raw from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation B, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation B from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

[13] The Board of Taxation's review of Australia's anti-deferral rules does not discuss the treatment of royalty income.

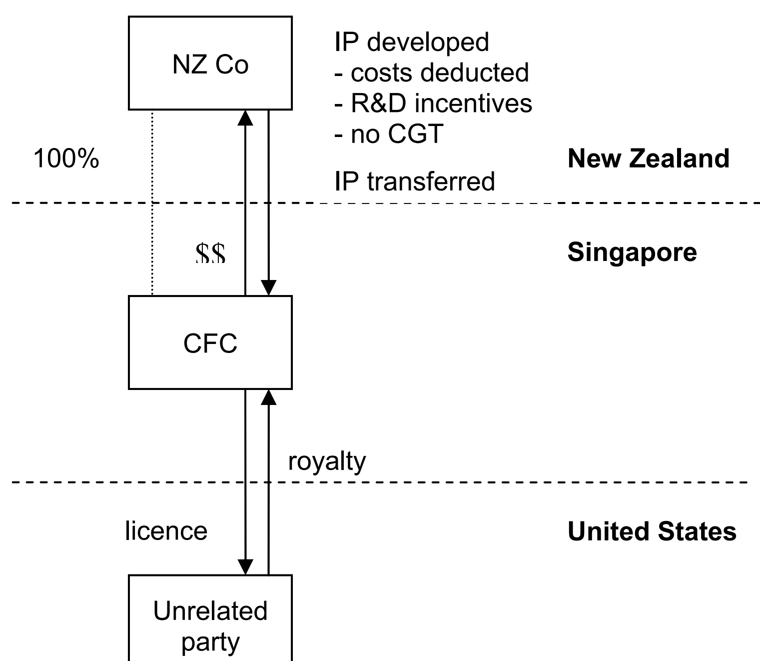
6.14 The Australian rule requires the CFC to have substantially developed, altered or improved the matter or thing, substantially enhancing its market value. The royalties must also be derived in the course of the CFC's business for them to be exempt.

6.15 We see a case for having a similar rule treating royalties as active income in these circumstances, provided there is a substantial pattern of activity. However, this treatment will not apply when the intellectual property originated in New Zealand (see below).

Intellectual property originating in New Zealand

6.16 A stricter approach should be taken to the treatment of royalties that are derived by a CFC from an unrelated party for intellectual property originating in New Zealand and then transferred offshore, as illustrated by figure 4. Such royalties will be treated as passive income, even if the CFC has developed the intellectual property or added substantial value to it.

FIGURE 4:
CFC DERIVES ROYALTIES FROM INTELLECTUAL PROPERTY ORIGINATING IN NEW ZEALAND



6.17 As mentioned earlier, both Australia and the United States would treat the royalties in this scenario as active income. However, a stricter approach is justified in the New Zealand context given that, unlike Australia and the United States, New Zealand does not tax intellectual property when it exits the domestic tax base.

6.18 One possible option would be to impose an exit tax on the intellectual property when it is transferred out of New Zealand. The introduction of such a tax would not be straightforward. There are always difficulties associated with valuing such property and determining the cost basis. What is even more important, however, is that change of this sort would represent significant reform in its own right and is not something we would contemplate merely as a consequence of CFC reform.

Rents

6.19 The suggested treatment of rental income was outlined in the May update.

6.20 In most jurisdictions, rental income is considered to be passive in nature. This is also our starting position.

6.21 In certain circumstances, rental income could be considered to have the character of active income. Specifically:

- when the CFC is actually in the business of renting;
- when the CFC is not in the business of renting, but is an active business earning incidental rental income – for example, by leasing spare capacity; and
- when the CFC holds property used by related CFCs for the purposes of carrying on an active business, receiving rental income from those other CFCs.

6.22 In practice, distinguishing between active and passive rental income can be difficult and subjective. However, real property, by its nature, is tied to the jurisdiction in which it is situated, so a nexus between the CFC and the income can be demonstrated. While equipment is obviously more mobile, concerns about profit shifting arise only if the CFC is earning rents from outside its jurisdiction. In the interests of keeping the definition of passive income limited and as straightforward as possible, all rental income derived from the leasing of real property or equipment situated in the same jurisdiction as the CFC will be treated as active income. Other rental income will be passive, subject to the rules about related party payments discussed in chapter 7.

6.23 Finance leases will be treated as loans giving rise to passive income, irrespective of whether the source of the payments is within the same jurisdiction as the CFC.

Chapter 7

RELATED-PARTY PAYMENTS

Summary of suggested treatment

Interest, royalties or rents received by a CFC (CFC A) from a related CFC (CFC B) will be disregarded under the new CFC rules if:

- CFC B passes the active business test; and
- both CFC A and CFC B are resident in the same jurisdiction.

7.1 Interest, rent and royalty payments received by a CFC from related CFCs will generally be passive income. We have considered whether there should be any exceptions to this general rule. The treatment of dividends, including those from related parties, is discussed in chapter 4.

7.2 Australia currently has no exemptions for related-party payments.

7.3 The United States exempts payments received by a CFC from related parties in two cases.

Same jurisdiction exclusion

7.4 In the United States, dividend and interest income received by a CFC from a related foreign company (which does not have to be a CFC) are excluded from passive income if the company is created or organised in the same jurisdiction as the CFC. They are also excluded if the company's assets (or a substantial part of them) and business are both located in that jurisdiction.

7.5 Rents and royalties received from a related foreign company are excluded from passive income if they were paid for the use or right to use property within the foreign country in which the CFC and related company are incorporated. However, the exclusion is lost if the payments reduce the payer's income.

Look-through exclusion

7.6 The United States' look-through exclusion is a temporary provision that expires at the end of 31 December 2008.[14] The exclusion provides that dividends, interest, rents and royalties received by a CFC from a related CFC are excluded to the extent that they are attributable or properly allocable to income of the related CFC that is neither passive income nor treated as effectively connected with the conduct of a trade or business in the United States. The rule applies whether or not the related party is in the same jurisdiction.

Suggested approach

7.7 We suggest introducing a "same jurisdiction" exception along the lines of the United States' rule for related-party interest, royalties and rents. The rationale for the exclusion is effectively to avoid taxing active income when operations in a country are split among a number of different CFCs (for example, when operational CFCs are held through a holding company).

7.8 Specifically, interest, royalties or rents received by a CFC (CFC A) from a related party CFC (CFC B) will be disregarded under the new CFC rules if:

- CFC B passes the active business test; and
- both CFC A and CFC B are resident in the same jurisdiction.

This means the payments will be excluded from passive income and total income for the purposes of the active business test (see chapter 3) and will not be treated as passive income for the purposes of attribution.

7.9 We do not support a look-through exclusion that applies to CFCs in different jurisdictions. Such transactions could lead to profit-shifting between jurisdictions, from high-tax to low-tax countries.

[14] This provision was inserted into the US Code for three years – expiring in 31 December 2008. It is reported to be very uncertain as to whether the provision will be extended.

Chapter 8

OTHER PASSIVE INCOME

Summary of suggested treatment

Insurance premium income of a CFC will be passive income. Investment income derived by a CFC that is carrying on an offshore insurance business will be subject to the rules applying to other CFCs set out in previous chapters.

Income from life insurance policies and net gains from the disposal of life insurance policies that are on revenue account will be passive income.

Personal services income earned by a CFC will be attributed to the controlling New Zealand-shareholder if:

- 80% of the CFC's income from services relates to services personally performed by the New Zealand shareholder; and
- substantial business assets are not part of the business structure used to derive the income from services.

Gains from the disposal of revenue account property used in an offshore active business will be treated as active income. Gains from the disposal of other revenue account property will be treated as passive income.

8.1 This chapter examines amounts not covered in earlier chapters that will be considered passive income under the proposed CFC rules.

Offshore insurance business

8.2 A CFC that carries on an offshore insurance business generates two main types of income: premiums and income from investment. Insurance and reinsurance premiums derived by a CFC will be passive income. There will be no special rules for investment income derived by a CFC that is carrying on an insurance business. Such income will be subject to the rules applying to other CFCs, set out in previous chapters, and is therefore likely to be treated as passive. The reasons that special rules are not suggested for offshore insurance businesses are the same as those set out in chapter 5 in relation to financial institutions.

Life insurance policies

8.3 Life insurance policies will be treated as passive assets. This means that CFCs holding life insurance policies will derive passive income from these policies.

