

13 October 2009

*A special report from the*  
Policy Advice Division of Inland Revenue

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## **New rules for taxing controlled foreign companies and foreign dividends**

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The recently enacted Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 introduces new rules for the taxation of foreign companies controlled by New Zealand residents and for foreign dividends received by New Zealand companies. The purpose of this report is to help affected businesses and their advisers understand the consequences of the changes.

### **Background**

The new rules represent a fundamental change to how New Zealand taxes offshore income earned through controlled foreign companies. The old system of taxing that income as it is earned is replaced by one that exempts the active offshore income of these companies. Further important features of the changes are an exemption from tax for most foreign dividends paid to companies and measures to protect the tax base as a result of adopting an active income exemption.

The purpose of these reforms is to bring New Zealand's tax rules into line with the practice in other countries and help New Zealand-based business to compete more effectively in foreign markets by freeing them from a tax cost that similar companies in other countries do not face. The changes will improve the competitiveness of New Zealand's tax system and encourage businesses with international operations to remain, establish and expand.

Previously, New Zealand residents were taxed on their share of all income earned by controlled foreign companies (CFCs) as that income accrued but with two significant exemptions:

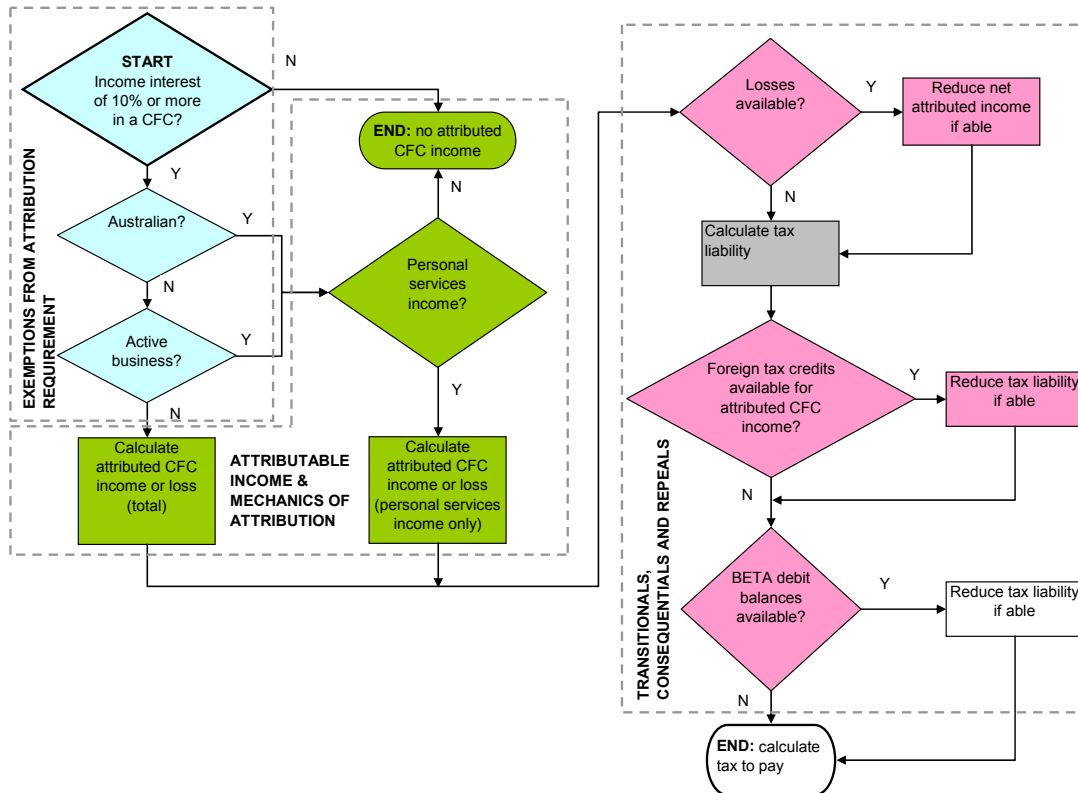
- The "grey list" provided an exemption from accrual taxation for CFCs based in one of eight listed countries (Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States).
- Conduit tax relief provided an exemption from accrual taxation for a New Zealand company with an income interest in a CFC to the extent that the New Zealand company was owned by non-residents.

New Zealand companies receiving foreign dividends were generally required to make a foreign dividend payment (FDP). Credits were available for foreign withholding taxes on the dividend, and also, for non-portfolio dividends, for foreign taxes on the underlying profits. A company receiving a non-portfolio dividend from a grey list country qualified for a deemed underlying foreign tax credit equal to its FDP liability on the dividend. Credits were also available under the branch equivalent tax account (BETA) mechanism to prevent double New Zealand taxation under the CFC and FDP rules.

Under the new rules, only certain types of income derived by CFCs will be attributed back to New Zealand shareholders. A “signposting” provision in section EX 18A shows how to find a person’s attributed CFC income or loss under the amended legislation.

Figure 1 below summarises how the new CFC rules are applied and where in this report they are explained.

Figure 1: using the new CFC rules



### Attributable income

Attributable income is referred to in the Act as the *attributable CFC amount* (a gross concept defined in section EX 20B) and as *net attributable CFC income or loss* (a net amount determined under sections EX 20C to EX 20E). In very broad terms, attributable income comprises passive income such as rent, royalties, certain dividends and interest. Taxing this income on accrual protects the domestic tax base against New Zealand-sourced income being shifted offshore to avoid tax.

In earlier policy documents, the terms “passive income” and “passive income definition” were used to describe the *attributable CFC amount*.

### Exemptions from attribution requirement

Under the new rules, the grey list and conduit exemptions have been repealed. Two categories of CFC are now exempt from the requirement to attribute income:

- *Non-attributing active CFCs* (section EX 21B). If less than 5 percent of a CFC's total income is attributable income, it is a non-attributing active CFC and neither its income nor its losses are attributable. This test may be undertaken either by applying the tax rules for measuring income (section EX 21D) or by reference to financial accounts, subject to certain adjustments (sections EX 21C and EX 21E).
- *Non-attributing Australian CFCs* (section EX 22). Broadly, if a CFC is resident and subject to tax in Australia, it is a non-attributing Australian CFC and is exempt from attribution.

### **Interest allocation rules**

The interest allocation rules in subpart FE are designed to prevent an excessive amount of debt from being allocated against the domestic tax base. Previously, these rules only applied to New Zealand entities controlled by non-residents. Now that much of the income derived by CFCs remains outside the New Zealand tax base, the rules have been extended so that they also apply to *outbound entities* – New Zealand residents with CFC interests, regardless of whether the entity is controlled by a non-resident.

The rules place an upper limit on interest deductions that can be taken against domestic income. Subpart FE already contains safe harbours and these also apply to outbound entities: interest deductions are not restricted unless the New Zealand group debt percentage is more than 75 percent (and, for a company or a trustee, is also more than 110 percent of the worldwide group debt percentage). Additional safe harbours and reliefs have been introduced for outbound entities which have most of their assets in New Zealand or have only modest interest deductions.

### **Treatment of foreign dividends**

The FDP rules in subpart RG have been repealed so that most foreign dividends received by New Zealand companies will now be wholly exempt.

Foreign dividends that are tax-deductible for the foreign company and dividends on fixed-rate shares are subject to income tax (section CW 9(2)(b) and (c)). If the foreign company is a CFC and the fixed rate or deductible dividend is paid to another CFC or New Zealand company, these distributions will be deductible in the same way as interest when calculating net attributable CFC income or loss. This prevents economic double taxation of attributable CFC income subsequently repatriated as a taxable dividend.

Dividends from non-attributing portfolio FIFs (that have less than 10 percent interest in a foreign company as described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39) will also be subject to income tax.

### **Application date**

The new rules apply for all income years beginning on or after 1 July 2009.

**Example 1**

Company A has a 30 April balance date. For its income year of 1 May 2009 to 30 April 2010 it will continue to apply the previous international tax rules. From its income year beginning 1 May 2010 it will apply the new international tax rules.

**Example 2**

Company B has a 30 June balance date. From its income year beginning 1 July 2009 it will apply the new international tax rules.

**Example 3**

Company C has a 30 November balance date. From its income year beginning 1 December 2009 it will apply the new international tax rules.

## **Exemptions from attribution requirement**

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*Sections CQ 2, DN 2, EX 21B to EX 21E, EX 22 and EX 23 of the Income Tax Act 2007; section 91AAQ of the Tax Administration Act 1994*

### **Key features**

#### ***Active business exemption***

A person with an income interest of 10 percent or more in a CFC will not generally have to include attributed CFC income or loss in the person's gross income if the CFC passes an active business test. This is expected to save most CFCs the work of calculating attributed income.

A CFC will pass the active business test and be a *non-attributing active CFC* if it has attributable income that is less than 5 percent of its total income. Attributable and total income, for the purposes of the test, are measured using either financial accounting or tax measures of income. These measures are defined in the legislation.

It is expected that most people will prefer to use accounting measures of income, because they will be more readily available or easier to calculate. Accounting measures may be used to calculate the ratio if they are taken from accounts that comply with international financial reporting standards (IFRS) and certain other conditions are met. Accounting measures of income based on pre-IFRS New Zealand financial reporting standards may also temporarily be used by some people, primarily small and medium-sized enterprises.

For people who do not wish to or are unable to use accounting measures of income, tax measures of income may also be used to calculate the ratio of attributable income to total income.

CFCs in the same country may be consolidated for the purposes of the calculation of the 5 percent ratio calculation, subject to certain conditions.

A CFC will also be a *non-attributing active CFC* for a person with an income interest in the CFC, if the person has applied for and obtained a determination from Inland Revenue that the CFC is an active insurance business.

### ***Australian exemption***

A person with an income interest of 10 percent or more in a CFC will not have to include attributed CFC income or loss in the person's gross income if the CFC is resident and subject to income tax in Australia, and meets certain other conditions. A CFC that meets these conditions is a *non-attributing Australian CFC*.

### ***Personal services income***

There is an exception to the active business and Australian exemptions for CFCs. If a CFC derives certain personal services income or incurs a loss in deriving such income, such income or loss is always attributed, even if the CFC is a non-attributing active CFC or a non-attributing Australian CFC.

### **Detailed analysis**

#### ***How to use the rules***

The goal is to work out whether a CFC qualifies for either the Australian or active business exemption.

Go to section EX 22 to work out whether or not the Australian exemption applies to a CFC.

If the Australian exemption does not apply, decide whether to use tax measures of income or accounting measures of income to check if the CFC qualifies for the active business exemption.

#### ***Use of accounting measures of income***

If accounting measures of income are to be used, they can be used for a single CFC or for a *test group* of CFCs.

If the measures are to be used for a test group, go to subsection EX 21E(2) to see which CFCs can be members of the test group.

Go to section EX 21C to determine whether a suitable accounting standard is available for the CFC or the test group and, if there is, choose that as the *applicable accounting standard*.

If no *applicable accounting standard* is available for the CFC or the test group, you will have to use tax measures of income.

If an *applicable accounting standard* is available, calculate the formula in subsection EX 21E(5) using accounts that comply with that standard. The formula is the ratio of attributable income to total income. There are six components in the formula, which are further explained in subsections EX 21E(7) to (12). Rules in subsection EX 21E(4) govern how the calculation is to be done. Subsection EX 21E(3) explains, based on the result of the calculation, whether the CFC or the CFCs in the test group qualify for the active business exemption.

If a CFC qualifies to use the active business exemption using accounting measures of income, there may still be some attributed CFC income or loss from the CFC under subsections CQ 2(2B) and DN 2(2).

If a CFC does not qualify to use the active business exemption using accounting measures of income, try again using tax measures of income.

*Use of tax measures of income*

If tax measures of income are to be used, they can be used for a single CFC or for a *test group* of CFCs.

If the measures are to be used for a test group, go to subsection EX 21D(1) to see which CFCs can be members of the test group.

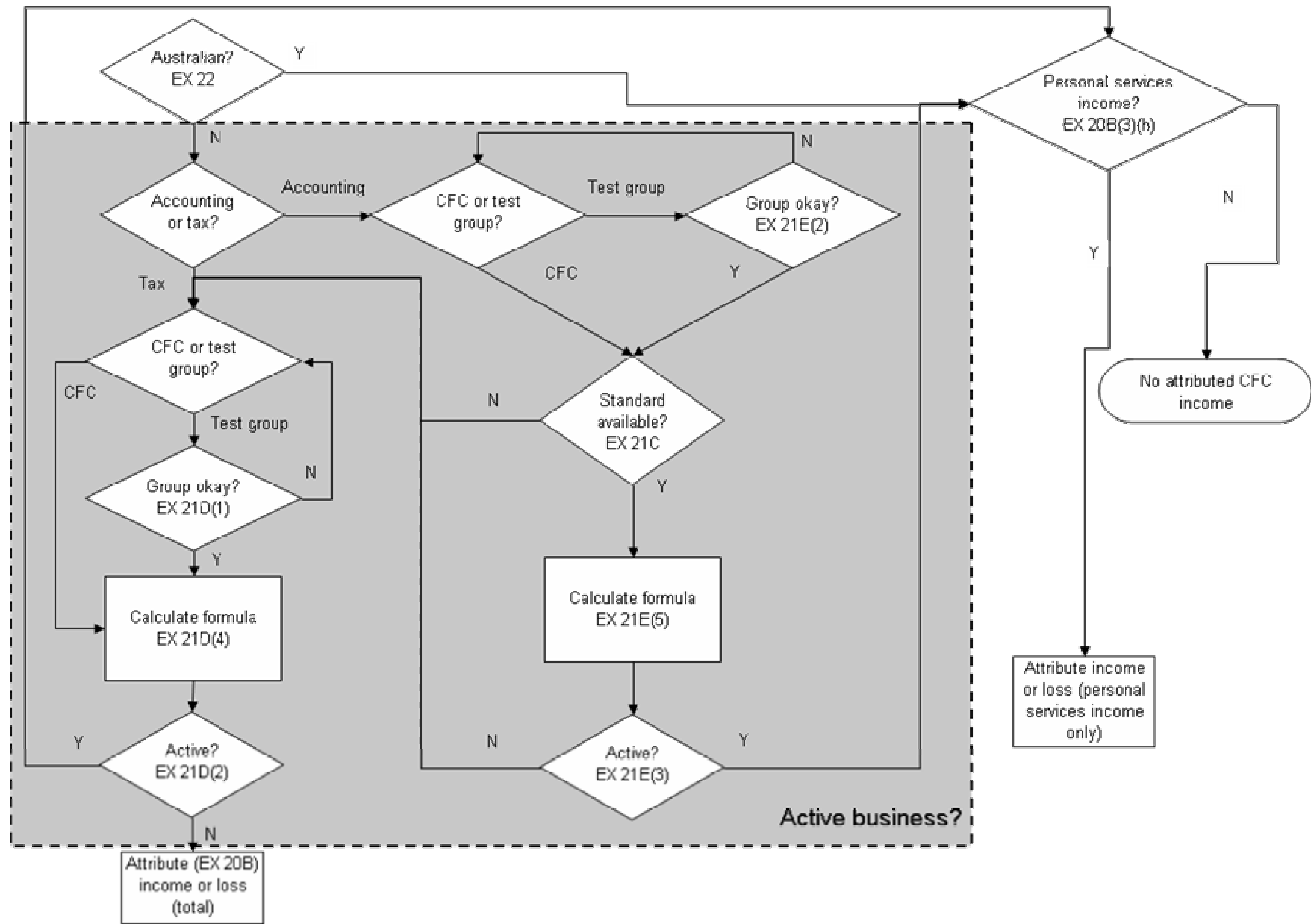
Go to subsection EX 21D(4) and calculate the formula there. This formula is the ratio of attributable income to total income. There are four components in the formula, which are further explained in subsections EX 21D(6) to (9). Rules in subsection EX 21D(3) govern how the calculation is to be done. Subsection EX 21D(2) explains, based on the result of the calculation, whether the CFC or the CFCs in the test group qualify for the active business exemption.

If a CFC qualifies to use the active business exemption using tax measures of income, there may still be some attributed CFC income or loss from the CFC under subsections CQ 2(2B) and DN 2(2).

If a CFC does not qualify to use the active business exemption using tax measures of income, certain income (see section EX 20B) from the CFC will be attributable under sections CQ 2 or DN 2.

Figure 2 illustrates the process described above.

Figure 2: How to use the rules



## ***Sections CQ 2 and DN 2 of the Income Tax Act 2007***

New paragraphs CQ 2(1)(h), CQ 2(1)(i), DN 2(1)(h) and DN 2(1)(i) apply to a person who holds an income interest in a CFC. If the CFC is a *non-attributing active CFC* or a *non-attributing Australian CFC*, the interest-holder does not have attributed CFC income under subsection CQ 2(1) or attributed CFC loss under subsection DN 2(1). In other words, these paragraphs implement the active business and Australian exemptions. The terms “non-attributing active CFC” and “non-attributing Australian CFC” are further defined in sections EX 21B and EX 22 respectively.

A holder of an interest in a non-attributing active CFC or a non-attributing Australian CFC may still have attributed CFC income under subsection CQ 2(2B), or attributed CFC loss under subsection DN 2(2). These subsections apply if the CFC derives income that is an amount of personal services income described by section EX 20B(3)(h). This income is always attributable.

Paragraph CQ 2(1)(g) has been repealed because there is no longer an exemption from attribution of CFC income for CFCs resident in grey list countries.

## ***The active business exemption (sections EX 21B to EX 21E of the Income Tax Act 2007)***

### ***Section EX 21B***

Section EX 21B defines a non-attributing active CFC as a CFC that:

- meets the requirements of section EX 21D (has a ratio of attributable to total income, using tax measures of income, of less than 5 percent); or
- is able to and chooses to apply section EX 21E, and meets the requirements of that section (has a ratio of attributable to total income, using accounting measures of income, of less than 5 percent); or
- meets the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 (is a CFC with an active insurance business).

A CFC may meet the requirements of sections EX 21D or 21E alone or as part of a *test group*. The income of the CFCs in a test group is consolidated for the purposes of calculating the ratio of attributable to total income, which can be advantageous for taxpayers. If the test group meets the requirements, all CFCs in the group are non-attributing active CFCs. There are additional requirements which must be met in order to use a test group. These are explained further in the analysis of sections EX 21C to 21E.

A CFC is a non-attributing active CFC for an accounting period of the CFC. If a CFC does not meet the requirements to be a non-attributing active CFC in one accounting period, it will not be a non-attributing active CFC in that period, regardless of whether it has been one in the past or will be one in the future. “Accounting period” is defined in section YA 1.

A CFC is a non-attributing active CFC for a person who holds an interest in that CFC. It is theoretically possible that one person with a 10 percent or greater interest in a CFC will be able to count that CFC as a non-attributing active CFC, but another person with a 10 percent or greater interest in the same CFC will not. This is expected to be rare in practice.



To meet the requirements of a determination made by the Commissioner under section 91AAQ of the Tax Administration Act 1994 for a particular accounting period, the taxpayer must first have applied for and obtained the determination and it must not have expired or been revoked. Section 91AAQ regulates this process. Secondly, any requirements laid out in the determination must also be satisfied. A CFC that fails to obtain a determination or to meet the requirements of the determination may still be a non-attributing active CFC if it meets the requirements of sections EX 21D or EX 21E.

*Accounting standards that may be used (section EX 21C)*

Section EX 21C states the sets of accounting standards that may be used to calculate the ratio of a CFC's attributable income to total income under section EX 21E, when a person holds an interest in that CFC. Certain conditions must be satisfied before any particular set of accounting standards can be used.

This means the person may be unable to use any of the sets of accounting standards because the relevant conditions are not satisfied. A person may also choose not to use any of the sets of accounting standards, even if they are available. In either case, the ratio of a CFC's attributable income to total income will be calculated under section EX 21D using tax measures of income.

If section GB 15C, which relates to use of the test in section EX 21E to avoid tax applies, it is not possible to use any of the sets of accounting standards in section EX 21C and so section EX 21D must be used to calculate the ratio of attributable income to total income. (See the analysis of section GB 15C for further information.)

If, under section EX 21C, a person is able use one or more sets of accounting standards to apply section EX 21E for a particular CFC or a particular test group of CFCs, only one set of accounting standards (called the *applicable accounting standard*) may be used for that purpose.

Subsection EX 21C(2) allows the use of generally accepted accounting practice with IFRS for a particular CFC if accounts exist that include the accounts of that CFC, those accounts comply with generally accepted accounting practice with IFRS, and specified audit requirements are met.

The accounts may be for the CFC alone or for a group of companies that includes the CFC. In the latter case, further work is likely to be required to separate amounts relating to the CFC when applying section EX 21E. The accounts may be held by the person who holds an interest in the CFC or by someone else. Under existing rules applying before enactment of section EX 21C, Inland Revenue can require that the accounts be produced to verify a tax position taken. (The comments in this paragraph apply equally to subsections EX 21C(4) and EX 21C(6)).

The term "generally accepted accounting practice with IFRS" means generally accepted accounting practice, as defined in section 3 of the Financial Reporting Act 1993, but with a restriction. The restriction is that the New Zealand equivalents to International Financial Reporting Standards must be used as the financial reporting standards referred to in that section. These New Zealand standards, referred to as "IFRS" in section YA 1 of the Income Tax Act 2007, have initially been issued by the International Accounting Standards Board, then approved, with modifications, by the New Zealand Accounting Standards Review Board. Some entities qualify to use a subset of these standards (the "framework for differential reporting for entities applying the New Zealand equivalents to the international financial standards reporting regime"). That subset is also acceptable for the purposes of section EX 21E.

The accounts must comply with generally accepted practice with IFRS. Often, absolute compliance is not practical but audited accounts will be treated as complying anyway. The analysis of subsection EX 21C(9) below provides further explanation.

The audit requirements are specified in subsection EX 21C(8). Analysis of that subsection below provides more information.

Subsection EX 21C(3) allows a person to use *generally accepted accounting practice with IFRS* for a *test group* of CFCs if accounts exist that include the accounts of the CFCs in the test group, the first-mentioned accounts comply with generally accepted accounting practice with IFRS, and specified audit requirements are met.

The *test group* is defined under subsection EX 21E(2) as a group of CFCs a taxpayer has an interest in, that are resident in the same country and that meet certain other requirements.

The complying accounts must include the accounts of all the CFCs in the test group. The complying accounts may also include the accounts of other entities, such as all the entities in a worldwide group. In that case, further work is likely to be required to separate amounts relating to the test group when applying section EX 21E. The accounts may be held by the person who holds an interest in the CFCs in the test group or by someone else. Under existing rules applying before the enactment of section EX 21C, Inland Revenue can require that the accounts be produced to verify a tax position taken. (Comments in this paragraph apply equally to subsections EX 21C(5) and EX 21C(7)).

The term “generally accepted accounting practice with IFRS” has the same meaning as in subsection EX 21C(2).

Subsection EX 21C(4) allows a taxpayer to use *IFRSEs* for a particular CFC if accounts exist that include the accounts of the CFC, the first-mentioned accounts comply with IFRSEs, and specified audit requirements are met.

An “IFRSE” is defined in section YA 1 as “an International Financial Reporting Standard approved by the International Accounting Standards Board, as amended from time to time”. In other words, subsection EX 21C(4) allows the use of accounts that comply with international financial reporting standards. Those standards are either required to be used or may be used in over 100 countries. In contrast, subsection EX 21C(2) allows the use of *New Zealand equivalents to* international financial reporting standards. In most respects, international financial reporting standards and the New Zealand equivalents to those standards are identical. However, that may not always be the case.

Subsection EX 21C(5) allows a taxpayer to use *IFRSEs* for a test group of CFCs if accounts exist that include the accounts of the CFCs in the test group, the first-mentioned accounts comply with IFRSEs, and specified audit requirements are met.

The term “IFRSEs” has the same meaning as in subsection EX 21C(4).

Subsection EX 21C(6) allows a person to use *generally accepted accounting practice without IFRS* for a particular CFC if specific requirements are met.

The term “generally accepted accounting practice without IFRS” means generally accepted accounting practice as defined in section 3 of the Financial Reporting Act 1993, but with the restriction that the financial reporting standards referred to in that section must not be New Zealand equivalents to international financial reporting standards. Pre-IFRS financial reporting standards (usually referred to as FRSs) will be used instead.

Subsection EX 21C(6) exists because a large number of small and medium-sized entities are not yet required to comply with New Zealand equivalents to international financial reporting standards, pending completion of a review of financial reporting requirements by the government. The subsection is intended to be temporary. It may be replaced or repealed as the future of reporting requirements becomes clearer or as FRS become outdated. The subsection is not to be used when accounts that comply with IFRS are available; IFRS accounts are to be preferred in that case.

The requirements that must be met to use generally accepted accounting practice without IFRS are that a company that is resident in New Zealand must:

- hold accounts that include the accounts of the CFC, that comply with generally accepted accounting practice without IFRS, and that meet specified audit requirements;
- not have revenue under either Financial Reporting Standard 34 or Financial Reporting Standard 35 (the intent is that insurance businesses will not be able to use generally accepted accounting practice without IFRS for the purpose of section EX 21E);
- not be an issuer under section 4 of the Financial Reporting Act 1993 in the current accounting period and not have been an issuer in the preceding accounting period;
- not be required by section 19 of the Financial Reporting Act 1993 to file its accounts with the Registrar of Companies;
- not be a large company under section 19A(1)(b) of the Financial Reporting Act 1993; and
- not have accounts (and not be a subsidiary of a company having accounts) that are prepared and audited under generally accepted accounting practice *with* IFRS (if such accounts are available, generally accepted accounting practice with IFRS should be used for the purposes of EX 21E).

Most but not all of the requirements match those in *Accounting Standards Review Board Release 9* (ASRB 9). ASRB 9 specifies the entities that are permitted to defer compliance with New Zealand equivalents to international financial reporting standards. In the event that ASRB 9 is withdrawn, amended or superseded, the requirements in the legislation will be unaffected.

Subsection EX 21C(7) allows a taxpayer to use *generally accepted accounting practice without IFRS* for a test group of CFCs if certain requirements are met. The requirements are mostly the same as those in subsection EX 21C(6), except that the accounts must include the accounts of all the CFCs in the test group, rather than just the accounts of the CFC. It is acceptable for the accounts to include the accounts of other entities, in addition to the CFCs in the test group. In that case, additional work is likely to be required to identify and separate amounts relating to the test group.

Subsection EX 21C(8) contains the two audit requirements that must be met in each of subsections EX 21C(2) to (7).

The first requirement in subsection (8) is that the accounts in question must be audited by a chartered accountant who is independent of the CFC and of the person who holds the accounts. In the case of a test group, the chartered accountant must be independent of all the CFCs in the test group.

The use of the term “chartered accountant” is regulated by the Institute of Chartered Accountants of New Zealand Act 1996, and requires membership of the New Zealand Institute of Chartered Accountants (NZICA). Because the accounts of a CFC will commonly be audited in a country other than New Zealand, requiring membership of NZICA in all cases is impractical. For that reason, it is also acceptable for the auditor to be a person who is not a chartered accountant (as defined in New Zealand legislation), provided they meet a professional standard, in their country, that is equivalent to the professional standard a chartered accountant must meet in New Zealand.

The second requirement in subsection (8) is that the auditor must have given an unqualified audit opinion or – in countries in which the term “unqualified audit opinion” is not used or has a different meaning – a type of audit opinion that is used in that country and is of a standard that is equivalent to an unqualified audit in New Zealand.

Subsection EX 21C(9) sets out the circumstances in which accounts will be treated as complying with a particular set of accounting standards for the purposes of subsections EX 21C(2) to (7). The subsection is required because accounts will rarely comply completely with accounting standards at a detailed level, even though they comply in all material respects. The fact that there is non-compliance at a detailed level should not, in general, prevent the use of the accounts for the purposes of applying section EX 21E.

The accounts will be treated as complying with the relevant standards if there is a statement in the accounts that they comply, the audit requirements of subsection EX 21C(8) are satisfied, and there is not evidence of wrong-doing or incompetence.

In the case of wrong-doing or incompetence, Inland Revenue must have reasonable grounds to suspect fraudulent activity, preparation of the accounts with an intent to mislead, or incompetence of the auditor. “Fraudulent activity” is fraudulent activity by the person who holds the interest in the CFC, by the CFC itself, by a CFC in the CFC’s test group, or by the auditor. “Mislead” and “incompetence” are not further defined.

Subsection EX 21C(9) does not affect in any way the requirements to keep records relating to CFCs, or the powers of Inland Revenue to require the production of records and other information relating to the CFC. If these records or information give Inland Revenue reasonable grounds to suspect fraud, an intent to mislead or incompetence, the accounts will not automatically be treated as complying with a particular set of accounting standards.

#### *The active business exemption using tax measures of income (section EX 21D)*

Section EX 21D sets out the rules for calculating the ratio of attributable income to total income when using tax measures of income. The ratio may be calculated either for a single CFC or, if certain requirements are met, for a *test group* of CFCs. If the ratio is not less than 0 and is less than 0.05, then in the case of a single CFC it will be a non-attributing active CFC, unless it is prevented from being one for some other reason (such as the application of section GB 15C). In the case of test groups, all the CFCs in the test group will be non-attributing active CFCs unless they are prevented from being non-attributing active CFCs for some other reason.

The ratio calculation, with only one exception, is based on amounts of income and no deductions for expenditure or losses incurred are included in the calculation.

Subsection EX 21D(1) contains the requirements that must be met for the ratio to be calculated for a test group of CFCs.

The first requirement is that all the companies must be resident in the same country. The test for residence in this case is that all of the companies are liable for income tax in the same country by reason of domicile, residence, place of incorporation, or centre of management. This is intended to exclude a CFC that is liable for tax in a country merely because of, for example, the presence of a permanent establishment in that country.

The second requirement is that the person undertaking the calculation (the person with the interest in the CFC) holds an income interest of more than 50 percent in each of the CFCs in the test group. This is intended to prevent a CFC being a part of a test group for more than one interest holder.

The third requirement is that all CFCs in the group must make the same choice of method and currency under subsection EX 21(4). They must either all make the choice to convert all transactions to New Zealand dollars at the applicable daily rate, or all make the choice to use the same reporting currency. If the reporting currency is used, subsections EX 21(5) and (6) must be observed in the normal way, and section EX 21(7) will apply to certain financial arrangements. The purpose of this provision is to limit the scope for manipulating the test by the deliberate choice of different reporting currencies for CFCs within the group.

The fourth requirement is that the CFCs in the test group must be consolidated for the purposes of the test (and only for the purposes of the test). Consolidation requires the elimination of all balances, transactions, income and expenses between CFCs in the group, and the use of like tax treatments for like transactions. For example, it would not be appropriate for different CFCs in the test group to use different options for calculating financial arrangement income for the same type of financial arrangement. It is expected that elimination will be carried out in a way that is consistent with accepted accounting principles. It is not expected or intended that there will be rigid compliance with any particular set of financial accounting standards. The rules for consolidation in subpart FM of the Income Tax Act 2007 are not to be used for the consolidation of CFCs.

Subsection EX 21D(2) designates a CFC (whether alone or as part of a test group) as a non-attributing active CFC if the ratio of attributable income to total income in subsection EX 21D(4) is less than 0.05 and, if zero, is not zero because of the application of paragraph EX 21D(3)(f). The ratio may be zero because attributable income is zero and there is some total income. In that case, the CFC is a non-attributing active CFC. If the ratio is zero for any other reason (paragraph EX 21D(3)(f) applies), the CFC is not a non-attributing active CFC. In that case, the formula has produced an unusual, and possibly unintended, result, so attribution is required.

Subsection EX 21D(3) explains how to apply the formula in subsection EX 21D(4).

If the formula is being applied for a test group, the test group is effectively treated as a single consolidated entity (using the consolidation described in the analysis of subsection EX 21D(1) in this report). Consolidated amounts are used in the formula. Consistent with the single-notional-entity approach, special rules apply if it is necessary to determine whether the test group is associated with a person or in the same group of companies as a person, such as in parts of section EX 21B. The person is associated with the test group if the person is associated with a member of the test group but is not a member of the test group. The person is a member of the same group of companies as a test group if the person is in the same group of companies as a member of the test group, but is not a member of the test group (these rules apply only for the purposes of calculating the formula and do not affect, for example, the application of the loss offset rules in Part I).

If either the numerator or denominator in the formula is negative, it is treated as being zero. The ratio calculation has been designed in such a way that a negative numerator or denominator should not be possible. If a negative result is produced, this is unintended and the result is set to zero.

If the denominator in the ratio formula is zero, the ratio is set to zero and the CFC will not be a non-attributing active CFC. A nil denominator implies either an unintended result or no activity on the part of the CFC. Because of the possibility of an unintended result, attribution is required. If the CFC is inactive, the calculation of attributed income should be trivial.

Subsection EX 21D(4) contains the formula for calculating the ratio of attributable income to total income.

The numerator contains the calculation of attributable income, being the attributable CFC amount for the CFC (or test group notionally treated as a single CFC) under section EX 20B, less two optional adjustments specified in subsection EX 21D(7).

The attributable CFC amount under section EX 20B is calculated using the rules in section EX 21. Those rules, broadly speaking, treat the CFC as resident in New Zealand for the purposes of the calculation. They also allow the use of a foreign currency for the bulk of the calculation, if certain conditions are met.

The first adjustment, if the holder of the interest in the CFC chooses to apply it, is to remove certain amounts relating to personal services under paragraph EX 20B(3)(h). These amounts are always attributable, but the adjustment means a CFC may qualify for the active business exemption in relation to its other income. It is not possible to remove the amount if it would also come within another paragraph of subsections EX 20B(3) or (4). The removal of the amount is only for the purposes of applying the active business exemption. When attribution is required, as it will be under either of subsections CQ 2(1) or (2B), the amount is included.

The second adjustment, which is again optional, is the subtraction of the cost of revenue account property if there would be an amount under paragraph EX 20B(3)(k) as a result of the disposal of the property. That paragraph includes the gross proceeds of the disposal as an attributable CFC amount. The effect of the adjustment is that only a net amount is included in attributable income. The adjustment is limited to the part of the cost of the property that would be allowed as a deduction for the period under section EX 20C, but also may not be more than the amount under paragraph (k). In this way, net losses on disposal are not possible. This is for partial consistency with the use of gross amounts in the ratio calculation. If any amounts would be required to be added back in relation to the deduction under subpart CH of the Income Tax 2007, they must also be added back in the formula.

The denominator in the formula contains the calculation of total income, being annual gross income for the accounting period less up to four adjustments.