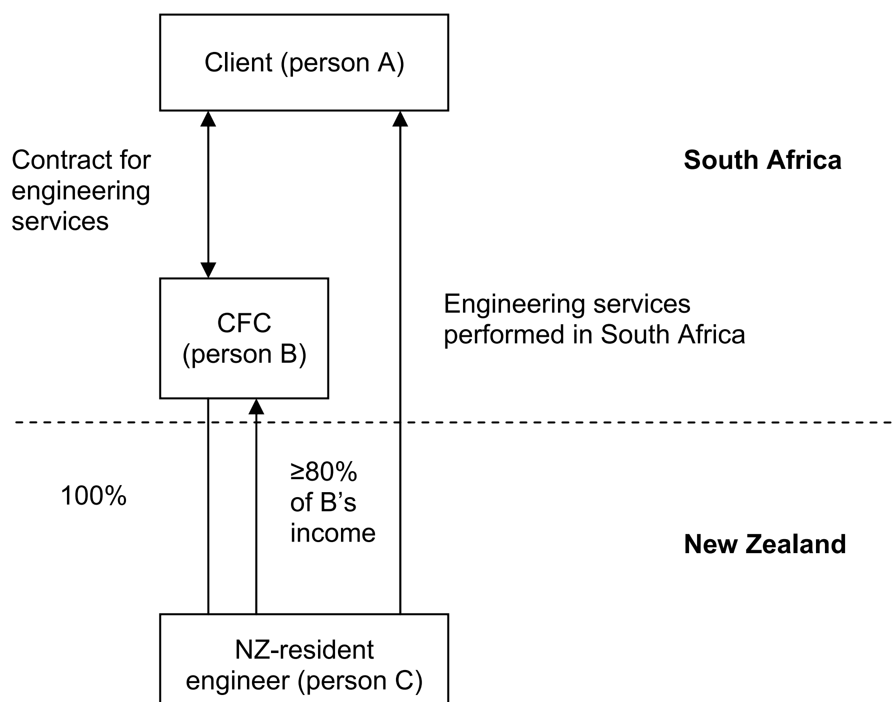
8.4 Net gains from the disposal of life insurance policies are also passive income under the rules in other countries, such as Australia. However, as New Zealand does not have a capital gains tax, passive income will arise on disposal of life insurance policies only if these policies are revenue account property, or if the CFC is in the business of trading in life insurance policies.

Personal service contracts

8.5 The May update noted that the active income exemption could undermine taxation of New Zealand residents' personal services income. This is because a New Zealand resident may provide personal services offshore through a company to avoid paying personal tax in New Zealand on income arising from personal effort.

8.6 Figure 5 illustrates the issue at hand. There is a contract between the CFC (person B) and the client (person A) for engineering services to be provided in South Africa. The service is performed personally in South Africa by a New Zealand resident (person C). In this case, the contract could have been made directly between the client and the engineer instead.

FIGURE 5:
PERSONAL SERVICES PROVIDED THROUGH A CFC



8.7 Countries differ in their treatment of such personal services income. Canada has a rule that income is passive when derived by a CFC providing services or undertaking to provide services if the services are performed by an individual resident in Canada. The United States has a rule that prevents the use of a shell company to re-characterise income earned by an individual from personal effort. The rule applies only if 25% or more of the CFC is owned by the individual who is to perform the services. Australia also has rules for domestic personal service companies, and they are similar to the New Zealand rules.

8.8 New Zealand has a personal service company rule that applies domestically to ensure that individuals pay the 39% tax rate in respect of annual income exceeding $60,000 that results from their personal effort when they use an intermediary to shelter that income (sections GC 14B to GC 14E of the Income Tax Act 2004). The rule attributes income earned by an interposed entity (person B) to the individual (person C) who provides the personal services when five criteria are met:

- Person C and person B are associated persons.
- At least 80% of person B's gross income from services is derived from a single source (person A).
- At least 80% of person B's gross income from services relates to services personally provided by person C (or a relative of C).
- Person C has income over $60,000 after application of the attribution rule.
- Substantial business assets are not part of the business structure used to derive the income from services.

8.9 The domestic rule should already cover the situation where a New Zealand-resident individual provides personal services offshore through a CFC. However, in our view, these criteria need to be modified to deal with the problems that arise in the cross-border context. Specifically, the personal service company rule, as it applies domestically, is aimed primarily at situations where an entity is interposed into a de facto employer/employee relationship between person A and person C in order to avoid the 39% personal income tax rate. In the context of reformed CFC rules, the concern is that a New Zealand resident uses a CFC to avoid tax on income from personal effort. The threshold for the top rate of personal income tax and the existence of employer/employee relationship are less relevant here. Therefore we suggest that the second and fourth criteria not be used in the international context.

8.10 In figure 5, income earned by the CFC would be attributed to the New Zealand-resident engineer since:

- the engineer has an interest in the CFC;
- 80% of the CFC's income from services relates to engineering services personally performed by the individual (or a relative of the individual); and

- substantial business assets are not part of the business structure.

8.11 This ensures a broad consistency of treatment of personal services income earned offshore with that earned domestically. Since the rule is narrowly targeted, applying in defined circumstances, the risk of affecting legitimate business structures is considered to be small.

Revenue account property

8.12 Revenue account property such as patents and shares has already been dealt with in previous chapters. For other forms of revenue account property, we suggest applying a modified version of the domestic tax treatment to the CFC.

8.13 Under New Zealand domestic tax law, the disposal of revenue account property gives rise to taxable income. In the context of the proposed CFC rules, gains from the disposal of revenue account property used in an offshore active business will be treated as active income. Gains from the disposal of other revenue account property will be treated as passive income.

Chapter 9

BASE COMPANY RULES

Summary of suggested treatment

Base company rules will be introduced but they will not apply to income derived from the sale of goods and from the supply of services related to the sale of goods.

They will also not apply to income earned by a CFC from services if the services are performed in the jurisdiction of the CFC.

They will apply only to income from services that are performed outside the jurisdiction in which the CFC is resident and if the employees performing the services are not resident in the CFC's local jurisdiction. In that case the nominally active income will be treated as passive income.

9.1 Base company rules generally target arrangements whereby income is derived by a CFC on behalf of a group of companies in a manner intended to avoid or defer domestic tax. They seek to keep this income within the domestic tax base by deeming what would otherwise be active income to be passive income when the underlying transaction exhibits particular characteristics that indicate risk to that base.

General considerations

9.2 Base company rules perform two main functions. For related-party transactions, they can supplement transfer pricing rules. More generally, however, they can prevent erosion of the domestic tax base through the establishment of a CFC to undertake activities without a genuine commercial reason. Transfer pricing rules offer less protection in this regard: even if a transaction is at arm's length, there may still be a risk that income that would otherwise be taxable in New Zealand has been moved offshore to benefit from the exemption for active income.

9.3 The design of base company rules inevitably involves trade-offs between base protection objectives and the other key objectives of the international tax review – minimising compliance costs and allowing New Zealand firms to get on with business. In principle, base company rules should not apply to commercially driven transactions. In practice, rules that consistently distinguish legitimate transactions from those driven primarily by tax considerations are difficult to formulate. Base company rules that are too broad risk becoming an obstacle to efficient business activity. They may also impose compliance costs on firms applying the active business test and/or attributing offshore income to their New Zealand shareholders, because such rules affect the definition of "passive" income.

9.4 The purpose of base company rules should not be to second guess firms' decisions about where to locate their operations. If a business activity is, in fact, carried on by a CFC in its local jurisdiction, the overall policy objective is to exempt the income derived from New Zealand taxation. As far as possible, base company rules should avoid cutting across that objective. They may, however, have a role to play when a nexus between the location of the CFC and the activity carried on is missing.

Sale of goods

9.5 Other countries that exempt the offshore active income of CFCs typically impose base company rules in relation to both the sale of property and the provision of services. The government has already announced that New Zealand's base company rules will not apply to income derived from the sale of goods and from the supply of services related to the sale of goods.

9.6 Our current transfer pricing rules for the sale of goods provide a level of protection against the sort of re-invoicing arrangement described in the December discussion document. The tangible nature of sale-of-goods transactions should also protect against sham transactions and artificial off-shoring. The absence of base company rules on the sale of goods will benefit CFCs carrying on export and distribution activities.

Provision of services

9.7 As noted, we are mainly concerned about transactions that route services through a CFC without there being any nexus between the location of that CFC and the activity carried on. When the service is not performed within the CFC's local jurisdiction, the question arises as to why the service was not provided by another group company – for example, by the New Zealand parent or by a CFC resident in the jurisdiction where the service was performed. As illustrated in figures 6 and 7, in the absence of any base company rules, domestic income could be shifted offshore, without any material change in a firm's business.