Annual gross income is calculated, broadly speaking, as if the CFC were a resident (the term “annual gross income” is defined in section BC 2). As with the calculation of the attributable CFC amount under section EX 20B, section EX 21 applies to the calculation. Income under subpart CQ of the Income Tax Act 2007 is not included in the measure of annual gross income because existing “look-through” rules treat CFC or FIF interests held by a first CFC as held directly by the interest-holder in the first CFC. This is to prevent double-counting of gross income.

The first adjustment is only required if optional adjustments were made to the numerator in the formula. If amounts were subtracted from the numerator, they must also be subtracted from the denominator.

The second adjustment is the removal of any expenditure or loss included in the calculation of the attributable CFC amount under section EX 20B. In practice, there should never be any such amounts, because section EX 20B includes only income; this adjustment is a purely protective measure, to be used in the event that section EX 20B does not operate as intended. The subtraction of personal services income or the cost of revenue account property from the numerator of the formula, under subsection EX 20D(7), is not expenditure or loss under section EX 20B, but is in any case removed in the first adjustment.

The third adjustment is the removal of income derived by the CFC from a company, if the CFC and the company could be members of the same test group under subsection EX 20D(1). The purpose of this adjustment is to prevent the inflation of total income by transactions between associated entities. In determining whether the CFC and the company could be members of the test group, it is not relevant that the required consolidation has actually been undertaken or not. It is relevant that if a person *were to* undertake the required consolidation, the CFC and the company would be eligible to be members of the same test group.

The fourth adjustment is the removal of income derived by the CFC from a supply to a company that could not be a member of a test group with the CFC, if the supply was made with the purpose of inflating the measure of total income (the analysis of section GB 15B in this report provides further information). The third and fourth adjustments have a similar purpose, with the following differences:

- The third adjustment applies to income derived by a CFC from a company that could be part of a test group with the CFC, while the fourth adjustment applies when the company could not be part of a test group with the CFC.
- The third adjustment does not require any purpose, while the fourth adjustment requires the purpose of increasing the measure of total income.

The ratio in the formula in subsection EX 21D(4) will never be less than zero (subsection EX 20D(3) ensures this). The ratio may be zero if attributable income is zero, or because of the application of paragraph EX 21D(3)(f).

*The active business exemption using accounting measures of income (section EX 21E)*

Section EX 21E contains the rules for calculating the ratio of attributable income to total income when using accounting measures of income. The availability of an applicable accounting standard under section EX 21C is a prerequisite for the use of section EX 21E. The ratio may be calculated either for a single CFC or, if certain requirements are met, for a *test group* of CFCs. If the measure of total income is more than zero and the measure of attributable income is not negative, and the ratio is less than 0.05, then the CFC (or every CFC in the test group) will be a non-attributing active CFC. This is subject to any limitations imposed by other provisions, such as section GB 15C.

The calculation requires, firstly, a base calculation of attributable income, subsequently altered by some compulsory adjustments and some optional adjustments. Secondly, it requires a base calculation of total income, also subsequently altered by some compulsory adjustments and some optional adjustments. The altered measure of attributable income is finally divided by the altered measure of total income.

Amounts used in the ratio calculation must comply with the applicable accounting standard, but will often be taken to comply in the absence of strict compliance at a detailed level (see the analysis of subsection EX 21E(13) in this report). It is accepted that the accounting standards may change over time. Any guidance provided in this report about the meaning of particular terms under accounting standards may be made obsolete by changes in the standards.

The use of section EX 21E is purely optional (see subparagraph EX 21B(2)(b)(ii)). If a person chooses to apply the section but its requirements are not met for a CFC, subsection EX 21B(3) and section EX 21D must also be applied to the CFC (subject to other provisions such as section GB 15C). In other words, there is no automatic requirement to attribute CFC income or loss when the requirements of section EX 21E are not met; it will depend on whether it is a non-attributing CFC by some other means.

Most amounts used in the ratio calculation are gross amounts, with no deductions for expenditure or losses incurred. However, and in contrast to the ratio calculation that uses tax measures of income (section EX 21D), some amounts relating to derivatives and non-derivative financial assets are included even if they are losses or expenditure. This is not “net” treatment in the sense of subtracting all expenditure incurred in earning a particular item of income. Rather, losses or expenditure on some derivatives or financial assets are netted off against income or gains on other items. This is done to reduce the cost of calculating the ratio, in recognition that ledger accounts and items on the face of financial statements will often be reported net, or net of derivative gains and losses.

By allowing the use of net amounts in some cases, the legislation creates the possibility of negative measures of attributable income or total income. As is clear from the restrictions on the measures of attributable income (which must not be negative) and total income (which must be positive), a CFC with negative measures of income is not a non-attributing active CFC under section EX 21E.

Subsection EX 21E(1) contains the requirement that an applicable accounting standard under section EX 21C be available to the person for undertaking the ratio calculation.



Subsection EX 21E(2) contains the requirements that must be met for the ratio to be calculated for a test group of CFCs. Section EX 21C imposes further requirements relating to the sets of accounting standards (the *applicable accounting standard*) that may be used by the test group. It is possible that the requirements of subsection EX 21E(2) will be met, but that no applicable accounting standard will be available for use under section EX 21C. In that case, the ratio may not be calculated for the test group under section EX 21E.

The first requirement for using a test group is that all the CFCs in the group are required by the applicable accounting standard to be consolidated for the accounting period. Typically, this means all the CFCs will be under common control, but the accounting standard is the authoritative reference. If the applicable accounting standard does not require that a CFC is to be consolidated with all the other CFCs in the test group for the whole of the accounting period, the CFC is not to be included in the test group. It is acceptable for the CFC to be required to consolidate, under the applicable accounting standard, with entities outside the test group as well as those in the test group. If there are entities outside the test group, additional work is likely to be required to identify amounts pertaining to the test group.

The second requirement for using a test group is that all the companies in the test group must be resident in the same country. This is the same requirement imposed on a test group under section EX 21D.

The third requirement for using a test group is that the person applying the test (the person with an income interest in the CFC) holds an income interest of more than 50 percent in every company in the group. Again, this is the same requirement imposed on a test group under section EX 21D.

The fourth requirement for using a test group is that all the CFCs must use the same functional currency. The calculations under section EX 21E will effectively be undertaken using the functional currency of a CFC (see the analysis of paragraph EX 21E(4)(g)), and the use of different functional currencies within a test group would therefore complicate that calculation.

The final requirement for using a test group is that audited and consolidated financial statements, complying with the applicable accounting standard, must exist. These must contain the accounts of all the CFCs in the test group. As with the first requirement, it is acceptable for the consolidated financial statements to also include the accounts of companies not in the test group, but additional work is likely to be required in this case to isolate the amounts applicable to the test group. Subsection EX 21E(13) states that the financial statements (being accounts) will be taken to comply with the applicable accounting standard if they meet the requirements of section EX 21C in relation to that standard (see especially subsection EX 21C(9)).

Subsection EX 21E(3) is the rule that makes a CFC a non-attributing active CFC if the CFC's ratio of attributable income to total income is less than 0.05, its attributable income is not negative, and its total income is greater than zero.

Subsection EX 21E(4) explains how the ratio calculation in subsection (5) is to be undertaken.

Amounts used in the calculation must be determined under the applicable accounting standard. Amounts will be taken to be determined under the applicable accounting standard if they are actually determined under that standard, or if the requirements in subsection EX 21E(13) are met. Some of the adjustments to base measures of attributable income and total income require the use of tax measures of income or expenditure. In those cases, it is clear that the amount will not be determined under the applicable accounting standard.

Each item in the formula (there are six items) must be adjusted so that there is no double-counting of amounts. Double-counting could occur if, for example, an amount was both income from a financial asset under paragraph EX 21E(7)(f) and income from property used to back insurance assets under paragraph EX 21E(7)(h). Double-counting across items, rather than within an item in the formula should be automatically prevented by the structure of section EX 21E.

Paragraph EX 21E(4)(g) requires that amounts are to be determined for a CFC using the functional currency of the CFC. The functional currency of a CFC is determined by the applicable accounting standard and cannot be freely chosen. The concept of “functional currency” is much more restrictive than the concept of “the currency of the CFC’s financial accounts” in subsection EX 21(4).

Amounts may have to be translated from a currency that is not the functional currency of the CFC, such as when the CFC makes sales outside its own country. In that case, conversion to the functional currency must comply with the applicable accounting standard (with one exception). Translation under the applicable standard will frequently result in the recognition of an exchange rate gain or loss, and the gain or loss may need to be included in measures of attributable or total income. The one exception to the general rule is that exchange differences arising on a monetary item that forms part of a net investment of the CFC in a foreign operation are ignored. A monetary item that is part of a net investment in a foreign operation is an item for which settlement is neither planned nor likely to occur in the foreseeable future (see the definition in International Accounting Standard 21, for example).

If the ratio in subsection EX 21E(5) is calculated for a test group, the test group is – broadly speaking – treated as a single CFC for the purposes of the calculation. Amounts for the test group must be consolidated under the applicable accounting standard. This requires elimination of transactions, balances, income and expenses between the group members. If consolidated financial accounts exist that include the accounts of companies in the test group and only those companies, it may be possible to use those accounts without alteration. If consolidated accounts include entities that are not members of the test group, a sub-consolidation will be required for the test group. Information from consolidation worksheets may be used for this purpose, providing it meets the requirements of subsection EX 21E(13).

Because the test group is effectively treated as a single entity for the purposes of section EX 21E, there are special rules for determining when a person who is not a member of the test group is associated with the test group, or is a member of the same group of companies as the test group. The analysis of subsection EX 21D(3) in this report provides more information.

Each item in the formula is to be adjusted to remove amounts attributable to minority interests. “Minority interest” is not further defined in the legislation. However, it is clear from the context that a minority interest is an interest in the CFC held by a person who is not the interest-holder calculating the ratio.

Removal of amounts attributable to minority interests is most relevant for test groups. For an individual CFC, removal of these amounts is expected to affect all amounts equally so that the ratio in the formula is unchanged. For a test group, removal of these amounts is necessary to prevent, for example, *all* the income of an active business that is only partly owned by a New Zealand resident from sheltering attributable income of a company that is wholly owned by that resident.

### Example: Removal of minority interest

Gordon has a 70% income interest in CFC A and a 55% income interest in CFC B.

CFC A is an investment company that buys, holds, and sells intellectual property, bonds and shares. It also has a sideline in rubber importing. CFC A does not develop any intellectual property itself. CFC A has intra-group transactions comprising \$15,000 of sales of rubber to CFC B and \$86,000 of interest income from a loan to CFC B.

CFC B is a shoe manufacturer.

Gordon initially wishes to consolidate the two CFCs for the purpose of the active business test using accounting measures of attributable income and total income.

The accounts of the CFCs are shown below.

\$000s	CFC A			CFC B			Consolidated
	To/from CFC B	To/from 3rd parties	Total	To/from CFC A	To/from 3rd parties	Total	
<b>Income</b>							
Sales	15	13	28		20254	20254	20267
less cost of goods sold		17	17	15	14811	14826	14828
Gross profit			11			5428	5439
<b>Other income</b>							
Interest	86	351	437			0	351
Dividend		901	901			0	901
Royalties		574	574			0	574
<b>Operating expenses</b>							
Interest			0	86	2913	2999	2913
Loss on financial assets		33	33			0	33
Rent		5	5			0	5
Other expenses			0		5020	5020	5020
<b>Net profit before tax</b>			1885			-2591	-706
Attributable income (before removal of minority interests)						0	892
Total income (before removal of minority interests)						20254	21159
<b>Ratio</b>							<b>4.2%</b>

\$000s	30% minority interest removed CFC A			45% minority interest removed CFC B			Consolidated
	To/from CFC B	To/from 3rd parties	Total	To/from CFC A	To/from 3rd parties	Total	
<b>Income</b>							
Sales	11	9	20		11140	11140	11149
less cost of goods sold		12	12	8	8146	8154	8158
Gross profit			8			2985	2991
<b>Other income</b>							
Interest	60	246	306			0	246
Dividend		631	631			0	631
Royalties		402	402			0	402
<b>Operating expenses</b>							
Interest			0	47	1602	1649	1602
Loss on financial assets		23	23			0	23
Rent		4	4			0	4
Other expenses			0		2761	2761	2761
<b>Net profit before tax</b>			1320			-1425	-121
Attributable income (after removal of minority interests)							624
Total income (after removal of minority interests)							11773
<b>Ratio</b>							<b>5.3%</b>

Attributable income comprises:

- Interest
- Royalties
- Loss on financial asset (this is not a share)

Total income comprises:

- Sales income
- Interest
- Royalties
- Loss on a financial asset

[Note that dividends are removed under EX 21E(9)(a) and EX 21E(12)(b)]

If the two CFCs were consolidated without consideration of minority interests (as in the top half of table) there would be attributable income of \$892,000 and total income of \$21,159,000, giving a ratio – using the formula in subsection EX 21E(5) – of 4.2%.

However, minority interests must be removed line-by-line because, conceptually, Gordon has rights and obligations in respect of only 70% of all the income and expense items of CFC A, and 55% of all the expense income and expense items of CFC B.

So, for example, Gordon counts only  $\$437,000 \times 70\% = \$305,900$  of interest income from CFC A and eliminates  $\$86,000 \times 70\% = \$60,200$  (being his share of the amount received from CFC B), giving consolidated interest income of \$246,700 (as in the interest income line in the bottom half of the table).

After removing minority interests in the consolidation there is attributable income of \$624,400 and total income of \$11,773,200, giving a ratio of 5.3%. If a test group is used, the CFCs in the test group are *not* non-attributing active CFCs.

Gordon opts not to use a test group. CFC B, on its own, satisfies the test for being a non-attributing active CFC, since it has no attributable income. CFC A does not.

A test group applies the same rules for exchange rate conversion as an individual CFC. Consolidated financial accounts are presented in a *presentation currency*, which may differ from the functional currency of any of the entities whose accounts are being consolidated. Because all the entities in a test group will have the same functional currency, conversion to a different presentation currency is unnecessary and the functional currency should be used. For the avoidance of doubt, the legislation requires that if a presentation currency is used to calculate amounts, translation of all amounts from the functional to the presentation currency must be undertaken using an average exchange rate for the year. The effect is that the amounts in presentation currency will be nothing more than a scaled-up or scaled-down version of the amounts in the functional currency.

Subsection EX 21E(5) contains the formula for calculating the ratio of attributable income to total income using accounting measures of income.

The intent, in defining the items used in the numerator in the formula, was to define a measure of attributable income that was a reasonable approximation to the tax measure of attributable income, while not requiring excessive adjustments to readily available accounting measures. Similar comments apply to the denominator. In cases in which net amounts are allowed to be used in the formula, the approximation will not be to tax measures of gross income, but to tax measures of net income or loss.

The numerator in the formula consists of a base measure of attributable income (*reported passive*). There are subsequent compulsory upward adjustments (*added passive*) and then optional downward adjustments (*removed passive*). Double-counting and double-elimination are prevented by requiring that amounts are included in *added passive* only to the extent they are not already included in *reported passive*. Amounts are included in *removed passive* only to the extent that they are already in *added passive* or *reported passive*.

The denominator in the formula consists of a base measure of total income (*reported revenue*). There are subsequent optional upward adjustments (*added revenue*) and compulsory downward adjustments (*removed revenue*). As with the numerator, double-counting and double-elimination are prevented.

Subsection EX 21E(7) defines the base measure of attributable income (*reported passive*).

The measure includes dividend, royalty, rental and lease income, whether or not in the ordinary course of business, and all are measured on a gross basis. It is intended that these terms have the meanings they have under the applicable accounting standard, rather than their meanings in the Income Tax Act 2007. For example, if generally accepted accounting practice with IFRS or IFRSEs are used, International Accounting Standard 18 (Revenue) provides some guidance about the recognition of dividends and royalties when received in the ordinary course of business. International Accounting Standard 17 (Leases) provides some guidance about the recognition of interest, rents and other lease income under a lease. If the applicable standard provides no guidance, the meanings of dividend, royalty, rental and lease should be determined according to the general understanding of accountants who would apply the standard.

It is important to note that the label given to a component of income in the accounts or on the face of financial statements does not determine the character of the amount. For example, if an amount would be a royalty under International Accounting Standard 18, but is included in “Other income” in the income statement because it is not in the ordinary course of business, it is still a royalty for the purposes of subsection EX 21E(7).

Another component of reported passive income is interest income. This is measured on a gross basis (with no deduction for expenses). Interest income is recognised under generally accepted accounting practice with IFRS and IFRSEs under the Revenue Standard (International Accounting Standard 18), if the interest is received in the course of ordinary activities of the entity. That standard specifies that the effective interest method (set out in International Accounting Standard 39) is to be used to calculate the amount of interest (this is essentially a yield-to-maturity calculation). Interest income may also be recognised other than under the Revenue Standard, such as when not in the ordinary course of activities of the entity. Again, the effective interest method would normally be used. It is expected that similar principles would apply under generally accepted accounting practice *without* IFRS, although there is no relevant standard to spell this out.

A further component of reported passive income relates to income or loss from a financial asset that is not a derivative.

The income or loss is included if it is a change in the reported fair value of the financial asset, a gain or loss on the derecognition of the asset or a foreign exchange gain or loss on the asset. Income or loss is to be included regardless of whether or not it appears in the income statement or elsewhere in the accounts. Losses will occur if the reported fair value declines, there is a loss on derecognition of the asset or there is a foreign exchange loss on the asset. Losses will not occur because expenditure, such as the cost of borrowing to purchase the asset, has been incurred in deriving income from the asset. Such expenditure is ignored for the purposes of the ratio calculation.

Not all amounts of income that relate to financial assets are included under paragraph EX 21E(7)(f). For example, some interest income is recognised under paragraph EX 21E(7)(b) even though it flows from the holding of a financial asset. If an amount is included under paragraph (f) *and* another paragraph, subparagraph EX 21E(4)(a)(ii) allows an adjustment to prevent double-counting.

### Example 1: income or loss from a financial asset (held-to-maturity)

Sandy owns SPECo, a CFC with a functional currency of CUA.\* On 1 April 2011 SPECo purchases a bond newly issued by a foreign government, for CUB973,357. The bond has a term of 3 years, a face value of CUB1,000,000, and pays interest six-monthly at a rate of 6% per annum. The effective interest rate on the bond is 7% per annum. The CUA/CUB exchange rate is initially 1.00, but rises to 0.50 (CUA appreciates) on 31 March 2012. The bond is classified as a held-to-maturity investment under NZIAS 39, so is to be measured (subsequent to recognition) at amortised cost using the effective interest method.

On 31 March 2012, following the usual payment of interest, the foreign government announces that it is facing a fiscal crisis and will be unable to service its debt as previously agreed. In future, it will pay no interest and will repay only 80% of the face value of bonds on maturity. On 31 March 2013, SPECo sells the bond for CUB700,000.

The following table shows the financial accounting calculation of income and losses from the bond.

#### At recognition (CUB)

	Cashflows	Accrued interest	Interest received	Amortised cost
1-Apr-11	-973,357			973357
30-Sep-11	30000	34068	30000	977425
31-Mar-12	30000	34210	30000	981635
30-Sep-12	30000	34357	30000	985992
31-Mar-13	30000	34510	30000	990502
30-Sep-13	30000	34668	30000	995169
31-Mar-14	1030000	34831	30000	0
Effective rate	7.00%			

#### Actual outcome (CUB)

	Bond	Accrued interest	Interest received	Amortised cost	Impairment	Sale price	Gain/loss on sale
1-Apr-11	-973,357			973357			
30-Sep-11	30000	34068	30000	977425			
31-Mar-12	30000	34210	30000	697154	-284481		
30-Sep-12	0	24400	0	721554			
31-Mar-13	0	25254	0	746809		700000	-46809
30-Sep-13	0	26138	0	772947			
31-Mar-14	800000	27053	0	0			

#### Actual outcome (CUA)

	Exchange rate	Accrued interest	Interest received	Amortised cost	Impairment	Forex gain/loss	Sale price	Gain/loss on sale
1-Apr-11	1.00			973357				
30-Sep-11	1.00	<b>34068</b>	30000	977425		0		
31-Mar-12	0.50	<b>17105</b>	15000	348577	<b>-142240</b>	<b>-488712</b>		
30-Sep-12	0.50	<b>12200</b>	0	360777		0		
31-Mar-13	0.50	<b>12627</b>	0	373404		0	350000	<b>-23404</b>

Attributable income in relation to the bond comprises the accrued interest earned over the period of ownership, the foreign exchange loss in the period ended 31 March 2012, and a loss on sale in the period ended 31 March 2013 (see bold type in the table above). The impairment loss is also intended to be included in attributable income. There is a total loss over the period of ownership, for the purposes of the test, of \$578,357.

\* CUA = Currency A, CUB = Currency B

### Example 2: income or loss from a financial asset (at fair value through profit and loss)

The same bond used in Example 1 is accounted for as a financial asset at fair value through profit and loss.

#### Actual outcome (CUB)

	Cashflows	Interest received	Interest rate	Fair value	Fair value gain/loss	Sale price	Gain/loss on sale
1-Apr-11	-973,357		7.00%	973357			
30-Sep-11	30000	30000	7.00%	977425	4068		
31-Mar-12	30000	30000	7.00%	697154	-280271		
30-Sep-12	0	0	6.50%	726808	29654		
31-Mar-13	0	0	6.75%	748616	21808	700000	-48616
30-Sep-13	0	0					
31-Mar-14	800000	0					

#### Actual outcome (CUA)

	Exchange rate	Interest received	Fair value	Forex gain/loss	Fair value gain/loss	Sale price	Gain/loss on sale
1-Apr-11	1.00		973357				
30-Sep-11	1.00	30000	977425	0	4068		
31-Mar-12	0.50	15000	348577	-488712	-140135		
30-Sep-12	0.50	0	363404	0	14827		
31-Mar-13	0.50	0	374308	0	10904	350000	-24308

Attributable income comprises interest received, changes in the reported fair value of the asset (which include a forex loss, a loss due to market interest rate movements and a loss due to the government announcement), and a loss on sale. There is a total loss over the period of ownership, for the purposes of the test, of \$578,357.

### Example 3: income or loss from a financial asset (available-for-sale)

The same bond used in Example 1 is accounted for as an available-for-sale financial asset.

#### Actual outcome (CUB)

	Cashflows	Accrued interest	Interest received	Amortised cost	Impairment	Interest rate	Fair value	Sale price	Gain/loss on sale
1-Apr-11	-973357			973357		7.00%	973357		
30-Sep-11	30000	34068	30000	977425		7.00%	977425		
31-Mar-12	30000	34210	30000	697154	-284481	7.00%	697154		
30-Sep-12	0	24400	0	721554		6.50%	726808		
31-Mar-13	0	25254	0	746809		6.75%	748616	700000	-46809
30-Sep-13	0	26138	0	772947					
31-Mar-14	800000	27053	0	0					

#### Actual outcome (CUA)

	Exchange rate	Accrued interest	Interest received	Amortised cost	Impairment	Forex gain/loss	Fair value	Fair value gain/loss	Sale price	Gain/loss on sale
1-Apr-11	1.00			973357			973357			
30-Sep-11	1.00	34068	30000	977425		0	977425	0		
31-Mar-12	0.50	17105	15000	348577	-142240	-488712	348577	0		
30-Sep-12	0.50	12200	0	360777		0	363404	2627		
31-Mar-13	0.50	12627	0	373404		0	374308	-1723	350000	-23404

Attributable income comprises interest income (using the effective interest method), changes in the reported fair value of the asset (whether the corresponding entries are in the income statement, such as for exchange rate changes and impairment, or directly in equity), and a loss on sale.

On sale of the bond, any amounts recorded directly in equity – which have already been counted as attributable income – are transferred to the income statement by including them in the loss on sale. However, it is not intended that the income or loss be counted again when this occurs. So although the loss on sale reported in the accounts is \$23,404, the gain of \$904 that is being transferred from equity is removed, giving a loss on sale to be recognised in the test of \$24,308. This gives a total loss over the period of ownership of the bond, for the purposes of the test, of \$578,357.



The definitions of “financial asset”, “derivative” and “derecognition” are contained in NZ IAS 39 (the New Zealand equivalent to International Accounting Standard 39), regardless of the applicable accounting standard being used in section EX 21E. In the case of “financial asset”, the definition is by reference to the definition in NZ IAS 32. The definitions from NZ IAS 39 are used only for the purposes of identifying which assets are non-derivative financial assets and when they are effectively disposed of, not for determining how these assets are measured. If, for example, generally accepted accounting practice *without* IFRS is being used as the applicable accounting standard, a person will use NZ IAS 39 to identify which assets of the CFC are financial assets. Having identified the assets, the person may use the values of those assets as determined under generally accepted accounting practice without IFRS. The use of the definitions from NZ IAS 39 is necessary because generally accepted accounting practice without IFRS does not rigorously define “financial asset” or “derivative”.

Income or losses from shares that are not revenue account property are excluded from the ambit of paragraph EX 21E(7)(f). This is to obtain a better approximation to tax measures of income; the assumption is that gains or losses on these shares would not be income or loss if tax measures of income were used. The term “revenue account property” is defined in section YA 1 of the Income Tax 2007 and is intended to have that meaning.

Another component of reported passive is income or loss from a derivative instrument. “Derivative instrument” is to be given the definition in NZ IAS 39. As with the use of NZ IAS 39 definitions for the purposes of paragraph EX 21E(7)(f), the definition is used only to identify which items the CFC holds are derivative instruments. Subsequent measurement is undertaken using the applicable accounting standard, whatever that may be.

Income or loss from a derivative may be recorded directly in the income statement in a set of accounts (profit and loss), or may be recorded directly as a component of equity and only later recognised in the income statement. It is only to be included in reported passive when it is recognised in the income statement. This is intended to prevent excessive volatility when cashflow hedges are used and the hedged cashflow has not yet occurred (assuming that hedge accounting can be used).

Income or loss from a derivative instrument is included only if the instrument is held for dealing, not held in the ordinary course of business, or is hedging the accounting measure of attributable income or a transaction that would give rise to such attributable income. In general, derivative income or losses will *not* be in reported passive to the extent they are the result of hedges of active income (income that is not attributable). This recognises that CFCs with active business will use derivatives to limit risk. For example, derivatives may be used to remove the risk that the exchange rate will fluctuate when sales of goods are made in a foreign currency.

The terms “ordinary course of business” and “dealing” are not further defined in the legislation.

A “hedging relationship” must be one of a type defined in NZ IAS 39. Again, this applies only to identify when there is a hedging relationship, not to determine how to measure any income or loss from a derivative instrument that is in a hedging relationship. NZ IAS 39 defines three types of hedging relationship. The two that are expected to be most common in practice are:

- a hedge of the exposure to changes in fair value of an asset or liability;

- a hedge of the exposure to variability in cashflows that could affect profit and loss and that is attributable to a particular risk associated with an asset or liability or to a highly probable transaction.

It is not necessary for the hedging relationship to qualify for hedge accounting treatment (under generally accepted accounting practice with IFRS or IFRSEs, this requires proper designation of the hedge and that the hedge be highly effective). However, the effectiveness of the hedging relationship and the existence of documentation of a hedge may be relevant in determining whether a hedge really exists. If a purported hedging relationship is not effective or only partly effective, it is likely that income from the hedge will be attributable income anyway (it is either not held in the ordinary course of business or the business deals in derivatives).

When the hedge is effective enough that a hedging relationship exists, but the hedge is still partly ineffective, the part of the gain or loss that reflects the ineffective portion of the hedge will normally be included in attributable income. This is because the legislation refers to “income or loss [...] from a hedging relationship [with the accounting measure of attributable income]”, and does not limit the income or loss to the amount attributable to the effective portion of the hedge. This is the case even though income or loss from the ineffective portion of the hedge may be presented in a different line item in the accounts.

If a CFC uses a derivative to hedge both non-attributable and attributable income (or transactions that give rise to both non-attributable and attributable income), the hedge gain or loss is recognised only to the extent it relates to the hedging relationship with attributable income. This will require apportionment on a reasonable basis. Any income or loss attributable to the ineffective portion of a hedge will usually be included in the amount to be apportioned.

**Example: Derivative gain (foreign currency hedge)**

CFCA, which has a functional currency of Canadian dollars takes out a single contract for exchange rate cover. It covers \$1,000,000 of US dollar sales and interest income over the following income year.

CFCA subsequently receives US\$700,000 of sales income and US\$100,000 of interest income at the end of the year. The Canadian/US dollar exchange rate ends up higher than expected at the time the hedge was taken out. There is a gain on the foreign currency hedge of CA\$333,333. This offsets sales and interest income that was CA\$300,000 lower than expected because of the stronger exchange rate.

The exchange rate cover contract is a derivative instrument. The instrument is in a hedging relationship (a cashflow hedge) with non-attributable income (sales). The instrument is also in a hedging relationship with attributable income (interest), and the income attributable to this hedging relationship should be included in *reported passive*.

A reasonable apportionment of the hedge gain in this case would be CA\$41,667, being  $US\$100,000 \div (US\$700,000 + US\$100,000) \times CA\$333,333$ .

The hedge is not completely effective, and \$33,333 of the derivative gain is attributable to the ineffective portion of the hedge. In the foregoing apportionment, one-eighth of the ineffective portion is attributed to the hedging relationship with interest income.

The final amount included in *reported passive* is income or gains from a business of insurance. This includes premium income from insurance or re-insurance activities. It also includes income or gains from property used to back insurance assets, such as interest, dividends, rents or fair value changes flowing from assets held to satisfy future insurance claims. If generally accepted accounting practice with IFRS or IFRSEs are used, International Financial Reporting Standard 4 or its New Zealand equivalent are likely to apply to such income.

There should be no income from a business of insurance if using generally accepted accounting practice *without* IFRS. CFCs are prevented from using that set of standards as the applicable accounting standard if they have insurance income under the relevant FRSS.

Subsection EX 21E(8) defines the compulsory upward adjustments to the base measure of attributable income (*added passive*). There are four adjustments.

The first adjustment is to add income from a life insurance policy that would be included in the attributable CFC amount under paragraph EX 20B(3)(g). This adjustment was included primarily because some life insurance products, even though excluded from the scope of the financial arrangement rules in the Income Tax Act 2007 and the financial instrument rules in NZ IAS 39, are close substitutes for interest-bearing investments. The amount to include is to be determined under tax concepts (see the analysis of section EX 20B in this report for more information). If an accounting measure of such income has already been included under subsection EX 21E(7) but the tax measure is higher, the difference must be added.

The second adjustment is to add income from the disposal of revenue account property that would be included in the attributable CFC amount under paragraph EX 20B(3)(k). The adjustment does not apply to the disposal of a share, a financial arrangement or a life insurance policy, because other provisions are designed to capture gains in those cases. The adjustment also does not apply unless the property is used in a way giving rise to income or gains that increase the accounting measure of attributable income. The amount of the upward adjustment is the same as the amount that would be included under paragraph EX 20B(3)(k), except to the extent the amount is already included in *reported passive*. See also the analysis of paragraph EX 21E(9)(d), which may allow removal of the cost of the property.

The remaining adjustments add income from services that would be part of the attributable CFC amount under paragraphs EX 20B(3)(l) to (n), which relate to income from services physically performed in New Zealand and certain income from the supply of telecommunications services. The amount of the upward adjustment is the same as the amount that would be included under the relevant paragraphs in subsection EX 20B(3), except to the extent the amount is already included in *reported passive*.

Subsection EX 21E(9) defines the optional downward adjustments to the base measure of attributable income (*added passive*). There are four adjustments. If a person chooses not to apply the adjustments, there is no adjustment.

The first adjustment is the removal of dividend income that would not be part of an attributable CFC amount under paragraphs EX 20B(3)(a) to (c). First, the amount that would not be part of the attributable CFC amount under those paragraphs is determined. That amount is then removed, but only to the extent that it was included in *reported passive* or *added passive* to begin with.

The second and third adjustments are the removal of royalty or rental income that would be attributable CFC amounts but are not, because they come within one or more of the exceptions in paragraphs EX 20B(5)(a) to (d) and EX 20B(7)(a) to (c). The amount to remove is the amount determined under those paragraphs, using tax measures of income. Removal is permitted only to the extent the amounts were already included in reported passive or added passive.

The fourth adjustment is the removal of the cost of revenue account property that, on disposal, produced an attributable CFC amount under paragraph EX 20B(3)(k). Such an amount was included, on a gross basis, in *added passive*. The effect of subtracting the cost is that only the net profit from the sale is included in attributable income. In order to be removed, further requirements must be met. The first requirement is that the amount of cost subtracted would have been an allowable deduction of the CFC in the accounting period if the CFC were resident in New Zealand. The second requirement is that the amount subtracted may not exceed the gross proceeds of the sale already included in *added passive* or (less likely) *reported passive*. Any amounts that would have to be added back in relation to the deductions under subpart CH of the Income Tax Act 2007, if the CFC were a New Zealand resident, reduce the amount of cost that is subtracted.

Subsection EX 21E(10) defines the base measure of total income (*reported revenue*) used in the ratio of attributable income to total income.

The core item of reported revenue for most CFCs with active businesses will be “revenue”. If the applicable accounting standard is *generally accepted accounting practice with IFRS* or *IFRSEs*, the amount of revenue to recognise is dictated by International Accounting Standard 18 (IAS 18, Revenue). If the applicable accounting standard is generally accepted accounting practice *without IFRS*, the amount of revenue to include is the amount reported as *operating revenue*. It is expected that revenue, under any standard, will usually include income from interest, dividends and royalties. It might not include income from leases because most lease income is excluded from IAS 18; if there is lease income that is not included in revenue under IAS 18, this income is included separately under paragraph EX 21E(10)(b). Revenue is also expected to include most income from the supply of services, such as attributable CFC amounts under paragraphs EX 20B(3)(l) to (n).

Another component of reported revenue is gains or losses on certain non-derivative financial assets. The description of this item is identical to the description in paragraph EX 21E(7)(f). The amount to be recognised may, however, be different from the amount under subsection (7), depending on whether some of the income is already included in revenue (there should be no double-counting).

A further component of reported revenue is gains or losses on certain derivative instruments. The description of this component is very nearly the same as the description in paragraph EX 21E(7)(g). The only difference is that instead of the hedging relationship being with the accounting measure of attributable income or transactions that would give rise to such attributable income, the hedging relationship must be with the accounting measure of total income. In practice, this component of reported revenue should bring in nearly all hedges except those that relate to expenses or liabilities.