Figure 6: Service performed domestically routed through offshore CFC

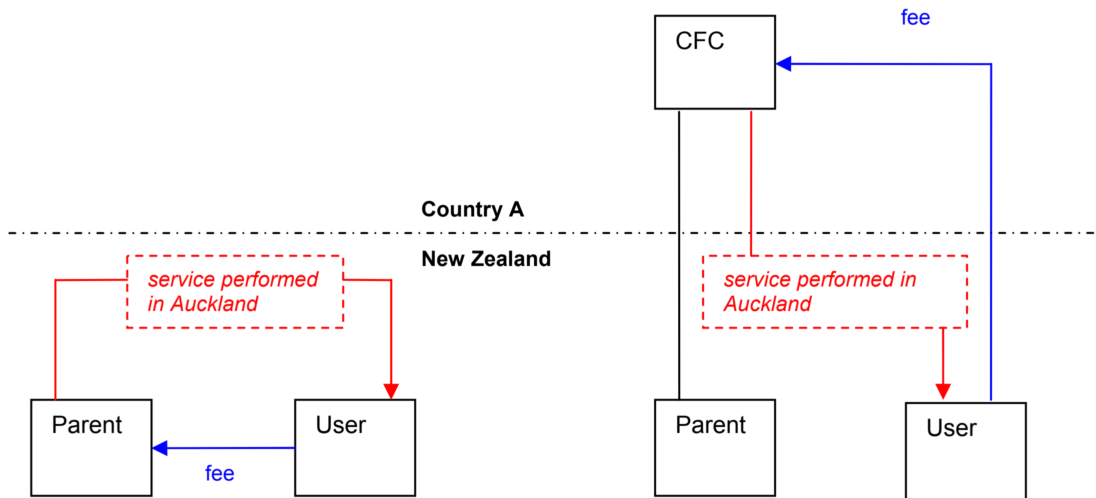
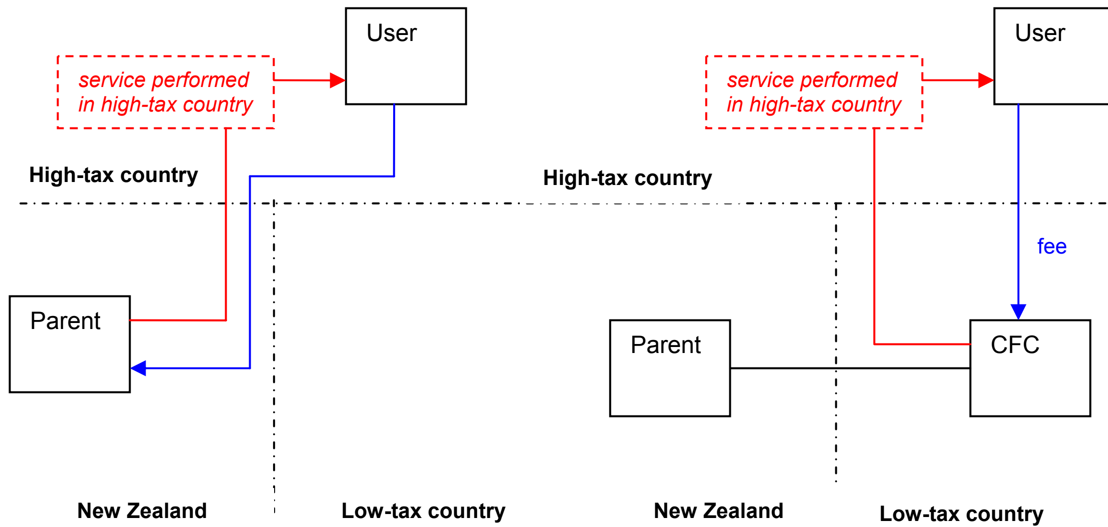


Figure 7: Service performed in high-tax jurisdiction routed through low-tax jurisdiction



9.8 We therefore suggest that base company rules operate to deem nominally active income derived by a CFC to be passive income if the performance of the service is undertaken outside the jurisdiction in which the CFC is resident. Under these rules, the income derived by the CFC in both figures 6 and 7 will be treated as passive. Base company income will be treated as passive income of a CFC in applying the active business test, and also for the purposes of attribution back to New Zealand shareholders when applicable. This approach was canvassed in the May update.

9.9 Our expectation is that the vast majority of legitimate business arrangements will be unaffected by the base company rules. It is important to note that the relevant question is where the service is performed, not the location of the person receiving the service. Provided the service is performed within the CFC's jurisdiction, the base company rules will not apply, even if the service is provided to a person in another jurisdiction (including New Zealand).

9.10 For example, a CFC providing call centre services should not be caught by this rule because the service will be performed in the jurisdiction of the CFC, even though it may be provided to users resident in New Zealand or third countries. On the other hand, consultancy services routed through a CFC but performed locally in the client's jurisdiction would be caught, because there is no connection between the performance of the service and the location of the CFC.

9.11 We are conscious that some legitimate arrangements may be caught by these rules. For example, a New Zealand business may establish a CFC as a regional centre of expertise, providing on-site services to other CFCs in neighbouring jurisdictions. Those services potentially give rise to base company income because the service is not performed in the jurisdiction of the CFC providing the service. (Services performed in the CFC's own jurisdiction on behalf of other CFCs would not be affected by the base company rules.)

9.12 To mitigate this problem, we suggest introducing a modification to the general base company rules, based on the residence of the employees delivering the service. If they are resident in the CFC's local jurisdiction, the fact that the service is performed by them outside the CFC's local jurisdiction will not give rise to base company income. This would be on the basis that the residence of the employees provided a sufficient nexus between the service and the location of the CFC to mitigate any concerns that the interposition of the CFC was artificial.

9.13 As far as we are aware, this exception to base company rules on services has no precedent internationally. It will therefore require monitoring to ensure that it does not give rise to unanticipated base maintenance concerns. It may be necessary to introduce pro rating rules to deal with cases where several individuals are involved in the provision of a service but only some are locally resident in the CFC's jurisdiction. More generally, the intention is that the exception should apply only if the service itself is performed personally by employees resident in the CFC's jurisdiction. If the service is performed mechanically, or provided by or through machinery or equipment that is located outside the jurisdiction of the CFC, the base company rules

will apply, even if auxiliary functions or services are carried on within the CFC's local jurisdiction, or elsewhere by employees resident in that jurisdiction. An example of this might be the transmission of information using a communications satellite. Because the transmission service is not provided in any particular location, or performed by individual employees, the base company rules would apply.

9.14 We note that Australia has base company rules that treat income from services as passive whenever the user is resident in Australia (or has a permanent establishment there). We did consider similarly applying New Zealand's base company rules to service transactions involving domestic users, on the grounds that the risk to our tax base is greatest when services are provided back into New Zealand. In the first place, there is a stronger prima facie argument that these are services that ought to be provided by a domestic entity rather than an offshore CFC. In addition, it is likely that the fee paid by the user will be deductible against New Zealand profits.

9.15 On balance, it seems advisable not to introduce such a rule at this time because of the potential impact on legitimate business structures. We are aware that New Zealand businesses use offshore service centres to provide services back into New Zealand for a variety of commercial reasons, including lower operating costs and the availability of appropriately skilled labour. Again, this is an area that will need monitoring to ensure that the absence of such a rule does not contribute to an erosion of the tax base.

Chapter 10

CALCULATING AND ATTRIBUTING CFC INCOME OR LOSS

Summary of suggested treatment

As a general rule, non-interest expenditure will be deductible in calculating the branch equivalent profits of a CFC to the extent they are incurred in deriving passive income, or in the course of a business carried on for the purpose of deriving such income, and not incurred in deriving active/disregarded income. Similar rules are suggested for non-interest expenditure incurred by shareholders in deriving an attributed CFC income or loss.

Interest deductions in the calculation of branch equivalent profits will be restricted. The preferred approach is to pro-rate apportionment on the basis of the ratio of passive assets to active/disregarded assets. Interest deductions by shareholders will be subject to the interest allocation rules described in chapter 11.

Special rules may be needed to deal with expenditure that relates to passive income that is not attributable because a CFC satisfies the active business test. The preferred approach is to allow such expenditure only if it is incurred in a year when the CFC is subject to attribution on its passive income.

Technical amendments will be required to ensure that foreign tax credits are available only for tax paid or payable by a CFC in respect of its passive income.

10.1 This chapter discusses technical issues relating to the mechanics of calculating and attributing a CFC's income or loss to its New Zealand-resident shareholders holding non-portfolio income interests. It considers how relevant provisions of the Income Tax Act 2004 will apply following the introduction of the active income exemption, and whether any modification of those provisions is required.

Categories of income under the new rules

10.2 Existing law provides that a CFC's branch equivalent income is calculated in broadly the same way as the net income or loss of a New Zealand resident. Section EX 18 sets out the basic formula for calculating a person's attributed CFC income or loss, namely that person's income interest in the CFC multiplied by the CFC's branch equivalent income or loss. Section EX 21 lays down the detailed rules for calculating attributed CFC income or an attributed CFC loss, applying the Act (subject to certain modifications) as though the CFC were a New Zealand resident.

10.3 Under the new rules, CFCs will derive three broad categories of income:

- **Active/disregarded income.** All income that is not within the meaning of "passive income" will be disregarded for the purposes of attribution. The distinction between active income and disregarded income is that the latter will be ignored for the purposes of the active business test described in chapter 3. This distinction is not relevant for the purposes of calculating the amount of attributed CFC income or loss.
- **Attributable passive income.** Passive income derived by a CFC that does not satisfy the active business test will be subject to attribution to New Zealand shareholders with non-portfolio income interests.
- **Non-attributable passive income.** Passive income derived by a CFC that satisfies the active business test will not be subject to attribution.

10.4 Amendments to subpart EX will be needed to ensure that only passive income is taken into account for the purposes of calculating the branch equivalent income of a CFC. It is anticipated that the correct treatment of non-attributable passive income will be achieved through the operation of the active business test, the effect of which should be to suspend the attribution requirements in relation to CFCs satisfying that test.

General treatment of expenditure

10.5 The treatment of expenditure under the new rules is a key issue. Existing law provides that a CFC's branch equivalent income is calculated in broadly the same way as the net income or loss of a New Zealand resident. Subparts CQ and DN of the Income Tax Act set out when attributed CFC income or an attributed CFC loss arises and provide that the amount of such income or loss is to be calculated in accordance with subpart EX. Section EX 21 applies the Act (subject to certain modifications) as though the CFC were a New Zealand resident, so the core provisions are in point. In particular, section BC 4 provides that a person's net income or loss is determined by the difference between annual gross income and annual total deductions, those amounts being, respectively, assessable income and deductions allocated to a particular income year (sections BC 2 and BC 3).

Nexus with passive income

10.6 Subpart DA sets out the general rule for deductions. Section DA 1 contains the general permission. It states that a person is allowed a deduction for an amount of expenditure or loss to the extent that it is incurred in deriving assessable or excluded income or in the course of carrying on a business for the purpose of deriving such income. The effect is to require a nexus between expenditure and assessable income.[15] Section DA 2 lays down the general limitations. These include the exempt income limitation at subsection (3), which prohibits deductions for expenditure or loss incurred in deriving exempt income.

[15] CIR v Banks (1978) 3 NZTC 61,236.

10.7 Consistent with the principles set out in subpart DA, an amount of expenditure or loss incurred will not be deductible when calculating branch equivalent income or loss except to the extent that it is incurred in deriving passive income or in the course of carrying on a business for the purpose of deriving such income, and is not incurred in deriving active/disregarded income.

10.8 In practice, a CFC's expenditure will often relate to both passive and active/disregarded income. The general permission incorporates the concept of apportionment by referring to deductions being allowed *to the extent* that they relate to assessable or excluded income.[16] Section DA 1(1)(b) allows a deduction for all expenses incurred in the course of carrying on a business for the purpose of deriving assessable or excluded income. The exempt income limitation at section DA 2(3) ensures that expenditure is not deductible to the extent that it is incurred in deriving exempt income. The apportionment rules will similarly apply to expenditure relating to both passive and active/disregarded income.

10.9 Expenditure relating to non-attributable passive income is discussed separately.

Interest payments and related matters

10.10 The treatment of interest payments requires special consideration. Section DB 7 provides that, subject to certain exceptions, a company (other than a qualifying company) is allowed a deduction for interest. This provision supplements the general permission and overrides various of the general limitations, including the exempt income limitation and the capital limitation. As a result, most companies can claim interest expenses regardless of whether there is any nexus between that expenditure and their assessable or excluded income.

Background to section DB 7

10.11 The predecessor to section DB 7 was section DD 1(3) of the Income Tax Act 1994.[17] Before the latter provision was introduced, in 2001, policy and technical arguments relating to interest deductibility were discussed in a number of official publications, including the 1992 *Final report of the consultative committee on the taxation of income from capital* (chapter 7) and the 1999 discussion document *Interest deductions for companies*. The fungibility of money made tracing or apportioning interest costs a largely meaningless exercise, involving significant compliance costs for often arbitrary results. Companies, particularly large companies with a range of assets and liabilities, frequently borrow for general purposes. Even when a company does borrow with a view to financing specific activities, its ability to raise and service the debt will depend on its aggregate position. Debt and equity funding for any particular asset are substitutable, so there is little economic significance in matching assets and loans. Allowing a company to

[16] *Buckley &Young Ltd v CIR* (1978) 3 NZTC 61,271.
[17] Also, section BD 2A and section DD 1(4). These provisions were effective from 24 October 2001 and applied to the 1997-98 and subsequent income years.

deduct interest payments only if there was a nexus with assessable or excluded income was considered more likely to distort its financial structure than to limit its deductions and increase revenue.

10.12 The major concern at the time was not interest expenditure relating to exempt income, but rather expenditure relating to capital amounts (which, generally, are not income for the purposes of the Income Tax Act and are not, therefore, expressly exempt). Indeed, section DB 7 does not apply to companies deriving exempt income (other than dividends and certain other amounts). Most companies were not expected to derive such income. The introduction of an active income exemption changes the landscape. Many CFCs will derive significant amounts of income no longer subject to New Zealand tax through the attribution rules. The question is how interest expenditure relating to such income should be treated.

Limiting interest deductions for CFCs

10.13 In principle, similar arguments about the fungibility of money apply to interest expenditure incurred by CFCs under the new rules. Nevertheless, our view is that deductions should be limited to interest payments on borrowings related to the derivation of passive income. The continued taxation of passive income on accrual is regarded as essential to protect the New Zealand tax base. Allowing a CFC to deduct all interest expenditure without regard to whether its borrowings are related to the derivation of passive income would frustrate this policy objective.

10.14 Restricting interest deductions is logically consistent with the introduction of interest allocation rules for outbound investment set out in chapter 11. Those rules will protect the domestic tax base by requiring that an appropriate level of group debt is allocated to CFCs. Limiting interest deductions by CFCs will prevent that debt being used to shelter passive income from accrual taxation.

10.15 There are various ways of attempting to limit the deductibility of interest payments. The main approaches were summarised in the 1999 discussion document on interest deductions:[18]

- **Tracking.** This would involve identifying how debt has been applied. Deductions for interest would be allowed if funds are used to produce passive income. Very broadly, this is the approach to interest deductibility authorised by the New Zealand courts when section DB 7 does not apply.[19]
- **Stacking.** This would involve "ordering" income and expenditure and allowing interest deductions only when there is sufficient income to satisfy the test. (Alternatively, the test could be applied by reference to assets.) There are two distinct models:

[18] *Interest deductions for companies; a government discussion document*. Published in September 1999. Available at www.taxpolicy.ird.govt.nz.

[19] Relevant cases include *Public Trustee v CIR* (1938) NZLR 436, *Pacific Rendezvous v CIR* (1986) 8 NZTC 5,146, and *Commissioner of Inland Revenue v Brierley* (1990) 12 NZTC 7,184. The Commissioner's interpretation of principles relating to interest deductibility is set out in *Tax Information Bulletin Vol. 18, No. 6* (July 2006).

  - allow deductions up to the amount of passive income (or to the extent that the debt does not exceed the value of passive assets);
  - allow deductions to the extent that interest expenditure exceeds active/disregarded income (or that the debt outstanding exceeds the value of active/disregarded assets).

- **Pro rata apportionment.** Under this approach, a proportion of total interest expenditure would be deductible, based either on the ratio of passive income to active/disregarded income or on the ratio of passive assets to active/disregarded assets.

10.16 The difficulties associated with tracking, particularly with respect to companies, have already been outlined. Because it disregards the fungibility of money, a tracking approach would be difficult to apply in practice and would allow scope for planning that may prevent the effective taxation of passive income.

10.17 As regards stacking, the first approach – allowing deductions up to the amount of passive income (or assets) – would also frustrate the policy of taxing passive income on accrual. Any CFC with a material level of commercial activity and a reasonable amount of debt would be able to use its interest deductions to shelter all or most of its passive income. The second approach – only allowing deductions to the extent that interest expenditure exceeds active/disregarded income (or assets) – runs into the opposite problem: a CFC with significant active income and only a modest amount of passive income would find itself unable to claim any deductions for interest.

10.18 In our view, pro rata apportionment offers the most appropriate solution for dealing with interest deductibility. As noted, we could look to either income or assets as the basis for apportionment. Looking to the asset structure of the CFC should give the most accurate reflection of how borrowed funds, along with other capital, are invested in the business. An asset-focused approach does have certain drawbacks, however. In particular, it would require all business assets to be valued, and identified as active or passive or both. Assets employed to derive both active/disregarded and passive income would likely create apportionment problems of their own.

Countering avoidance

10.19 Restrictions on interest deductibility applied on an individual CFC basis are vulnerable to planning activity. The general interest allocation rules discussed in chapter 11 will require that a certain amount of group debt be located offshore, but they will make no provision about how debt is distributed between CFCs. It would therefore be possible to circumvent the rules on pro rata apportionment by concentrating debt in a CFC with mainly passive income, which in turn provided equity funding to related CFCs with a higher proportion of active/disregarded income. Compare figures 8 and 9.