**Example: Derivative gain (foreign currency hedge of income and expenses)**

CFCB, which has a functional currency of Canadian dollars, takes out a single contract for exchange rate cover. It covers US\$100,000 of *net* costs over the following income year, being US dollar purchase costs less US dollar sales and interest income.

The exchange rate cover contract is a derivative instrument. The instrument is in a hedging relationship (a cashflow hedge) with expenditure. More precisely, it is in a hedging relationship with the amount of expense that is forecast to exceed income.

The amount of any hedge gain or loss is not included in *reported revenue*, because the hedging relationship is not with income.

The final component of reported revenue is insurance income. The description of this component is the same as the description in section EX 21E(7)(h). This will often have the character of revenue, but income from insurance contracts that is dealt with in International Financial Reporting Standard 4 (and its New Zealand equivalent) is explicitly excluded from the revenue standard IAS 18 (and its New Zealand equivalent).

Subsection EX 21E(11) defines the optional upward adjustments to the base measure of total income (*added revenue*). There are two adjustments. They add certain income from a life insurance policy or certain income from the disposal of revenue account property. These adjustments are described in the analysis of subsection EX 21E(8). The assumption behind these adjustments is that such amounts are more likely than others not to be included in revenue or operating revenue, because they will often not be in the ordinary course of business.

Subsection EX 21E(12) defines the compulsory downward adjustments to the base measure of total income (*removed revenue*). There are seven adjustments.

The first adjustment is the removal of the cost of revenue account property, if it was also removed from the measure of attributable income under paragraph EX 21E(9)(d).

The second adjustment is the removal of the amount of a dividend, if it was also removed from the measure of attributable income under paragraph EX 21E(9)(a). Bearing in mind the desire to produce a reasonable approximation to the tax measure of total income, the basis for removal is that these dividends would not be gross income of a New Zealand-resident company. However, to reduce compliance costs, if the dividends are not removed from the measure of attributable income, they are not required to be removed from total income either.

The third adjustment is the removal of personal services income that would be an attributable CFC amount under paragraph EX 20B(3)(h). This income is disregarded for the purposes of the ratio calculation, though will still be taxable under subsections CQ 2(2B) and DN 2 if the CFC qualifies for the active business exemption. In contrast, the personal services income was not explicitly removed from attributable income (the numerator in the formula), because it is unlikely to have been included in any of the categories of attributable income using accounting measures.

The fourth adjustment is the removal of income or loss from a share that is not revenue account property. "Revenue account property" is defined in section YA 1. The income or loss may have been included in reported revenue (as operating revenue, for example, if generally accepted accounting practice without IFRS was the applicable accounting standard). This adjustment is for greater consistency with the tax measure of total income (gross income).

The fifth adjustment is the removal of income derived by the CFC from a second CFC, if the second CFC could be part of a test group with the first CFC. This is to prevent the inflation of total income by arrangements between associates.

The sixth and seventh adjustments apply only when the applicable accounting standard is generally accepted accounting practice without IFRS. The inclusion of *operating revenue*, which is a very wide measure, in *reported revenue* makes these adjustments necessary; they are not thought to be required in relation to the much narrower measure of revenue as defined under IAS 18 or the New Zealand equivalent.

The sixth adjustment removes income if it is income from a liability, such as a reduction of a provision. It is possible that such income would be included in operating revenue, although this would be rare. Income from a liability is not removed if it is income in the ordinary course of business from a sale or supply of services. This might be the case, for example, when a prepaid service is provided, with the income in that case corresponding to a reduction of an unearned income liability.

The seventh adjustment removes income if it is income from an asset that is not a financial asset and not revenue account property. “Financial asset” is defined in NZ IAS 32, but that standard is used only to identify relevant assets, not to measure income relating to those assets. “Revenue account property” is defined in section YA 1. This adjustment prevents, for example, revaluations of real property from being included in the measure of total income. It could be possible, although unusual, for such amounts to be included in “operating revenue”. The adjustment is intended to provide a closer approximation to tax measures of income.

Subsection EX 21E(13) sets out the conditions under which accounts are taken to meet the requirements of the applicable accounting standard. Strict compliance at a detailed level with the requirements of the standard will often not be practical, and an unqualified audit opinion will usually require compliance only in all material respects. Therefore, this subsection does not require strict compliance.

The primary requirement in subsection EX 21E(13) is that the accounts meet the requirements of section EX 21C for the applicable accounting standard (see particularly section EX 21C(9)). This means, in simplified terms, the accounts must state they comply with the relevant standard, the accounts must have received an unqualified audit by an independent chartered accountant, and there must not be reasonable grounds to suspect fraud, intent to mislead or incompetence.

If only information taken directly from published accounts were used in the test, this primary requirement could be sufficient.

However, this will sometimes not be the case. For example, in producing consolidated accounts for a corporate group, each CFC might provide information in a relatively aggregated form (such as line items actually appearing in the financial statements). When more detailed information is required, this will not be taken from the accounts that have been audited but directly from the CFC’s internal accounting systems or from other similar sources.

This information will still be taken to comply with the relevant accounting standard, as long as:

- it is information that is drawn from the compliant accounts (even though not appearing on the face of financial statements), or that was used to prepare the compliant accounts (such as detailed information from CFC accounts that has been aggregated before being provided for the preparation of the compliant accounts); and
- the information is consistent with the compliant accounts; and
- there is no evidence of fraud, intent to mislead or incompetence (see the analysis of subsection EX 21C(9) for further information).

The word “consistent” is not further defined, so has its ordinary meaning. One implication of the consistency requirement is that information from the compliant accounts should be used if available, in preference to other information.

As with subsection EX 21C(9), nothing in subsection EX 21C(13) affects requirements to keep records or information, or to make those available when required by Inland Revenue.

### ***The Australian exemption (sections EX 22 and 23 of the Income Tax Act 2007)***

Section EX 22 defines a non-attributing Australian CFC.

A CFC qualifies to be a non-attributing Australian CFC if it is resident in Australia and is subject to income tax in Australia.

“Resident in Australia” means resident in Australia according to the Income Tax Act 2007. See, for example, section YD 2. There is also a requirement that the CFC is treated as a resident of Australia under every tax treaty between Australia and another country. This requirement might not be satisfied if, for instance, the CFC was incorporated in Australia but was managed from another country. In that case, it would be common for a tax treaty to treat the CFC as resident in the other country and Australia would lose worldwide taxing rights over the CFC.

For a CFC to be “subject to tax” requires one of two things. Firstly, the CFC can itself be subject to Australian income tax. Or secondly, the CFC can be part of a consolidated group for Australian tax purposes, if that consolidated group (through the “head company”) is itself subject to Australian income tax. It is not sufficient for a person with an income interest in the CFC to be subject to Australian tax on the CFC’s income.

A CFC will not qualify to be a non-attributing Australian CFC if its liability for Australian income tax has been reduced by an exemption from or reduction of income tax for certain offshore business income. These restrictions also applied to prevent Australian CFCs qualifying for the grey list exemption when there was a grey list.

If a non-attributing Australian CFC holds an interest in another CFC, the Australian exemption will not automatically apply to that other CFC. This is because the other CFC is effectively treated as held by the resident holders of interests in the first CFC, rather than by the first CFC (this is not a change of law; see existing sections EX 10 and EX 21(13)(c)). The eligibility of the other CFC for the exemption must be separately assessed.

If a non-attributing Australian CFC holds an interest in a FIF, the Australian exemption will not automatically apply to that other FIF. Again, this is because the FIF is effectively treated as being held by the resident holders of interests in the CFC, rather than by the CFC itself (see section EX 58).

Section EX 23 previously applied to CFCs resident in grey list countries that received certain tax concessions and thereby did not qualify for the grey list exemption. This has been repealed along with the grey list exemption for CFCs. If an Australian-resident CFC is not a non-attributing Australian CFC because it has reduced its income in a way described in section EX 22(1)(b), it is treated in the same way as any other CFC. It may be a non-attributing active CFC, or there may be attributed CFC income or loss from the CFC.

### ***Anti-avoidance rules for the active business exemption (sections GB 15B and 15C)***

Two anti-avoidance rules may affect the application of the active business exemption (sections EX 21D and EX 21E). The presence of these rules is not intended to imply anything about the general anti-avoidance provision (section BG 1). They are included for clarity. They may apply alone or in addition to the general anti-avoidance provision.

#### *Section GB 15B*

Section GB 15B applies when a CFC makes a supply with the purpose of increasing the tax measure of its total income in section EX 21D. This is an anti-avoidance rule. Increasing total income lowers the ratio of attributable income to total income, and the rule makes it clear that supplies made for this purpose are to be ignored.

It is expected that two CFCs who repeatedly sell goods back and forth between each other would come within the rule. Similarly, a sale which is put through an intermediate CFC with the purpose of increasing the intermediate CFC's total income for the purposes of section EX 21D would be caught.

However, the purpose of inflating total income must be the main purpose for section GB 15B to apply. It is accepted that there will commonly be sales between CFCs, such as between a regional supplier and country offices, that have no tax motivation.

Section GB 15B does not apply if the CFC makes a supply to a person who could be a member of a test group with the CFC. Separate rules apply in that situation (see section EX 21D(9)(c)) to require the removal of the income from the measure of total income.

#### *Section GB 15C*

Section GB 15 applies when a person enters an arrangement having a purpose, that is more than incidental, of enabling a CFC to meet the requirements of section EX 21E (active business exemption based on accounting measures of income) when the CFC would not meet the requirements of section EX 21D (active business exemption based on tax measures of income) to be a non-attributing active CFC.



This is an anti-avoidance rule to prevent manipulation of the active business exemption when using accounting measures of income. Accounting measures of income may often be used to determine whether a CFC qualifies for the active business exemption (see section EX 21E). The use of accounting measures is allowed because it can reduce compliance costs for taxpayers. Some effort has been made to align accounting and tax measures of income (see the required adjustments in section EX 21E, for example). However, accounting measures of income will inevitably be different from tax measures. There is therefore a risk that some taxpayers will attempt to exploit the differences to benefit from the active business exemption when, under tax measures of income, it is clear they should not benefit.

There are two conditions that must be satisfied before the section applies.

The first is that a person, being any person at all, must have entered an arrangement with a purpose, that is more than incidental, of enabling a CFC to meet the requirements of section EX 21E. It is expected that it will be rare for a person who enters into a normal commercial transaction, not motivated by tax concerns, to satisfy this requirement. The purpose must be “more than incidental”. Here there is a parallel with the definition of “tax avoidance arrangement” in section YA 1 (“not merely incidental”). However, that definition refers to arrangements having a purpose “or effect” of tax avoidance, whereas section GB 15 refers only to a purpose. It is accepted that an arrangement will, from time to time, have the effect of enabling a CFC to meet the requirements of section EX 21E even when the CFC would not meet the requirements of section EX 21D. It is the purpose that matters.

The second condition is that the CFC would not meet the requirements of section EX 21D. If, in the presence of the arrangement, the CFC would qualify for the active business exemption using tax measures of income, the anti-avoidance rule does not apply. In this case, there does not seem to be an exploitation of differences between the accounting and tax measures of income.

The anti-avoidance rule has a wide application.

While not limiting that general application in any way, two specific situations in which the rules are intended to apply are:

- when financial arrangements between CFCs, or between a CFC and a New Zealand resident, are entered into with a purpose of generating accounting losses when there is no economic loss for the group; and
- when artificial transactions such as repeated sales are used to inflate the measure of total income used in the ratio of attributable income to total income.

There were originally separate rules for these two situations, but they were removed from the bill during the Parliamentary process because they were considered to be redundant.

In relation to the first situation, the Finance and Expenditure Committee, in its report to Parliament on the bill, stated: “The amendment we propose is general and would capture, for example, situations where taxpayers use loans (or make financial arrangements) between related parties with different functional currencies to shelter passive income”.

The anti-avoidance rule has to cover such situations. When tax measures of income are used, all significant financial arrangements are measured in New Zealand dollars. However, translation of all financial arrangements to New Zealand dollars was thought to be inappropriate when using accounting concepts of income. This is because the use of accounting concepts is intended – as much as possible – to allow taxpayers to use pre-prepared financial accounting information. It is only the existence of the anti-avoidance rule that has allowed this approach to be enacted.

**Example: Financial arrangements**

CFCA, which has a functional currency of Australian dollars, lends US\$1 million to CFCB, which has a functional currency of US dollars (for simplicity, the loan is made in such a way that no cash changes hands). The Australian dollar strengthens compared with the US dollar, resulting in a foreign exchange loss for CFCA because the loan is now worth less in its functional currency of Australian dollars. The attributable loss may be offset against other attributable income. CFCB has no corresponding income, because the loan is worth exactly the same in its functional currency of US dollars. There is no economic loss for the group, but net income has been reduced.

The anti-avoidance rule may apply if the financial arrangement was entered into with a purpose of generating the attributable loss for CFCA so that CFCA could meet the requirements of section EX 21E.

**Example: Inflating the measure of total income**

CFCA sells factory automation equipment. CFCB, in another country, is a finance company for the group. CFCA sells its equipment to CFCB, which then sells it to a third party. This inflates CFCB's total income and allows it to qualify for the active business exemption using accounting measures of income.

Assume for the purposes of the example that if tax concepts of income were used, CFCB would not qualify for the active business exemption (for example, because section EX 21D(9)(d) requires the removal of the sales).

The anti-avoidance rule may apply if the sales are made through CFCB for the non-incidental purpose of allowing CFCB to meet the requirements of section EX 21E.

If section GB 15C applies, the CFC in question does not qualify for the active business exemption (as it is not a non-attributing active CFC) and its income or loss must be attributed.

In addition, if the arrangement involves a financial arrangement between the CFC and an associated CFC, it is possible that the associated CFC also does not qualify for the active business exemption. This occurs if the arrangement produces a foreign exchange loss for the first CFC and allows it to reduce its accounting measure of attributable income. This rule is designed to include matching economic gains and losses on either side of a financial arrangement, rather than just the loss, but may apply more widely.

***Commissioner's determination for active insurance CFCs***

Under section EX 21B(3), an insurance CFC will be a *non-attributing active CFC* if:

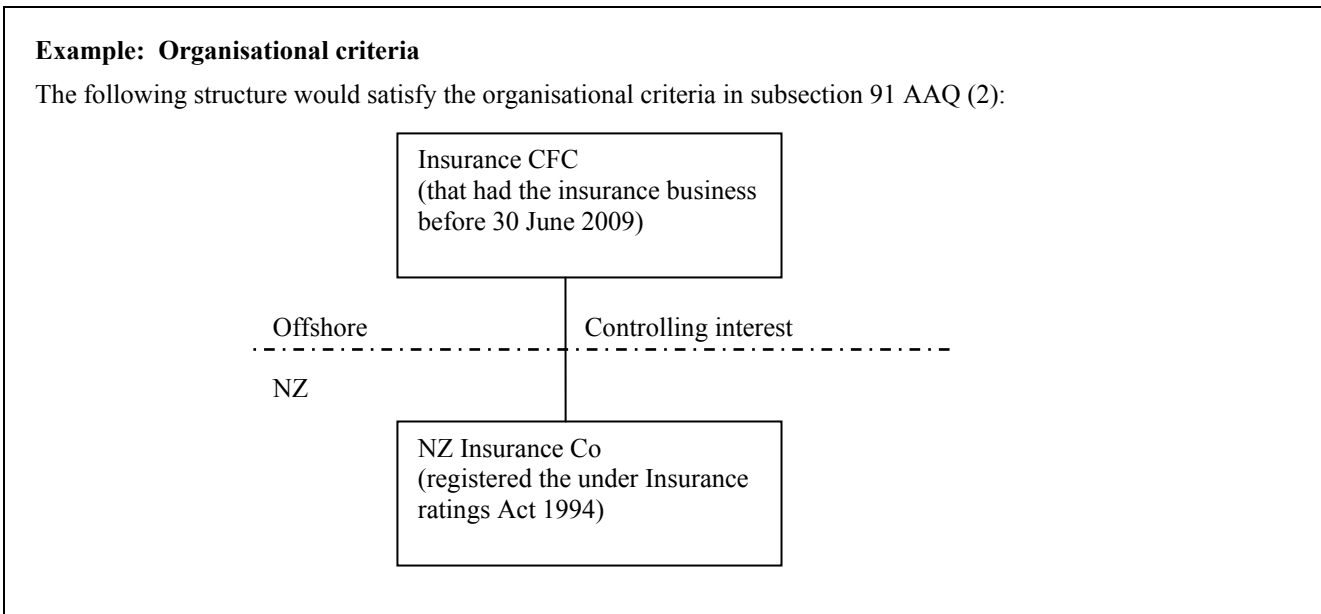
- a person with an interest in the CFC has applied for and obtained a determination from Inland Revenue under section 91AAQ of the Tax Administration Act 1994 that the CFC is an active insurance business; and
- the CFC satisfies any requirements laid out in the determination.

The determination facility is an interim measure until further work is done to consider special rules for extending the active income exemption to accommodate financial institutions. The active income exemption and active business tests for CFCs do not currently accommodate “active” insurance CFCs as insurance premiums and many types of investment income are included in the attributable CFC amount in section EX 20B.

For a determination to be granted, the insurance CFC must satisfy the criteria set out in section 91AAQ of the Tax Administration Act 1994. Some criteria relate to the legal status and organisation of the insurance business and its New Zealand parent, while others relate to the activities through which the insurance business earns its income.