Figure 8: 75% of CFCs' combined interest expenditure deductible

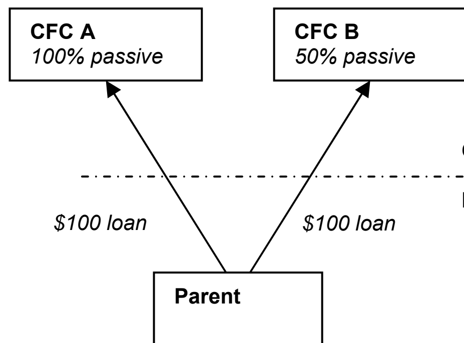
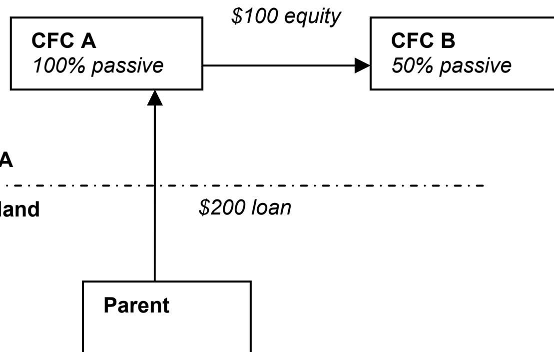


Figure 9: 100% of CFCs' combined interest expenditure deductible



10.20 We are considering options to deal with this sort of structure. One possibility would be to apply rules equivalent to the interest allocation rules to individual CFCs. Thus, interest deductions available after pro rating would be further reduced, for the purposes of calculating branch equivalent income, if a CFC's debt-to-asset ratio exceeded both the 75% safe harbour and 110% of the worldwide group ratio.

10.21 Alternatively, a look-through rule could perhaps be applied, limiting interest deductions by reference to the amount of equity a CFC holds in other CFCs deriving active/disregarded income. In figure 8, half of CFC A's debt is used to finance equity investment in CFC B, which has 50% passive income. In the calculation of CFC A's branch equivalent income, therefore, interest deductions could be restricted to 75% of the total by applying the formula *1 - (0.5 x 0.5)*.

Transaction costs of borrowing money

10.22 Section DB 5 provides that a person is allowed a deduction for expenditure incurred in borrowing money used as capital in deriving income, overriding the capital limitation. We consider that, in the calculation of branch equivalent income, such deductions should be subject to the same pro rata limitation as will apply to interest deductions generally.

Money borrowed to acquire shares in group companies

10.23 Section DB 8 allows a company a deduction for money borrowed to acquire shares in other group companies. This provision supplements the general permission and overrides various of the general limitations, including the exempt income limitation and the capital limitation. If a company is not anyway able to claim a deduction for the interest under section DB 7, section DB 8 allows a deduction in relation to shares generating exempt inter-corporate dividends, for which the nexus requirements of subpart DA are not satisfied.[20]

10.24 If interest deductions are restricted according to a CFC's ratio of passive to active/disregarded income, as suggested, this should override section DB 8 in the calculation of branch equivalent income.

Shareholder deductions

10.25 The deductibility of expenses incurred directly by New Zealand shareholders in deriving their attributed CFC income or loss also requires consideration. Such expenses could include professional fees associated with share acquisitions and interest on borrowings used to finance offshore investment.

Non-interest expenditure

10.26 The nexus test imposed by the general permission (section DA 1(1)(a)) should apply directly to non-interest expenditure incurred by shareholders. Attributable CFC income is income for the purposes of section BD 1 by virtue of section CQ 1. Thus, an amount of expenditure or loss will be prima facie deductible if it satisfies the general permission.

10.27 The exempt income limitation, on the other hand, is unlikely to apply of its own accord. If CFC income is not attributed to New Zealand shareholders under subpart CQ, it will fall outside the meaning of income for the purposes of section BD 1. In substance, however, active/disregarded income derived by a CFC will be exempt. Accordingly, in our view, the exempt income limitation, or an equivalent, ought to apply to expenditure incurred by shareholders in relation to such income. If necessary, express provision to this effect will be made. The intention would be to ensure that shareholders' expenditure is deductible only to the extent that it is incurred in deriving passive income and is not incurred in deriving active/disregarded income. When such expenditure relates partly to passive and partly to active/disregarded income, apportionment will be required.

[20] The policy rationale for section DB 8 was considered by the Consultative Committee on the Taxation of Income from Capital in its 1991 report, *Tax accounting issues* (chapter 2). The report analysed the equivalent provision in the Income Tax Act 1976 (section 106(1)(h)(ii)). The Committee noted that dividends received by companies were exempt and that the requirement for interest expenditure to have a nexus with assessable income could not therefore be satisfied in relation to such interest. However, because the income would normally be taxable in the hands of the underlying shareholders, it was reasonable for this expenditure to be deductible. The inter-corporate dividend exemption has since been restricted to dividends from foreign companies and other companies in the same wholly owned group, and the general provision on interest deductibility (section DB 7) has been introduced. Nevertheless, the 1999 discussion document *Interest deductions for companies* argued that what is now section DB 8 would continue to be important to taxpayers and remained appropriate in policy terms.

10.28 Again, the treatment of expenditure related to non-attributable passive income is considered separately.

Interest expenditure

10.29 When a CFC borrows directly, interest deductions should be allowed only to the extent that its total income consists of passive income. No new restrictions on the application of sections DB 5, DB 7 and DB 8 to New Zealand shareholders borrowing to fund equity investment in CFCs are suggested. The interest allocation rules outlined in chapter 11 will require an appropriate amount of group debt to be allocated by the New Zealand parent to its CFCs.

10.30 New Zealand shareholders that are outside the scope of sections DB 7 and DB 8 will remain eligible for interest deductions according to established principles, subject to the interest allocation rules (where applicable). As for non-interest expenditure, the intention would be for the exempt income limitation, or an equivalent, to apply to interest payments incurred by shareholders for the purposes of deriving active/disregarded CFC income.

Attributed CFC losses

10.31 Subpart DN deals with attributed losses from foreign equity. Section DN 1 supplements the general permission (and overrides the capital limitation) to allow a deduction for an attributed CFC loss. Section DN 2 specifies when an attributed CFC loss arises. Section DN 3 provides that the amount of that loss is to be calculated in accordance with subpart EX, applying the Act as broadly as though the CFC were New Zealand-resident.

General rule

10.32 Under the Act's core provisions, a net loss arises when total deductions for the year exceed assessable income (section BC 4(3)). Because expenditure will be deductible in the calculation of branch equivalent income or loss only if there is a nexus with passive income, or if interest payments are allowable under the suggested pro rating rules, there should be no need for special rules distinguishing "active net losses" from "passive net losses". Expenditure relating to active/disregarded income will not be deductible. Therefore any net loss arising to a CFC under section BC 4 will necessarily reflect the fact that deductions relating to passive income exceed such income in a particular year.

Losses: ring-fencing, carry-forward, and group offset

10.33 A net loss incurred by a CFC is attributed to its shareholders rather than being quarantined within the CFC itself. The use of such losses by the shareholders to whom they are attributed is subject to jurisdictional ring-fencing rules. Section DN 4 provides that an attributed CFC loss may be offset only against attributed CFC or branch equivalent FIF income from CFCs/FIFs in the same jurisdiction (section DN 4). Any excess becomes an attributed CFC net loss that may be carried forward and used under section IE 1 (by virtue of section IE 3) or section IE 3(5), or used against

current or future income of another company in the same group under section IG 4. Both carry-forward and group-offset of attributed CFC losses are also subject to jurisdictional ring-fencing.

10.34 The move to an active income exemption does not appear to require any change in these rules. It is worth noting that New Zealand's rules for attributed losses are, in practice, already more relaxed than the equivalent rules in Australia. There, CFC losses are quarantined within the CFC that incurred them and prior-year losses may be carried forward only if the CFC was a CFC in the year the loss was incurred and in all intervening years and are generally not available if the CFC switches residence between a listed country and an unlisted country. Current Australian law also quarantines foreign losses by reference to four separate classes of income, although the Australian government has announced its intention to remove that restriction.

Non-attributable passive income

10.35 Non-attributable passive income is passive income derived by a CFC that satisfies the active business test and is not, therefore, subject to attribution on any of its income. The treatment of such income requires careful consideration. The principal issue is how a nexus-based approach to expenditure applies when there is a possibility that some or all of the associated income may remain outside the tax base, even though that income is passive and therefore prima facie assessable. This is most likely to create difficulties when expenditure is incurred in one year and the income to which it relates is derived in later years.