*Organisational criteria*

In the simplest case, the entity criteria in subsection 91 AAQ(2) will be met if the insurance CFC is controlled by a New Zealand insurance company and the CFC carried out an insurance business in its country of residence before 30 June 2009.



The organisational criteria are designed to accommodate more complex structures that are economically equivalent to this basic structure. For example, a New Zealand owner can still qualify if it is in the same group of companies as a New Zealand company that is registered under the Insurance Ratings Act 1994. Similarly, a group of insurance or insurance-related CFCs can apply for the determination on a country-consolidated basis under section 91AAQ (3). Finally, a New Zealand-controlled offshore insurance branch operation that existed before 30 June 2009 and that was subsequently converted into an insurance CFC could qualify so long as the CFC was in the same group of companies as the previous branch business.

### *Activity criteria*

The activity criteria in subsection 91AAQ(4) will be met if the CFC's insurance business is carried out with the main purpose of producing a commercial return on the CFC's capital and it produces "all or nearly all" of its income from insurance premiums covering risks within the CFC's jurisdiction or from investment income from assets that are commensurate with these risks. Income from the reinsurance of other companies' insurance contracts does not count towards "income from insurance premiums".

The determination for insurance CFCs is intended as a temporary proxy measure for the active business exemptions that apply for other CFCs. This suggests that "all or nearly all" can be read to mean "at least 95 percent" of the CFC's total income. However, the determination does not specify an exact threshold as it may be appropriate to take into account a CFC's particular circumstances and historic benchmarks in some cases. Similarly, the interpretation of "commensurate" will require judgement as to the level of investment assets that would be reasonably required to cover the insurance risks based on the size and risk profile of the insurance business. Historical results and competitor benchmarks may be used to provide guidance on this point.

Subsection 91AAQ(5) lists some factors that the Commissioner may take into account when considering if a CFC meets the activity criteria. These include the amount of deductions that the New Zealand owner takes to support the CFC compared with the amount of assessable income earned by the CFC.

## **Attributable income**

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### *Section EX 20B of the Income Tax Act 2007*

Section EX 20B insets a definition of income that is attributable to a CFC (referred to in the legislation as the *attributable CFC amount*). This definition is central to the new CFC rules. The definition is applicable, in the first instance, in the active business test to decide whether a CFC is active or passive. If the CFC fails the active business test, it will have attributable income that must be attributed to the New Zealand shareholders.

### **Key features**

#### ***Attributable income (section EX 20B of the Income Tax Act 2007)***

The definition of "attributable CFC amount" can be divided into broad categories. The types of income that come under the definition include interest, royalties and rents, being income that is highly mobile and not location-specific. However, exceptions apply when the income is associated with an active business and there is limited risk to the New Zealand tax base.

The broad categories of *attributable CFC amount* are as follows:

- certain types of dividend;
- interest;

- royalties;
- rents;
- other attributable income (income from offshore insurance businesses, life insurance policies, personal services and the disposal of revenue account property);
- certain income related to telecommunications services; and
- base company services income.

A number of exceptions are also provided for under section EX 20B. For example carve-outs are provided for certain royalty payments, certain rents and telecommunication services. If an item of income falls within the scope of any one of the exceptions, that item of income will be excluded from the definition of “attributable CFC amount” unless that item of income is caught in another paragraph of subsection EX 20B(3) or (4).

## **Detailed analysis**

### ***Certain types of dividend (subsections EX 20B(3)(a) to (c))***

The dividends that are included in the attributable CFC amount match the foreign dividends that would be subject to income tax (not exempt under section CW 9) if received by a company resident in New Zealand. They also include unimputed dividends received from New Zealand companies. More specifically, the attributable dividends are:

- dividends from a less than 10 percent interest in a FIF described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39 (section EX 20B(3)(a)). These comprise shares in ASX-listed Australian companies, Australian unit trusts with adequate turnover or distributions, certain venture capital investments into New Zealand companies that have since migrated to a grey list country, and shares in Guinness Peat Group plc;
- dividends from fixed-rate foreign equity (section EX 20B(3)(c));
- dividends from deductible foreign equity (section EX 20B(3)(c));
- dividends received by CFCs from New Zealand companies to the extent that they are unimputed (section EX 20B(3)(b)).

If the CFC holds an attributing interest in a FIF that is calculated using the comparative value, deemed rate of return or fair dividend rate methods, any dividends from this FIF will not be included in the attributable CFC amount. This is because these FIF interests have no income other than FIF income under section EX 59(2).

Fixed-rate foreign equity and deductible foreign equity are defined in section YA 1.

Fixed-rate foreign equity includes foreign dividends that are a specific, fixed percentage of the amount paid for the equity (as well as variations on this) and any dividend that is regarded as equivalent to payment for money lent.

A deductible foreign equity distribution is a dividend where the foreign company paying the dividend (or another company owned by or on the same group as the foreign company which pays the dividend) is allowed a deduction for the payment of the dividend against foreign income tax.

Subsection EX 20B(3)(b) deals with dividends paid by a New Zealand company to the CFC. A New Zealand dividend that is fully-imputed will not be included in the attributable CFC amount. A partly imputed dividend will only be attributed to the extent to which it is not imputed.

**Example**

A CFC receives \$100 of dividends from a New Zealand company with \$21 of imputation credits attached (that is, the dividend is half-imputed). \$50 of this dividend will be treated as part of the attributable CFC amount.

Note that although there is an exemption for dividends paid within a New Zealand wholly owned group (section CW 10), a dividend paid by a New Zealand company to a CFC that is in the same wholly owned group as the New Zealand company will still be attributable to the extent to which it is not imputed.

***Financial arrangement income and interest (subsections EX 20B(4) and EX 20B(12))***

The definition of “attributable CFC amount” includes income from financial arrangements held by a CFC. Section EX 20B(4)(a) and (b) sets out the criteria when financial arrangement income is caught within the definition of “arrangement income”. Paragraph (a) includes a financial arrangement or short-term agreement for sale and purchase for which the CFC has made an election under section EW 8 (*Election to treat certain excepted financial arrangements as financial arrangements*) into the definition of “arrangement income”. However, income from a financial arrangement that is not a derivative instrument is not attributable if the financial arrangement is:

- a loan provided by the CFC to an associated active CFC in the same jurisdiction (section EX 20B(12)(a)); or
- an agreement for the sale or purchase of property or services or a hire purchase agreement that is entered in the ordinary course of a business by the CFC or for property or services produced or used in the CFC’s business (section EX 20B(12)(b)).

Income from financial arrangements that are derivative instruments is attributable if the derivative instrument is held for the purposes of dealing in the derivative instrument, is not entered in the ordinary course of the CFC’s business or is a hedge instrument for attributable income or for a transaction that produces income that is attributable (section EX 20B(4)(b)).

Under the financial arrangements rules, an instrument will give rise to either income or expenditure. If an arrangement gives rise to income, that income is included in a CFC’s attributable CFC amount, subject to the rules described above. Expenditure under a financial arrangement is dealt with separately, under the rules for calculating net attributable CFC income or loss in sections EX 20C to EX 20E. There is no “netting off” between financial arrangements. Thus, if a CFC holds one financial arrangement giving rise to income and another that gives rise

to, say, an equal amount of expenditure, income and expenditure from the two instruments cannot be directly offset against each other. Rather, income from the first arrangement must be included as appropriate under section EX 20B and expenditure under the second arrangement must be brought in under sections EX 20C to EX 20E.

### ***Royalties (subsection EX 20B(5))***

The general rule under the new international tax rules is that royalties (as defined in section CC 9 of the Income tax Act 2007) are included within the definition of “attributable CFC amount” unless they fall under one of four exceptions. The four exceptions ensure that when there are genuine commercial reasons for the intellectual property to be owned by a CFC, any royalties the CFC derives from that property will not be subject to attribution. The four exceptions are:

#### *1. Third-party active royalties (subsection EX 20B(5)(a))*

This refers to royalties received by a CFC from a third party where:

- the CFC has created, developed, or added substantial value to the intellectual property;
- the CFC is regularly engaged in the activity of creating, developing, or adding substantial value to the intellectual property; and
- the property does not have a prior link to New Zealand.

#### *2. Related-party active royalties (subsection EX 20B(b))*

This refers to royalties received by a CFC from a related CFC where:

- the CFC has created, developed, or added substantial value to the intellectual property;
- the CFC is regularly engaged in the activity of creating, developing, or adding substantial value to the intellectual property;
- the royalty is at an arm’s-length amount under transfer pricing rules; and
- the property does not have a prior link to New Zealand.

#### *3. Same jurisdiction active royalties (subsection EX 20B(5)(c))*

This refers to royalties received by a CFC from a related CFC where:

- the related CFC is within the same jurisdiction as the CFC;
- the related CFC would pass the active business test; and
- the property does not have a prior link to New Zealand.

*4. Royalties from property owned by a New Zealand resident (subsection EX 20B(5)(d))*

This refers to royalties received by a CFC from a third party where:

- the intellectual property is owned by a New Zealand resident and is licensed to the CFC; and
- it is licensed between the New Zealand owner and the CFC for an arm's-length amount applying transfer pricing rules.

*Third-party active royalties (subsection EX 20B(5)(a))*

Royalty payments received from a third party are not considered to be attributable if the CFC satisfies the criteria set out in section EX 20B(5)(a). The criteria are:

- the CFC has created, developed, or added value to intellectual property;
- the CFC is regularly engaged in the activity of creating, developing, or adding substantial value to the intellectual property;
- the royalty is paid by a person who is not associated with the CFC; and
- the intellectual property does not have a prior link to New Zealand.

**Example 1**

CFC 1 operates a research facility in the United States. Its core business is to perform research on animal feed. In particular, it has been developing a special feed for sheep that would increase the quality of the wool the sheep produces. Through the research of its employees, CFC 1 discovered that a particular combination of grains results in a silkier texture to the wool produced by the sheep. It begins to license the formula to other companies that manufacture livestock feed. CFC 1 is not associated with any of the companies it receives royalties from.

In this example, the royalties CFC 1 receives from the unrelated third party will be excluded from the definition of "attributable CFC amount" under the third-party active royalty exclusion. CFC 1 is regularly engaged in the creation and/or the development of intellectual property, the royalty is from intellectual property that is developed by CFC 1 and the property has no prior link to New Zealand.

**Example 2**

Assume the same facts as above. CFC 1 is also engaged in buying ready-to-use formulas off its competitors and licenses them out to other companies also. In this case, the royalties received from the ready-to-use formulas will not be excluded from the definition of "attributable CFC amount", because the royalties did not arise from intellectual property that CFC 1 had created, developed or added substantial value to.

*Related-party active royalty (subsection EX 20B(5)(b))*

Royalty payments received from a related party are not considered to be attributable if the CFC meets the criteria set out in section EX 20B(5)(b):

- the CFC has created, developed or added value to intellectual property;
- the CFC is regularly engaged in that activity;



- the royalty is paid by a person who is not associated with the CFC;
- the royalties are at an arm's-length amount under transfer pricing rules; and
- the intellectual property does not have a prior link to New Zealand.

The criteria for this exclusion are the same as those in the third-party active royalty exclusion (section EX 20B(5)(a)), with the additional requirement that the royalty must be at an arm's-length amount under transfer pricing rules (section EX 20B(5)(b)(iv)).

**Example**

CFC 1 is based in Ireland. CFC 1 has always been in the business of producing vegetarian products under the Veges Cool brand. It owns the intellectual property rights to the Veges Cool brand. In particular, Veges Cool is a well known brand of quality vegetarian sausages in Europe. CFC 1 was recently acquired by NZ Co. NZ Co has many other CFCs in Europe. To save costs, NZ Co decides it would be more efficient for its other CFCs in Europe to directly manufacture the Veges Cool sausages and distribute the product to the local market rather than manufacture Veges Cool brand sausages from Ireland and distribute them to the rest of Europe.

To do this, CFC 2 in Belgium pays a royalty to CFC 1 for the use of the Veges Cool brand on the sausages it produces. The amount paid to CFC 1 is at an arm's-length price.

In this example, the royalty received by CFC 1 will be excluded from the definition of "attributable CFC amount". CFC 1 is regularly engaged in creating, developing and adding substantial value to the Veges Cool brand, the brand has no prior link to New Zealand and the royalty is an arm's-length amount.

*Same jurisdiction active royalties (subsection EX 20B(5)(c))*

Royalty payments received from a related party are not attributable if it meets the criteria set out in section EX 20B(5)(c):

- the related CFC is liable to tax in the same jurisdiction as the CFC;
- the related CFC would pass the active business test; and
- the property does not have a prior link to New Zealand.

While this exclusion only applies to related parties, it is important to note that the requirements are different from the related-party active royalty exclusion under section EX 20B(5)(b).

In particular, the CFC paying the royalty must pass the active business test, in the absence of applying this royalty exclusion (section EX 20B(5)(c)), the same jurisdiction rent exclusion (section EX 20B(7)(c)) and the same jurisdiction financial arrangement exclusion (section EX 20B(12)(a)). This issue of circularity will be discussed in more detail at the end of this section.

**Example 1**

CFC 1 is based in India. It holds a number of recipes for different condiments. None of the recipes it holds have a prior link to New Zealand. CFC 2, also based in India, licenses the recipe for ketchup off CFC 1 and manufactures it and distributes it for profit. CFC 3, also based in India, licenses the recipe for aioli from CFC 1 and manufactures it and distributes it for profit as well. Both CFC 2 and 3 are active CFCs, because both have less than 5 percent of attributable income, before the exclusions allowed under section EX 20B(5)(c), (7)(c) and (12)(a) are applied.

CFC 1, 2 and 3 are all owned by the same New Zealand shareholder – NZ Co. All three CFCs are liable to tax in India.

In this example, CFC 1 is merely a holding company. Any royalties it receives from CFC 2 and 3 will not be subject to attribution.

**Example 2**

Assume the same facts as in example 1, except that CFC 1 pays interest to CFC 3 on a loan CFC 3 made to CFC 1. CFC 3 does not pass the active business test taking into account the interest it receives from CFC 1 for the loan.

In this situation, the royalty CFC 1 receives from CFC 3 will not be excluded from attribution as CFC 3 is not an active CFC in the absence of the exclusion allowed under section EX 20B(12)(a).

*Regularly engaged in creating, developing or adding substantial value to intellectual property (subsection EX 20B(5)(a) and (b))*

Central to the third-party active royalty and related-party active royalty exclusions is the requirement that the CFC be regularly engaged in creating, developing or adding substantial value to intellectual property. The requirement that the CFC be regularly engaged in creating and/or enhancing intellectual property is aimed at ensuring that there is a genuine commercial rationale for the intellectual property to have been developed by a CFC in that particular jurisdiction. The exclusions are not intended to apply to CFCs that create and/or enhance intellectual property on a one-off basis.

**Example 1**

CFC 1 is a company based in the Netherlands. It has, for a number of years, owned research facilities in the Netherlands where it employs scientists, engineers and technicians who regularly perform experiments, tests and other technical activities that ultimately result in the creation or development of intellectual property that CFC 1 sells or licenses. CFC 1 often performs radical new research in fields where no current products are on the market. It will also often further develop intellectual property that it acquires from other companies.

Through the research of its staff, CFC 1 develops a design for a new robotic milking machine and subsequently licenses the design to other companies.

In this example, CFC 1 is a company that is regularly engaged in creating, developing, or adding substantial value to intellectual property.

**Example 2**

CFC 1 is a new company that has been operating in the United Kingdom for just under a year. Since it was established, the company has undertaken further research on a technique to produce low-calorie ginger beer. CFC 1 acquired the initial technique from another company in the United Kingdom. The new technique developed by CFC 1 proves to be extremely successful as it enhances the initial technique by substantially improving the taste of the ginger beer. CFC 1 is now able to produce low-calorie ginger beer with the flavour of a full-calorie ginger beer. CFC 1 begins to license the technique to other companies.

To date, CFC 1 has not created, produced or added substantial value to any other intellectual property.

In this example, while CFC 1 has only produced the single technique in making low-calorie ginger beer that retains the taste of full-calorie ginger beer, it is still considered to have been regularly engaged in creating, developing or adding substantial value to intellectual property. The fact that CFC 1 had been engaged in the research and development of this technique since the establishment of the company and continues to engage in research means it satisfies the *regularly engaged* requirement. CFC 1 added substantial value to the initial technique by improving the taste of the ginger beer. Although CFC 1 did not develop the initial technique, it improved it by substantially improving the taste of the ginger beer it produced.

### **Example 3**

CFC 1 has been operating in China for the last 10 years. Its operations have mainly been manufacturing rubber soles for shoes. It employs a team of engineers to look after the machinery in its factories. By chance, one of the engineers discovers a new method of producing rubber soles which are 10 times more durable than regular soles. CFC 1 patents this method and begins receiving royalties from other companies that use this new method of rubber sole production.

In this example, CFC 1 has not satisfied the criteria that it is regularly engaged in the creation, development or adding substantial value to intellectual property. In particular, the creation or development of intellectual property is not part of the core day-to-day business of CFC 1.

### *Property linked to New Zealand (subsection EX 20B(13), (14) and (15))*

Of the four royalty exclusions, three of them require that the intellectual property generating the royalty income not be linked to New Zealand. The reason for this is that intellectual property is highly mobile and can be easily transferred and held offshore, royalties relating to intellectual property that has a link to New Zealand are therefore attributable. However, it is recognised that there may be legitimate commercial reasons for intellectual property to be held offshore, therefore there is a mechanism in the legislation to allow the intellectual property to break its link to New Zealand.