Calculating branch equivalent income

10.36 The Australian approach is to allow deductions for expenditure relating to non-attributable passive income in calculating CFC income, even though, strictly, the nexus test is not satisfied. The corollary is that passive income earned by a CFC reduces any carried forward passive losses, even if the CFC is not subject to attribution at the time this income is derived.[21]

10.37 This approach is not easy to replicate exactly in New Zealand because we treat CFC losses differently. While Australia quarantines losses within the CFC itself, New Zealand allows losses to be attributed to, and utilised by, shareholders (subject to jurisdictional ring-fencing). We have considered various options for dealing with non-attributable passive income, and they are outlined below. Our provisional view is that option 2 provides a workable, straightforward solution, delivering certainty while also minimising compliance costs.

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[21] Section 382 of Australia's Income Tax Assessment Act 1936 (the ITAA 36) provides that attributable income is the amount that would be the CFC's taxable income under certain assumptions, one of which is (in broad terms) that its only taxable income is its passive/tainted income and all other income is exempt income. The general nexus rule in section 8 of the Income Tax Assessment Act 1997 provides that a loss or outgoing may be deducted to the extent that it is incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing such income. There are various detailed provisions in Part X (Division 7) of the ITAA 36 concerning attribution: sections 425, 426 and 428 are relevant to the treatment of non-attributable passive income (referred to, in Australia, as "exempt passive income").

Option 1: Treat non-attributable passive income in the same way as active/ disregarded income

10.38 Under this approach, expenditure incurred in deriving non-attributable passive income would not be deductible, and no losses in relation to such income would arise. This is attractive inasmuch as it preserves the integrity and conceptual simplicity of the current nexus test by requiring a link between expenditure and income that is actually subject to New Zealand tax. The major drawback is uncertainty about the deductibility of expenditure, which would depend on whether or not the CFC was subject to attribution at the time the corresponding income was derived. For CFCs that routinely satisfy, or fail to satisfy, the active business test, this may present few problems, but practical difficulties may arise for CFCs closer to the 5% threshold.

Option 2: Allow expenditure related to passive income only if it is incurred during a year when the CFC is subject to attribution on its passive income

10.39 This option would replace the nexus test for expenditure with a rule that looked to the status of the CFC in the year to which the expenditure is allocated under the core provisions. All deductions relating to passive income would be allowed if they were allocated under section BD 4 to a year for which a CFC did not satisfy the active business test and was therefore subject to attribution; no regard would be had to whether the expenditure related to future passive income which turned out not to be attributable because the CFC satisfied the active business test for the year in which that income was derived. For years in which a CFC did satisfy the active business test, any net passive loss would not be available for attribution to shareholders. This approach should be straightforward and workable.

Option 3: Allow all deductions relating to passive income (including non-attributable passive income) and reduce carried-forward losses by passive income derived (including non-attributable passive income)

10.40 This option would give us a system for dealing with non-attributable passive income similar to Australia's but operating on a per-jurisdiction basis, consistent with the overall approach of New Zealand's rules. It would mean that expenditure relating to non-attributable passive income was deductible, and that net losses from a CFC not subject to attribution could be used to offset attributable passive income from another CFC (or branch equivalent FIF) operating in the same jurisdiction. By the same token, non-attributable passive income from one CFC could reduce current-year and carried-forward losses relating to other CFCs or branch equivalent FIFs in the same jurisdiction.

10.41 We consider this option to be conceptually robust and most likely to produce accurate results. However, we also note that it would involve compliance costs for CFCs that satisfy the active business test, because of the need to track passive income and losses on an ongoing basis. While the active business test will require some monitoring of this income in any event, the basis of that calculation will be different if the test is based on NZ IFRS and IFRS principles.

10.42 In effect, a taxpayer carrying forward attributed passive losses would have to forgo the protection otherwise afforded by the active business test and calculate passive income and losses for all the CFCs in a jurisdiction, even if no attribution of the income was required. It may be possible to give taxpayers some choice about whether or not to engage in that exercise, but if they elected not to, they would be unable to carry forward attributed CFC losses.

Shareholder deductions

10.43 Similar considerations arise in relation to expenditure incurred directly by New Zealand shareholders in deriving non-attributable passive income.

10.44 The main expense incurred by shareholders is likely to be interest. It has already been suggested that, in line with sections DB 7 and DB 8, the nexus test should not generally apply to such expenditure. Therefore the question of whether the CFC to which the expenditure relates is subject to attribution is not relevant. Interest deductions would be allowed in accordance with those provisions, subject to the interest allocation rules.

10.45 For interest expenditure incurred by shareholders not covered by sections DB 7 and DB 8, and for other expenditure, it may be appropriate to adopt a similar approach to that suggested for expenditure incurred by CFCs themselves. Under option 2, passive expenditure incurred by a shareholder will be allowed if the CFC to which it relates was subject to attribution in the year to which the expenditure was allocated under the core provisions. Expenditure relating to more than one CFC, some of which is subject to attribution in the year in question and some of which is not, will need to be apportioned.

Foreign tax credits under section LC 4

10.46 Section LC 4 provides that a person with an attributed CFC income is allowed a credit for tax paid by or on behalf of the CFC in respect of that income. If a CFC satisfies the active business test for a year, none of its income will be attributed back to its New Zealand shareholders in that year under the CFC rules. Accordingly, credits will not be available under the terms of section LC 4(1) for tax paid by or on behalf of that CFC. If a CFC does not satisfy the active business test, the requirements of section LC 4(1) could be met and credits may be available. Section LC 4(3) will need to be amended to ensure that credits are available only for tax paid or payable by a CFC in respect of its passive income.

Transitional issues

10.47 Further consideration needs to be given to transitional matters relating to attributed CFC net losses carried forward under section IE 1 (by virtue of section IE 3) and to foreign tax credits carried forward under section LC 4(6). These matters will be discussed in a subsequent paper.

Chapter 11

INTEREST ALLOCATION RULES

Summary of suggested treatment

Interest allocation rules will apply to a New Zealand company with controlled foreign companies unless it has:

- 90% or more of its assets in New Zealand; or
- less than $250,000 of interest deductions.

Companies required to comply with interest allocation rules will apportion their interest deductions if their New Zealand group debt percentage ratio is greater than 75%. The apportionment is based on the 75% safe harbour, or 110% of the worldwide group debt percentage, whichever is higher.

Existing rules will be used to measure debt and assets for the purpose of the interest allocation rules, except that:

- fixed rate shares issued to New Zealand taxpayers will be treated as debt for the purpose of the interest allocation rules;
- equity investment in CFCs will not be counted as assets; and
- the definition of "worldwide debt" will exclude liabilities that do not provide funds and liabilities that do not give rise to deductions (except fixed rate shares, which will be treated as debt for this purpose).

Introduction

11.1 The government announced in the May update that the package of international tax reforms would include interest allocation rules for outbound investment. This chapter outlines technical details of the new rules. While some design features are taken from similar rules used in Australia, we are aware that the New Zealand business environment may be different – for example, New Zealand companies face a smaller domestic market and may expand offshore at an earlier stage of their life cycle. Submissions are invited on the suggested rules.

11.2 Current tax legislation contains interest allocation rules applying to foreign controlled New Zealand companies, referred to as thin capitalisation rules. These rules will be extended and modified to apply to all New Zealand companies with offshore operations.

11.3 Accordingly, the new interest allocation rules will apply to:

- foreign-controlled New Zealand companies, as under the current thin capitalisation rules – the inbound companies; and
- New Zealand companies with controlled foreign companies (CFCs) – the outbound companies.

11.4 The provisions of the new interest allocation rules will, unless indicated otherwise, apply to both inbound and outbound companies. Some technical changes may tighten the operation of the existing rules.

11.5 While the interest allocation rules may have broad potential scope, exemptions within the rules mean that they are expected, in practice, to restrict interest deductions in extreme cases. If the rules discussed in this chapter are implemented, then outbound companies need not apply them when:

- more than 90% of the group's assets are in New Zealand; or
- total interest deductions of the company are less than $250,000.

Companies not falling within these exemptions will need to apply the interest allocation rules, but there will be no interest denials when:

- the New Zealand group's debt-to-asset ratio is below the 75% safe harbour; or
- debt funding is below 110% of the worldwide group debt percentage.

In both cases, the on-lending concession will help companies avoid interest denials.

Exceptions for outbound companies

11.6 The interest allocation rules will provide exceptions for outbound companies that have a small amount of outbound investment and/or a small amount of interest expense.

11.7 These exceptions, which are based on similar rules in Australia, are expected to benefit outbound companies when the risk of profit shifting is relatively small.

Entities with a small amount of outbound investment

11.8 Companies with a small amount of offshore investment do not have a significant scope to over-allocate their global interest costs against New Zealand income.

11.9 In our view, New Zealand companies with 90% or more of their assets in New Zealand should not be required to apply the interest allocation rules.

11.10 Companies with minimal offshore assets will be able to do a simple calculation to determine if they qualify for this exemption. This will reduce compliance costs and ensure that the interest allocation rules do not inhibit companies from exploring offshore opportunities. Export companies with distribution and marketing facilities that have minimal offshore assets could also benefit from this exemption.

Entities with a small amount of interest deduction

11.11 Submissions on the December discussion document requested that small New Zealand entities should be exempt from the interest allocation rules. However, an exemption based on "size" criteria, such as total income, total assets and number of employees, would not offer sufficient protection for the New Zealand tax base. Entities that are "small" under these criteria could still allocate an excessive proportion of their global interest costs to New Zealand.

11.12 Instead, an exemption based on small amounts of interest deduction, such as $250,000, may be more appropriate. This criterion would exempt many small New Zealand entities from the interest allocation rules while limiting the risk to the New Zealand tax base.

11.13 Companies will be able to determine if they qualify for this exemption by examining the amount of interest deduction they are claiming. However, suitable rules are needed to ensure that they include all interest deductions claimed by related and associated parties.

11.14 We also have some concerns about the application of this exception to a special purpose company that holds interests in CFCs with real estate investments. This company could be fully debt-funded in New Zealand (with interest deductions up to the $250,000 threshold) while holding offshore real estate investments that generate tax-exempt rental income. It would not be appropriate to exempt the special purpose company from the interest allocation rules.

General principles of the interest allocation rules

11.15 Companies required to comply with interest allocation rules will, in the first instance, calculate their New Zealand group's debt-to-asset ratio. Companies with a New Zealand group debt-to-asset ratio that is within the 75% safe harbour will not have to apportion their interest deductions, which is consistent with the existing thin capitalisation rules.

11.16 The 75% safe harbour allows New Zealand businesses significant scope for offshore expansion before they need to consider the impact of the proposed interest allocation rules. This safe harbour is consistent with the government's desire not to unduly restrict New Zealand businesses from exploring offshore investment opportunities.

11.17 The 75% safe harbour provides a level of protection for the New Zealand tax base. Companies that exceed the 75% safe harbour could have their interest deductions apportioned. The apportionment is based on the 75% safe-harbour debt-to-asset ratio or 110% of the worldwide group debt-to-asset ratio, whichever is higher. The excess interest deductions will be denied.

Definition and measurement of debt

11.18 Under the current thin capitalisation rules a company includes as debt all financial arrangements that provide funds to the company and give rise to an allowable deduction. This debt is consolidated across all the entities in the company's New Zealand group. The same approach to debt will be adopted for interest allocation rules for outbound investments.

11.19 In addition, we suggest an adjustment for fixed rate shares issued to New Zealand taxpayers. This rule, which currently applies for the purposes of the minimum equity rules for banks, will apply for the purpose of the new interest allocation rules.

Fixed rate shares issued to New Zealand taxpayers

11.20 Fixed rate shares issued to New Zealand taxpayers should be treated as debt for the purpose of the interest allocation rules. For groups with interest denial, an after-tax advantage could be gained by issuing fixed rate shares instead of debt. This would have the effect of avoiding the impact of the interest allocation rules.

11.21 Fixed rate shares are close substitutes for debt as they have commercial characteristics that are very much like conventional debt. They also have tax characteristics that are substitutable with debt because they carry imputation credits that reduce shareholder level taxes in New Zealand.

11.22 As fixed rate shares have tax and commercial characteristics that are similar to debt, they should be treated in the same way as debt under the interest allocation rules. Otherwise, companies could avoid the impact of the rules by issuing fixed rate shares instead of conventional debt.

11.23 Some commentators have pointed out that issuing ordinary shares to New Zealand taxpayers could achieve the same tax outcome. However, ordinary shares have commercial characteristics that are sufficiently different from debt to warrant a different treatment under the interest allocation rules.

Definition and measurement of assets

11.24 The definition of "total assets" under the existing thin capitalisation rules, with the adjustments from equity investment in CFCs, will apply for all interest allocation purposes. Under these measurement rules, total assets of a New Zealand group include all consolidated assets of the entities in the group as reported in the group's financial accounts.

Adjustments for equity investment in CFCs

11.25 Equity investments in CFCs would not be counted as assets of the New Zealand group under the interest allocation rules. This adjustment removes offshore assets to the extent they are equity-funded by a New Zealand company from the asset base used to calculate the safe harbour, thereby reducing the amount of debt a New Zealand company can have before it has to apportion its interest deductions.

11.26 This adjustment is consistent with the proposed active income exemption. As profits from equity investments in CFCs would no longer be fully taxable in New Zealand, interest costs associated with these tax-exempt investments should not be allowed as deductions in New Zealand. Removing the equity investments in CFCs from the asset base used in the comparison with the safe harbour achieves this.

11.27 We recognise that, in principle, passive outbound investments should not be removed from the asset base to the extent that they are taxed in New Zealand. However, if we include passive outbound investments in the asset base, adjustments will need to be made to the calculation of the foreign tax credits given against New Zealand tax arising on such income to account for interest deducted in New Zealand on debt funding such investments. Moreover, distinguishing between outbound equity investments that are active and those that are passive for the purpose of the interest allocation rules could be difficult both to design and difficult for companies to comply with. Overall, removing all equity investments in CFCs from the asset base provides a simpler approach. This is the approach adopted by Australia.

On-lending concession

11.28 Submissions have pointed out that it is often cheaper, or more practical, for New Zealand multinationals to raise debt in New Zealand to fund their offshore operations. It is common in these circumstances for New Zealand companies then to shift the debt costs offshore through intra-group loans.

11.29 The interest allocation rules should recognise and facilitate this practice as it is consistent with the basic objective of these rules. Therefore an on-lending concession should apply to loans that are provided by a New Zealand company to its CFCs at arm's length terms.

11.30 No legislative change would be necessary because the existing on-lending concession already covers this scenario. The current on-lending concession applies to any funds lent to borrowers that are non-residents and do not operate a fixed establishment in New Zealand. This is expected to cover the funds lent by a New Zealand company to its CFC.

11.31 When the on-lending concession applies, the total debt and total assets in the group debt percentage ratio are both reduced by the on-lent amount. This adjustment removes the on-lent amount from the safe harbour calculation.

Financial institutions

11.32 Submissions have pointed out that the general interest allocation rules may not be appropriate when applied to financial institutions, a matter dealt with at present through the on-lending concession. However, for financial institutions the concession can lead to a different result than it does for foreign-owned banks, which have to comply with the minimum capital requirements.

11.33 Australia has dealt with this problem by introducing specific interest allocation rules for financial intermediaries. We are considering whether special rules should be introduced in New Zealand to deal with this situation. If such rules are to be contemplated, they would be subject to consultation with interested parties at a later date.

"Debt" and "asset" defined

11.34 In summary, for the purpose of calculating the safe harbour ratio of a New Zealand company with CFCs:

- "Debt" is defined as:
  (1) all financial arrangements that provide funds to the taxpayer and give rise to an allowable deduction;
  plus
  (2) any fixed rate shares issued to New Zealand shareholders;
  less
  (3) any debt provided at arm's length terms to a CFC.

- "Assets" is defined as:
  (1) all assets of the New Zealand group as recorded in the financial accounts;
  less
  (2) any equity investment in a CFC;
  less
  (3) any debt provided at arm's length terms to a CFC.

Worldwide group debt percentage

11.35 If a New Zealand group's debt-to-asset ratio exceeds the 75% safe harbour, allowable interest deductions for the group will be limited to a level consistent with the safe harbour or 110% of its worldwide group debt percentage, whichever is the higher. The worldwide group debt percentage ensures that companies operating in a high-leverage business environment are not artificially restricted by the 75% safe harbour.

11.36 The worldwide group debt percentage of a New Zealand group is defined currently as the group's consolidated worldwide debt as a percentage of its consolidated worldwide total assets. Consolidated worldwide debt and worldwide assets are calculated in accordance with New Zealand's generally accepted accounting principles.

11.37 The existing measurement rules for the worldwide group debt percentage will apply to all New Zealand companies required to comply with the interest allocation rules, with an amendment to the definition of "worldwide debt".

Definition of "worldwide debt"

11.38 At present, "debt" under the safe harbour calculation includes financial arrangements that provide funds and give rise to deductions for taxation purposes. However, the definition of "worldwide debt" includes all liabilities under generally accepted accounting practice.

11.39 A variety of non-interest bearing liabilities and liabilities that do not provide funds are included in the worldwide debt calculation. As a result, the level of worldwide group debt percentage could be greater than it would under the definition of debt used in the safe harbour calculation. This disparity provides an opportunity for companies to over-allocate global interest costs to the New Zealand tax base.

11.40 Ideally, the definition of worldwide debt and the definition used to calculate the safe harbour would be aligned. The definition of worldwide debt would thus exclude liabilities that do not provide funds and liabilities that do not give rise to deductions.

11.41 It is envisaged that, in practice, companies will start with the amount of liabilities reported in their consolidated financial statements. They will remove from this amount those liabilities that do not provide funds and liabilities that do not give rise to deductions (except fixed rate shares issued to New Zealand taxpayers as these would be treated as debt for this purpose).