Section EX 20B(14) sets out the situations when the intellectual property will create a link with New Zealand. It includes situations that are relatively straightforward. Subsection EX 20B(15) sets out the circumstances where the intellectual property's link to New Zealand is broken. In particular, this is when the intellectual property is sold offshore to an unrelated third party that is not a New Zealand CFC. Note that the intellectual property can re-establish its link to New Zealand, if at any time, it meets any one of the situations set out in subsection (14).

### **Example 1**

CFC 1 owns the secret formula that allows normal meat cells to be grown into artificial meat suitable for consumption. Although CFC 1 is based in the Cayman Islands, it employs New Zealand scientists and engineers who perform all their research in Otago. As such, the development of the secret formula was all done in New Zealand by CFC 1's New Zealand-based employees.

In this example, the secret formula for growing artificial meat will have a link to New Zealand by virtue of having been created and developed in New Zealand.

### **Example 2**

The news of this artificial meat is very well received and generates much international interest. As a result, multiple offers to buy the secret formula are made to CFC 1. In the end, CFC 1 decides to sell the formula to a German company. The German company is not associated with CFC 1 in any way, and it is not a New Zealand CFC.

At this point, the secret formula's link to New Zealand has been broken as provided for in section EX 20B(15). If the secret formula is subsequently owned by a CFC, there will be no prior link to New Zealand.

### **Example 3**

The German company does further testing and discovers that there is little consumer interest in the artificial meat. In particular, the taste of the meat does not guarantee commercial success. As a result, the German company decides to sell the formula to try and recuperate some of its losses. The German company eventually sells the formula to an Austrian company. The Austrian company discover there is a big market in New Zealand for the artificial meat as high-quality dog food. The Austrian company subsequently sets up a branch in New Zealand where it does further market testing of their product, with a view to selling the dog food in New Zealand first, then to the rest of the world.

At this point, the secret formula will have re-established its link to New Zealand by virtue of the property being used for the purposes of business carried on in New Zealand by virtue of the property being further developed in New Zealand. If the formula is later sold again to a New Zealand CFC, the New Zealand CFC will not be able to access any of the four royalty exclusions.

### *Royalties from property owned by a New Zealand resident (subsection EX 20B(5)(d))*

Royalty payments received from a third party on property that is owned by a New Zealand resident are not attributable if the payments meet the criteria in section EX 20B(5)(d):

- the intellectual property is owned by a New Zealand resident and licensed to the CFC; and
- it is licensed between the New Zealand owner and the CFC for an arm's-length amount applying transfer pricing rules.

Note that if the property is owned by a New Zealand resident that is treated as non-resident under a double tax agreement, that person will not meet the residence requirement of this exclusion (section EX 20B(5)(d)(ii)).

This exclusion also contemplates the situation where an upper-tier CFC may sublicense the property to a lower-tier CFC which then licenses it to a third party (section EX 20B(5)(d)(i)).

### **Example 1**

NZ Co owns the intellectual property rights on a special training programme for ballet dancers. Its programme is called "The Extreme Ballerina". The programme was extremely popular in New Zealand and NZ Co decides to expand to the international market. To do this, NZ Co would license its programme to its CFCs. CFC 1 is based in the Netherlands. It pays NZ Co a royalty for the use of the programme, and it subsequently sublicenses it to dance studios in the Netherlands. The royalty CFC 1 pays to NZ Co is an arm's-length amount. The dance studios that use "The Extreme Ballerina" are not associated with CFC 1.

In this example, the royalties CFC 1 receives from the dance studios will be excluded from attribution.

### **Example 2**

Assume the same facts as in example 1. "The Extreme Ballerina" proves to be extremely successful in the Netherlands also. NZ Co now wants to expand into the Asian market. It sets up CFC 2 in Singapore, but decides to let CFC 2 sublicense "The Extreme Ballerina" from CFC 1 in the Netherlands. Like CFC 1, CFC 2 will license the programme to its local Singaporean dance studios.

In this example, the royalty received by CFC 2 from the dance studios will be excluded from attribution, as will the royalty it pays to CFC 1. The royalty paid to CFC 1 will only be excluded if CFC 2 had received the royalty from a non-associated third party. In this example, the non-associated third party would be Singaporean dance studios.

### ***Rents (subsections EX 20B(3)(e), EX 20B(6) and EX 20B(7))***

The general rule is that rent earned by a CFC will be treated as attributable income. Section EX 20B(6) sets out the types of rental payment that are subject to attribution. The following rents are attributable:

- a lease or sublease of land;
- a lease or sublease of personal property;
- a licence to use intangible property; and
- a hire or bailment.

However, it is recognised that rent is often associated with running an active business. For example, a CFC may be in the business of letting or it may hold property used by related CFCs for the purposes of running an active business and receive rental income from those CFCs.

For that reason, subsections EX 20B(7)(a) and (b) exclude rent from third parties from attribution if it is derived from a lease of real or personal property in the same jurisdiction as the CFC.

Furthermore, rent received by a CFC from a related CFC is not attributable when the related CFC would pass the active business test, as long as both CFCs are liable to tax in the same jurisdiction (section EX 20B(7)(c)).

#### **Example 1**

CFC 1 operates a car rental business in Bermuda where it leases vehicles to tourists. CFC 1 is liable to pay income tax on the income it derived in Bermuda.

In this example, the rental income CFC 1 derives from its car rental business will be excluded from attribution.

#### **Example 2**

CFC 1 is a holding company for CFC 2 and CFC 3. All three CFCs are based in the Netherlands and are all liable to income tax there. CFC 2 and CFC 3 both hire equipment off CFC 1 for its operations. CFC 2 passes the active business test because less than 5 percent of its income is subject to attribution, before the exclusions allowed under section EX 20B(5)(c), (7)(c) and (12)(a) are applied. The rental payment received from CFC 2 will be excluded attribution for CFC 1 under subsection EX 20B(7)(c).

CFC 3 does not pass the active business test, because more than 5 percent of its income is subject to attribution. For that reason, the rental income CFC 1 receives from CFC 3 will be subject to attribution.

Section EX 20B(7)(d) (Payment under hire purchase agreements and finance leases) and payments that fall within the definition of “royalty” under section CC 9 of the Income Tax Act 2007 are not considered as rent under the definition of “attributable CFC amount”, but may be – and are likely to be in some cases – attributable under other provisions. For example, income from finance leases is attributable as *arrangement income* and payments that fall within the definition of “royalty” will be attributed under the royalty provision.

In the case of licence fees received for the use of intangible property, the royalty provisions will apply to these payments, as the royalty exclusions in subsection EX 20B(5) will apply (see subsection EX 20B(7)(g)). In short, the royalty exclusions are still applicable to rents from a licence to use intangible property, even though these payments fall outside the scope of the definition of “royalty”.

#### **Example**

CFC 1 is based in Hong Kong and is in the business of developing software. Once a programme has been developed and the relevant testing done, CFC 1 then licenses its programme to its clients. Its clients are able to use the programmes in an unaltered state without the ability to exploit the programme – for example, clients are not allowed to make and sell copies of the programme. This is a classic example of “shrink-wrap software”.

Licence fees for the use of “shrink-wrap software” do not fall within the definition of “royalty” under section CC 9 of the Income Tax Act 2009. However, subsection EX 20B(7)(g) extends the royalty exclusions in subsection EX 20B(5) to payments under a licence to use intangible property which does not fall within the definition of “royalty” under section CC 9.

Therefore CFC 1 will be able to exclude the licence payments from attribution if it meets the requirements of any one of the royalty exclusions (see subsection EX 20B(5)). In this example, it would appear that the *third party active royalties* exclusion (subsection EX 20B(5)(a)) will be the most relevant exclusion. Provided the licence payments meet all of the requirements of subsection EX 20B(5)(c), CFC 1 will be able to exclude those payments from attribution.

#### **Other attributable CFC amounts**

The definition of “attributable CFC amount” includes types of income other than dividends, interest, royalties and rents. These types of income relate to:

- offshore insurance businesses;
- life insurance policies;
- personal services; and
- the disposal of revenue account property.

#### ***Income from offshore insurance business (subsection EX 20B(3)(f))***

Section EX 20B(3)(f) generally treats the premium of an insurance contract or a reinsurance contract as attributable income. However, when this type of income forms the core part of a CFC’s insurance business, that CFC can apply for a Commissioner’s determination. A process has been established (see *Determination of active insurance active business*) to enable active insurance CFCs to be considered to have passed the active business test (and be treated as a non-attributing active CFC). This is a temporary measure until special rules are considered for extending the active income exemption to financial institutions.

**Example**

CFC 1 is based in the Cayman Islands and only derives income from the premiums it receives from insurance contracts.

In this example, the income derived from insurance contracts by CFC 1 will be attributable unless CFC 1 applies for a Commissioner's determination and the Commissioner subsequently considers CFC 1 to have passed the active business test. In the absence of a Commissioner's determination, the premiums received from the insurance contracts will be considered as attributable income.

***Income from life insurance policies (subsections EX 20B(3)(g) and EX 20B(8))***

Income from life insurance policies is generally treated as attributable under section EX 20B(3)(g). Subsections EX 20B(8)(a) to (c) sets out the circumstances when the income from life insurance policies is considered an attributable CFC amount. Accordingly, income a CFC derives from holding a life insurance policy is treated as attributable income (subsections EX 20B(8)(a) and (b)). Additionally, income from a disposal of the life insurance policy is also attributable to the extent that these policies are on revenue account (section EX 20B(8)(c)).

However, section EX 20B(8) provides that income from life insurance policies that are FIF interests is not subject to attribution under the CFC rules, as that income is already attributed under the FIF rules. Net gains from the disposal of such interests will continue to be attributable where the net gain is not taxable under the FIF rules.

***Income from personal services (subsections EX 20B(3)(h), EX 20B(9) and GB 27(3)(e))***

Income from personal services is treated as attributable if it meets the criteria set out in subsection EX 20B(9). However, there is an important distinction between income from personal services and other forms of attributable income because this income will always be subject to attribution irrespective of whether the CFC passes the active business test. Another way to look at this is that a non-attributing active CFC will still be required to attribute any personal services income it receives even if it passes the active business test – because less than 5 percent of its total income is income that is subject to attribution.

Furthermore, such income will be disregarded for the purposes of applying the active business test (see subsections EX 21(D)(7) and EX 21E(12)(c)).

In many ways the criteria set out in subsection EX 20B(9) is an extension of the domestic attribution rule for income from personal services (see sections GB 27 to 29).

The personal services income will be considered as attributable income if it meets all of the following criteria:

- The “working person” is a New Zealand resident.
- The personal services are not essential support for a product supplied by the CFC.
- The individual and the CFC are associated persons under section YB 3 (Company and non-corporate 25 percent interest holder) or the individual is a relative of a person associated with the CFC under section YB 3 at the time the services are performed.

- At least 80 percent of the CFC’s gross income from personal services during the tax year relates to services personally performed by the individual (or a relative of the individual).
- Substantial business assets are not a necessary part of the business structure that is used to derive the income from personal services. (That is, to derive the income, the CFC uses depreciable property that, at the end of the accounting period, has a total cost of more than either \$75,000 or 25 percent or more of the CFC’s total assessable income from services performed in that period.)

Note that section EX 20B(9)(b) provides that when the services personally performed by the individual are essential support for a product supplied by the associated entity, they are not subject to attribution. This is because the provision is not intended to apply to income earned from services that are provided in relation to the sale of goods by a CFC. Therefore income from personal services is not subject to attribution if the services are essential support for a product supplied by the CFC.

Another important point to note about the personal services rule under the CFC rules is that if the personal services income is attributed under those rules, the domestic attribution rule will be “switched off” (subsection GB 27(3)(e)). This will ensure that the personal services income will only be attributed once to the “working person”.

**Example**

Joe is a graphic designer based in New Zealand. Joe’s wife Jill is the sole shareholder of Jill Co – a CFC in the Bahamas. Jill Co derives most of its income from the services Joe provides as a graphic designer, and some royalty income from several patents it holds. Joe is the only graphic designer employed by Jill Co.

In this example, the income derived by Jill Co from Joe’s services as a graphic designer will be subject to attribution as the income satisfies the requirements of subsection EX 20B(9) – in particular, that Joe is a New Zealand resident, the personal services are not essential support for a product supplied by Jill Co, Joe and Jill Co are associated under section YB 3, all of Jill Co’s income from personal services is produced by Joe and substantial business assets are not a necessary part of the business structure that is used to derive the income from personal services.

In short, the personal services income derived by Jill Co will be attributable to Joe and subject to New Zealand tax. However, this income will only be subject to attribution once, as the domestic personal services rule is effectively “switched off” if that income is subject to attribution under the CFC rules (see subsection GB 27(3)(e)).

The personal services income derived by Jill Co will be ignored for the purposes of applying the active business test to Jill Co. In this example, the only other income derived by Jill Co is the royalties Jill Co receives from the patents it holds. Depending on whether the royalty income meets any of the exclusions under subsection EX 20B(5), that income may be exempt from attribution – in that Jill Co has less than 5 percent of attributable income, disregarding the personal services income that is already subject to attribution.

***Income from the sale of shares (subsections EX 20B(3)(i) and EX 20B(10))***

Section EX 20B(3)(i) defines income from the sale of shares that are on revenue account as attributable CFC income while section EX 20B(10) sets out the exceptions to this. Revenue account gains are disregarded when a CFC sells an interest in a FIF whose income is calculated using either the comparative value, deemed rate of return, fair dividend rate or the cost method. This is consistent with the way in which these gains would be treated if held directly by a New Zealand company.



### ***Income from the disposal of share options (subsection EX 20B(3)(j))***

Section EX 20B(3)(j) provides that income from the disposal of share options held on revenue account is treated as attributable income. This is consistent with the treatment of income from the disposal of shares held on revenue account, as discussed above.

### ***Income from the disposal of revenue account property (subsection EX 20B(3)(k))***

Gains from the disposal of revenue account property held by a CFC that is not used in an offshore active business will be treated as attributable income (section EX 20B(3)(k)).

However, this rule does not apply to income from the disposal of revenue account property if the property is a share, financial arrangement or life insurance policy, as these items are dealt with specifically in other parts of the definition of attributable CFC amount.

### ***Base company income (subsection EX 20B(3)(l))***

Under subsection EX 20B(3)(l), income derived by a CFC for a service that is wholly or partly performed in New Zealand is defined as attributable income of the CFC.

International telecommunications services are excluded from the base company income rule. Income derived from telecommunication services are dealt with in another subsection.

#### **Example**

Parent Co is based in New Zealand and has a subsidiary in the Cayman Islands (CFC 1). CFC 1 derives its income from providing consulting services all over the world, but with a large proportion of the services provided to New Zealand residents. The majority of the services are therefore performed in New Zealand.

Subsection EX 20B(3)(l) will treat the income CFC 1 derives from the consulting services that are performed in New Zealand as attributable income. However, any other income that is derived from the consulting service which is performed outside of New Zealand will not fall within the definition of attributable CFC amount.

### ***Income from telecommunications services (subsections EX 20B(3)(m) to (n) and EX 20B(11))***

Certain income from telecommunications services is attributable income.

#### ***Income from the use of a telecommunications asset outside any country (subsection EX 20B(3)(m))***

Income derived from the use of a telecommunications asset that is wholly or partly located outside any country is attributable income. In the event that only part of the asset is located outside any country, apportionment will be required.

This rule only applies if the asset is owned by the CFC or another CFC that is associated with the CFC.

Assets that are subject to this subsection include (but are not limited to) telecommunications cables, satellites, and associated plant, equipment and facilities. The rule does not apply to a cellphone handset or transmitting equipment located on board a ship or aircraft.

The types of income that would be derived from the use of a telecommunications asset include (but are not limited to) income from the transmission of telecommunications data using the asset; the lease of the asset; and the licence or sale of rights – whether direct or indirect – to use the asset.

*Income when telecommunications services performed in New Zealand (subsections EX 20B(3)(n) and EX 20B(11))*

Consistent with “base company income”, income as a result of providing a telecommunications service is generally taxable to the extent the service is physically performed in New Zealand (paragraph EX 20B(3)(n)).

However, an exception is made when the service is the transmission, emission or reception of information between New Zealand and the CFC’s country of residence (subsection EX 20B(11)). In this instance, there is a decreased likelihood that the CFC has been established to escape New Zealand tax, because such a service typically *must* be partly performed in both locations. There also appears to be a greater-than-normal degree of practical difficulty in calculating the income attributable to services performed in New Zealand.

The exception applies only if two requirements are met. The first requirement is that there be a close connection between the CFC and a network operator. The term “network operator” is defined in the Telecommunications (Interception Capability) Act 2004. A sufficiently close connection exists if:

- the CFC is a network operator; or
- a person who is a network operator holds a 50 percent or greater income interest in the CFC; or
- a person who has a 50 percent or greater voting interest in a network operator also holds a 50 percent or greater income interest in the CFC.

The second requirement is that the service is not performed using equipment or staff of the CFC, or of an associated CFC, that is physically located in New Zealand. The expectation is that the New Zealand owner of a telecommunications CFC would use its own equipment and staff at the New Zealand end of the connection, rather than the CFC’s. The second requirement reduces the incentive to substitute the CFC’s staff or equipment merely to escape the tax that the New Zealand owner would ordinarily pay on these New Zealand operations.