110% uplift

11.42 The 110% loading allows companies to increase their debt capacity in New Zealand relative to their worldwide group. For example, companies with a worldwide group debt percentage of 80% will be allowed to apportion their interest deductions based on a ratio of 88%. In this case, the 110% loading is concessionary. However, it does offer a degree of protection for companies whose New Zealand operations are in some way atypical of their worldwide operations.

11.43 We suggest retaining the 110% uplift under the new interest allocation rules. We note that Australia has a 120% loading, but it is calculated on the basis of debt-to-equity ratio, rather than debt-to-asset ratio.[22] Our calculation suggests that the 110% loading on debt-to-asset ratio is always higher than the 120% loading on the debt-to-equity ratio when the 75% safe harbour ratio is exceeded.

Investments in associate entities

11.44 Current thin capitalisation rules focus on the entities that the New Zealand parent controls. Entities that the New Zealand parent does not "control", it is assumed, could not be used to over-allocate interest deductions to New Zealand.

11.45 However, the approach ignores an intermediate group of entities that a New Zealand company has significant influence over but does not control. A more precise approach to the interest allocation rules would take into account the funding relationships between the New Zealand company and these entities, which are commonly known as associate entities. Australia's interest allocation rules do this.

11.46 We have not suggested introducing similar rules at this time because of the complexity involved. The potential compliance costs for businesses of such rules are also a concern. The application of the interest allocation rules will, however, have to be monitored, to ascertain the need to buttress the rules in this way.

Miscellaneous issues

Implications for non-residents and non-resident controlled entities

11.47 It is intended that the amended interest allocation rules would apply to non-resident controlled entities that have to apply the existing thin capitalisation rules. They include any non-resident controlled entities that do not have any outbound investment.

11.48 The main proposals that apply to outbound investments are expected to have little or no effect on these non-resident controlled entities. Nevertheless, they could be affected by some of the technical amendments discussed in this chapter because:

- some fixed rate shares would be classified as liabilities; and
- a narrower definition of worldwide debt could apply.

[22] The 120% uplift on debt-to-equity ratio is equivalent to (120%× worldwide debt)/[(120%×worldwide debt)+worldwide equity].

Remedial issue

11.49 The December discussion document also raised a remedial issue that arises in relation to non-residents with New Zealand-sourced income. An example of this is non-residents who own land and buildings and are earning rental income in New Zealand. They are currently subject to New Zealand tax and the existing thin capitalisation rules should apply.

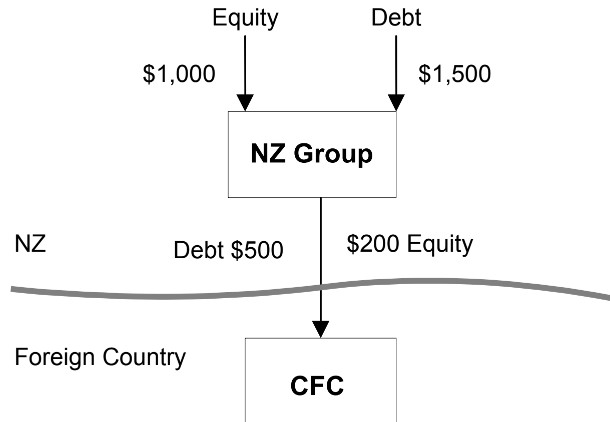
11.50 However, the current rules do not work properly in this case. A technical deficiency in the tax legislation allows non-residents without a permanent establishment who hold New Zealand assets directly to finance their assets entirely by debt. This deficiency should be corrected.

How the interest allocation rules will work

11.51 Examples 2A and 2B illustrate how the 75% safe harbour will operate.

Example 2 – Scenario A: CFC that is partly debt-funded

NZ Group invests $700 in an offshore CFC, $200 in the form of equity and $500 in the form of related party debt at arm's length terms.



The NZ Group is required to consider if it is subject to the interest allocation rules. The first step is to calculate the group's debt-to-asset ratio to see if it is within the 75% safe harbour limit.

For the purpose of determining the group's debt-to-asset ratio, the total debt and total assets of the NZ Group are as follows:

Total debt of NZ Group is

Financial arrangements that provide funds	$1,500
less fixed rate shares	$ 0
less on-lent amount	$ 500
	$1,000

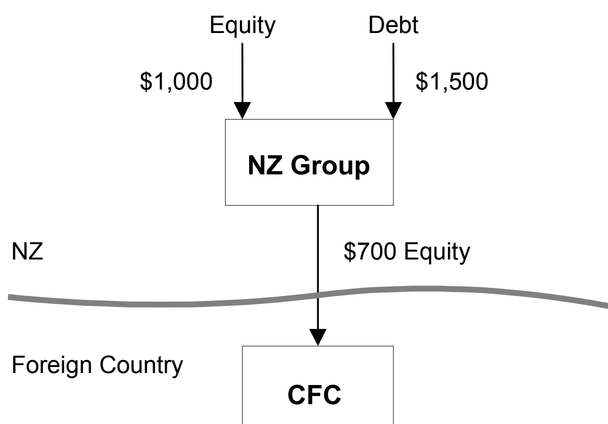
Total New Zealand assets of NZ Group are

Total consolidated assets in financial accounts	$2,500
less on-lent amount	$ 500
less equity investment in CFCs	$ 200
	$1,800

Therefore the NZ Group's debt-to-asset ratio is 1,000/1,800, which is 56%. This is within the 75% safe harbour, and the interest allocation rules will not apply to NZ Group.

Example 2 – Scenario B: CFC that is equity-funded

In this example, NZ Group invests $700 in an offshore CFC, all in the form of equity.



For the purpose of determining the group's debt-to-asset ratio, the total debt and total assets of the NZ Group are as follows:

Total debt of NZ Group is

Financial arrangements that provide funds	$1,500
less fixed rate shares	$ 0
less on-lent amount	$ 0
	$1,500

Total New Zealand assets of NZ Group are

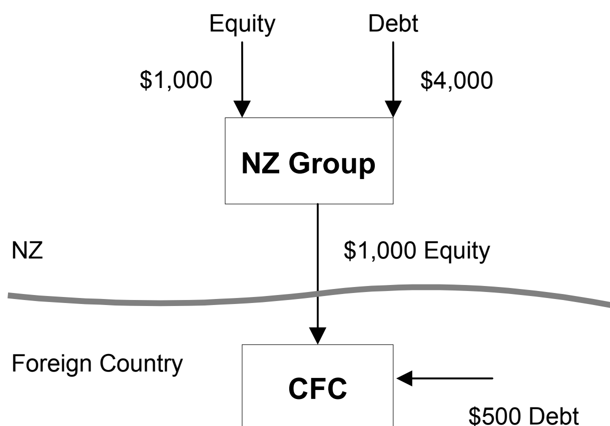
Total consolidated assets in financial accounts	$2,500
less on-lent amount	$ 0
less equity investment in a CFC	$ 700
	$1,800

The NZ Group's debt-to-asset ratio is 1,500/1,800, which is 83.3%. This ratio exceeds the 75% safe harbour, and apportionment may be required. The worldwide debt-to-assets ratio is 1500/2500, 60%, so 110% of this is 66%. Therefore the NZ Group's interest deduction will be apportioned on the basis of the 75% safe harbour. Broadly, (83.3%-75%)/83.3%, or approximately 10% of the total interest deduction will be denied under the proposed interest allocation rules.

11.52 Example 3 shows how the worldwide group debt ratio will operate.

Example 3: CFC that has external debt funding

In this example, NZ Group invests $1,000 in a CFC, all in the form of equity. The CFC has a bank loan of $500 that falls into the definition of worldwide debt.



For the purpose of determining the group's debt-to-asset ratio, the total debt and total assets of the NZ Group are as follows:

Total debt of NZ Group is

Financial arrangements that provide funds	$4,000
less fixed rate shares	$ 0
less on-lent amount	$ 0
	$4,000

Total New Zealand assets of NZ Group are

Total consolidated assets in financial accounts	$5,000
less on-lent amount	$ 0
less equity investment in CFCs	$1,000
	$4,000

The NZ Group's debt-to-asset ratio is 100% in this example. This is in breach of the 75% safe harbour. Therefore the NZ Group's interest deduction will have to be apportioned on the basis of the 75% safe harbour or 110% of the worldwide group debt percentage ratio, whichever is higher.

To calculate the worldwide group debt percentage ratio, NZ Group has to include all its consolidated worldwide debt, which is $4,500. The consolidated worldwide assets of the NZ Group are $5,500.

Overall, this amounts to a worldwide debt percentage ratio of $4,500/$5,500 (or 81.8%). As 110% of 81.8% is 90%, and this proportion is higher than 75%, the interest deduction will be apportioned on the basis of 90% under the interest allocation rules. Broadly, this means (100-90)/100, or 10%, of the interest deduction will be denied.