The exception in subsection EX 20B(11) is only an exception to paragraph EX 20B(3)(n). For example, if paragraph EX 20B(3)(m) applies to an amount of income to which subsection EX 20B(11) also applies, the income is attributable.

***Exclusions for rent, royalties and interest received from an associated CFC in the same jurisdiction (subsections EX 20B(5)(c), EX 20B(7)(c) and EX 20B(12)(a))***

As noted in the sections above, certain rent, royalties and financial arrangement income from associated active CFCs in the same jurisdiction as the CFC is excluded from attribution (see subsections EX 20B(5)(c), (7)(c) and (12)(a)).

There is a possibility that the status of the associated CFC cannot be determined, because the associated CFC itself needs to apply the same exclusions.

**Example**

CFC A and CFC B are 100 percent commonly owned and are both resident in the same jurisdiction.

When it applies the active business test, CFC A has a numerator of \$49,990 and a denominator of \$1 million, but only if it can exclude royalties of \$50,000 received from CFC B. CFC B has a numerator of \$99,980 and a denominator of \$2 million, but only if it can exclude interest of \$100,000 received from CFC A.

CFC A can only exclude the royalties if CFC B is active, and CFC B can only exclude the interest if CFC A is active, but neither CFC is active until it applies the exclusion.

As a solution to this circularity problem, when a CFC (CFC A) determines the status of an associated CFC (CFC B), it will do so without applying any of the exclusions to CFC B. That is, for this purpose only, CFC B's status is to be determined assuming that any rent, royalties or interest it receives from an associated CFC in the same jurisdiction is subject to attribution.

**Example**

Continuing from the example above, CFC A would determine that CFC B's numerator was \$199,980 and its denominator was \$2,100,000, meaning that CFC B would not be active for this purpose. CFC A would then have to recognise the \$50,000 of royalties as attributable income. Similarly, CFC B would be required to recognise the \$100,000 of interest as attributable income.

**Mechanics of attribution**

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*Sections CQ 2, DN 2, EX 18A, EX 20C to EX 20E and EX 21 of the Income Tax Act 2007*

There is a signposting provision in section EX 18A showing the scheme for finding a person's attributed CFC income or loss under the new rules.

Sections CQ 2 and DN 2 provide that a person has attributed CFC income or loss if the person has an income interest of 10 percent or more in a CFC that has net attributable CFC income or loss and is not a non-attributing active CFC or a non-attributing Australian CFC. Special rules apply to income from personal services.

The rules for calculating net attributable CFC income or loss for a CFC are set out in sections EX 20C to EX 20E and section EX 21 as follows:

- Section EX 20C provides that net attributable CFC income or loss is to be calculated using a prescribed formula and lays down the main rules concerning deductibility of expenditure.
- Sections EX 20D and EX 20E make provision regarding the deductibility of interest expenditure for excessively debt-funded CFCs.
- Section EX 21 applies the Act (subject to certain modifications) for specified purposes as though a CFC were a New Zealand resident. Those specified purposes include the calculation of net attributable CFC income or loss.

### **Key features**

Net attributable CFC income or loss is the income or loss of a CFC that is attributed to New Zealand residents with an income interest of 10 percent or more. Non-attributing active CFCs and non-attributing Australian CFCs are not subject to attribution other than for any income or loss derived from personal services.

The starting point for calculating net attributable CFC income or loss for a CFC is to determine the attributable CFC amount in accordance with section EX 20B. This amount is then reduced to reflect expenditure incurred by the CFC, giving a net figure.

As a general rule, deductions for expenditure incurred other than under a financial arrangement will be allowed if the expenditure is incurred by the CFC in deriving an attributable CFC amount. Different rules apply to expenditure incurred by a CFC under financial arrangements because of the difficulties associated with matching debt to particular income streams.

Of expenditure (typically, interest) incurred under financial arrangements that provide funds to the CFC, only a fraction is deductible. The fraction is based on the value of the attributable assets of the CFC as a proportion of its total assets. If a CFC is excessively debt-funded, the fraction is calculated by reference to the assets of all the interest holder's CFCs. The same rule applies to certain dividends that are deductible for the purposes of calculating net attributable CFC income or loss, namely distributions relating to fixed-rate foreign equity and deductible foreign equity distributions made by the CFC to New Zealand-resident companies or to other CFCs.

The rules provide flexibility for intra-group financing arrangements, recognising that multinationals may operate financing subsidiaries to obtain debt finance on behalf of the group and then on-lend the funds to operating subsidiaries. An adjustment for on-lending may be made when calculating the net attributable CFC income or loss of a CFC. The effect of the adjustment is to allow a full deduction for expenditure incurred under financial arrangements that provide funds to the CFC and for any deductible dividends to the extent the funds are on-lent to associated CFCs. A similar adjustment may be made when determining whether a CFC is excessively debt-funded.

Expenditure incurred under financial arrangements such as derivative instruments that do not provide funds to the CFC is either deductible or non-deductible according to whether any income derived from the arrangement would be included in the CFC's attributable CFC amount.

## **Detailed analysis**

### ***When attributed CFC income or loss arises***

Section CQ 2 sets out when a person has attributed CFC income from a foreign company. A number of criteria must be satisfied, including that the foreign company is a CFC with net attributable CFC income under section EX 20C (subsection (2)(f)(i)). Section DN 2 makes equivalent provision in relation to attributed CFC loss.

In general, a person does not have attributed CFC income or loss from a CFC that is a non-attributing active CFC or a non-attributing Australian CFC (section CQ 2(1)(h) and (i) and section DN 2(h) and (i)).

### ***Income from personal services***

Sections CQ 2(2B) and DN 2(2) make special provision for income or loss derived by a CFC from personal services under section EX 20B(3)(h). This income is always subject to attribution: under sections CQ 2 and DN 2 if the CFC is a non-attributing active CFC or a non-attributing Australian CFC; otherwise, under section EX 20B(3)(h) and (9). In view of this, income from personal services may be disregarded for the purposes of determining whether a CFC is a non-attributing active CFC (section EX 21D(7)(a)). Where such income is attributed under the CFC rules, the equivalent attribution rule in subpart GB does not apply (section GB 27(3)(e)).

### ***Net attributable CFC income or loss***

Net attributable CFC income or loss is calculated under sections EX 20C to EX 20E and provides the basis for attribution to resident shareholders, much as branch equivalent income did previously.

Net attributable CFC income or loss is the CFC's attributable CFC amount, determined under section EX 20B, less the CFC's allowable expenditure. The relevant formula is found in section EX 20C(2) and refers to two categories of allowable expenditure – limited funding costs and other deductions.

### ***Limited funding costs***

The item, limited funding costs, is an adjusted amount, based on a CFC's funding costs as defined in section EX 20C(6)(a). Limited funding costs are not fully deductible under the formula in section EX 20C(2); deductions are restricted by applying the fraction found under section EX 20C(8).

Funding costs comprise expenditure incurred under financial arrangements that provide funds to the CFC and distributions relating to fixed-rate foreign equity and deductible foreign equity distributions made by the CFC to New Zealand-resident companies or to other CFCs.

When determining limited funding costs from funding costs, an adjustment may be made under section EX 20C(5). The adjustment is based on the value of funds on-lent by the CFC to associated CFCs (group funding) as a proportion of the CFC's own funding. Where funding costs exceed limited funding costs, the difference is allowed as other deductions (section EX 20D(9)(b)). The significance of this re-characterisation is that, under the formula in section EX 20C(2), other deductions are allowed in full rather than being restricted through the application of a fraction.

The effect of this adjustment is that, if a CFC borrows and then on-lends funds to an associated CFC, it is allowed a full deduction for its own interest expenditure on those funds. Thus, if a quarter of a CFC's funding is on-lent to associated CFCs, three-quarters of its funding costs will be included as limited funding costs subject to restriction, with the remainder being fully deductible. The adjustment is arithmetical and does not allow for borrowed funds to be matched to amounts on-lent.

### ***Other deductions***

The item, "other deductions", is defined in section EX 20C(9). As noted earlier, other deductions are allowed in full rather than being restricted through the application of a fraction.

Paragraph (a) of section EX 20C(9) deals with deductions not relating to financial arrangements and shares. This expenditure is deductible if it is (i) incurred for the purpose of deriving an attributable CFC amount and (ii) not incurred for the purpose of deriving an amount that is not an attributable CFC amount. If an item of expenditure relates to both attributable and non-attributable amounts, the combined effect of subparagraphs (i) and (ii) is to require apportionment of that expenditure.

Paragraph (b) deals with any funding costs excluded from limited funding costs by virtue of the on-lending adjustment described earlier.

Paragraph (c) deals with deductions relating to financial arrangements that do not provide funds to the CFC. Deductions are allowed only if they relate to an arrangement referred to in section EX 20B(4), namely one that would produce an attributable CFC amount if it produced a net gain rather than a net loss.

### ***Fraction***

Section EX 20C(8) defines the item "fraction" that is applied under the formula in section EX 20C(2) to restrict deductions for limited funding costs. Section EX 20C(10) to (12) and sections EX 20D and EX 20E are also relevant.

Typically, the fraction is based on the proportion, by value, of the CFC's assets that produce an attributable CFC amount (section EX 20C(10) and (11)). Thus, a CFC that uses one-third of its assets to earn attributable CFC amounts will be able to set one-third of its limited funding costs against those amounts when calculating its net attributable CFC income or loss. If an asset is used to derive both attributable and non-attributable amounts, its value will need to be apportioned. Asset values are adjusted to reflect any adjustment for on-lending under section EX 20C(5).

As a backstop against structures that concentrate debt in CFCs with mainly attributable assets in order to maximise allowable deductions, section EX 20C(8)(b) caps the fraction for a CFC that is excessively debt-funded at the amount calculated under section EX 20D. This cap is determined by reference to the assets of all the interest holder's CFCs (section EX 20D(9) to (13)). A CFC is considered to be excessively debt-funded if it has a debt-asset ratio, determined under section EX 20D(4), of more than 0.75 and also has a relative debt-asset ratio, determined under section EX 20E, of more than 1.10.

### ***Detailed calculation rules***

Section EX 21 sets out detailed calculation rules which apply for the purposes specified in subsection (1) – calculating the attributable CFC amount under section EX 20B, calculating net attributable CFC income or loss under section EX 20C, and determining under section EX 21D whether a CFC is a non-attributing active CFC. Subsection (2) provides that, for those purposes, the rules in the Act are applied as if the CFC were always a New Zealand resident, subject to the modifications set out in the rest of the section.

## **Interest allocation rules**

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### *Subpart FE of the Income Tax Act 2007*

Subpart FE has been amended to apply the interest allocation rules to New Zealand residents with interests in CFCs. These rules are designed to prevent excessive interest deductions being allocated against the New Zealand tax base.

### **Key features**

Interest allocation rules have been extended to outbound entities: New Zealand residents with an income interest in a CFC. The existing safe harbours apply. Interest deductions are not restricted unless the New Zealand group debt percentage is more than 75 percent (and, for a company or a trustee, is also more than 110 percent of the worldwide group debt percentage).

An outbound entity will not typically be required to apportion interest expenditure unless New Zealand group assets are less than 90 percent of the assets of the worldwide group and the total interest deductions of the New Zealand group are more than \$250,000. In addition, an adjustment mechanism has been introduced for outbound entities with finance costs of less than \$2 million. This eliminates apportionment for outbound entities with finance costs of up to \$1 million and provides tapered relief for those with finance costs between \$1 million and \$2 million.

Various changes have been made to the definitions of “debt” and “assets” in subpart FE. Fixed-rate foreign equity and fixed-rate shares held by New Zealand residents are now included when determining total group debt for the New Zealand group. Equity investments in CFCs are no longer included within the total group assets of the New Zealand group. The rules for measuring the debt of the worldwide group have been aligned with those for measuring the debt of the New Zealand group.

## **Detailed analysis**

### ***Application of rules to outbound entities***

Previously, the interest allocation rules only applied to New Zealand taxpayers controlled by a single non-resident. Subpart FE has been amended so that the rules also apply to outbound entities – New Zealand-resident companies, individuals and trustees with an income interest in a CFC (sections FE 1(1)(a)(i) and FE 2(1)(e) to (f)).

The safe harbours set out in section FE 5 apply to outbound entities as well as to entities controlled by non-residents. Thus, an outbound entity will not be subject to restriction of its interest deductions under subpart FE unless it has a New Zealand group debt percentage that is more than 75 percent (and, for a company or a trustee, is also more than 110 percent of the worldwide group debt percentage).

Additional carve-outs apply to outbound entities by virtue of section FE 5(1B). There is an exemption from the requirement to apportion interest expenditure if:

- the value of New Zealand group assets is 90 percent or more of the value of the assets of the worldwide group; or
- total interest deductions of the New Zealand group are not more than \$250,000 and the group does not include an entity with an income interest in a CFC that derives rent from land in the country or territory in which the CFC is resident.

### ***Apportionment of interest***

Section FE 6 contains the formula for apportioning interest for an excess debt entity. The effect of the formula, when it applies, is to produce an additional amount of income for the entity. As well as interest, the formula includes dividends paid in relation to fixed-rate foreign equity or fixed-rate shares (subsections (2) and (3)(ab)).

An adjustment mechanism has been introduced for outbound entities with finance costs of less than \$2 million (subsections (2) and (3)(ac)). The effect of the adjustment is to eliminate apportionment under this section for outbound entities with finance costs of up to \$1 million. For outbound entities with finance costs of between \$1 million and \$2 million, tapered relief is available, gradually reducing as costs increase towards the \$2 million cut-off point.

### ***Determination of New Zealand group***

For an outbound entity that is a company (an excess debt outbound company), the New Zealand group is determined by reference to the New Zealand parent (section FE 12(4)). The group comprises those companies for which control can be traced from the parent (section FE 28). The meaning of “control” for these purposes is determined under section FE 27. The New Zealand parent is identified under section FE 26 by tracing ownership interests up the chain of companies on a tier-by-tier basis until no New Zealand-resident company has an ownership interest of 50 percent or more in the last company in the chain (subsection (4B)).



For an outbound entity that is an individual or a trustee, the New Zealand group is determined under section FE 3. It includes all associated persons who are resident or have a fixed establishment in New Zealand or who derive New Zealand-sourced income that is not relieved under a double tax agreement. Excess debt outbound companies, and those within the New Zealand group of such companies, are not included.

The associated persons rules prevent the use of non-arm's-length arrangements to undermine the intent of the income tax legislation. In the context of the interest allocation rules, the application of these rules is intended to stop the use of close associates to bring excessive levels of debt within the New Zealand tax base, contrary to the policy intent. The rules governing when a person is associated with an individual or a trustee are set out in sections YB 1 to YB 16. Those provisions are discussed in detail elsewhere in this report.

Section FE 29 provides that companies or groups owned by the same natural person or trustee are to form a single New Zealand group.

### ***Determination of worldwide group***

It may also be necessary to determine the worldwide group of a company or a trustee that is an outbound entity, for the purposes of calculating the worldwide group debt percentage. For a company, the worldwide group is determined under sections FE 31B and FE 32 and includes the company, its New Zealand group, and its worldwide GAAP group (being all non-residents required to be included with the company in consolidated financial statements under generally accepted accounting practice). For a trustee, the worldwide group is determined under section FE 3 and includes the trustee, the trustee's New Zealand group, and all CFCs in which either the trustee or another member of the New Zealand group has an income interest.

### ***Measurement rules***

The general measurement rules set out in subpart FE apply to outbound entities for the purposes of calculating total group debt and total group assets of the New Zealand and worldwide groups. In particular, the New Zealand group debt percentage can be measured on various dates (section FE 8). Various bases for the valuation of total group assets may also be used (section FE 16), and the on-lending concession under section FE 13 applies to arm's-length debt provided by an outbound entity to its CFCs.

Various amendments have been made to the definitions of debt and assets in subpart FE. In particular:

- Fixed-rate foreign equity and fixed-rate shares held by New Zealand residents are now included when determining *total group debt* for the New Zealand group under section FE 15.
- Equity investments in CFCs are now excluded when determining *total group assets* for the New Zealand group under section FE 16.
- The rules in section FE 18 for measuring the debt of the worldwide group have been aligned with those for measuring New Zealand group debt. Accordingly, non-interest bearing liabilities and liabilities that do not provide funds are no longer treated as debt for the worldwide group, even if they are included as debt under generally accepted accounting practice.

## Foreign dividend exemption

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Sections CW 9 and HA 8B of the Income Tax Act 2007

### Key features

Section CW 9 provides that a dividend from a foreign company is treated as exempt income if derived by a company resident in New Zealand. However, there are several exceptions to this general rule, including:

- dividends from a less than 10 percent interest in a FIF described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39. These comprise shares in ASX-listed Australian companies, Australian unit trusts with adequate turnover or distributions, certain venture capital investments into New Zealand companies that have since migrated to a grey list country, and shares in Guinness Peat Group plc;
- dividends from fixed-rate foreign equity; and
- dividends from deductible foreign equity.

The foreign dividend is subject to income tax in these instances.

Foreign dividends that are received by non-companies (such as individuals or trustees of a trust) remain subject to income tax. However it should be noted that if a foreign dividend is received by a company that is acting in its capacity as a trustee of a trust, that foreign dividend will be subject to income tax.

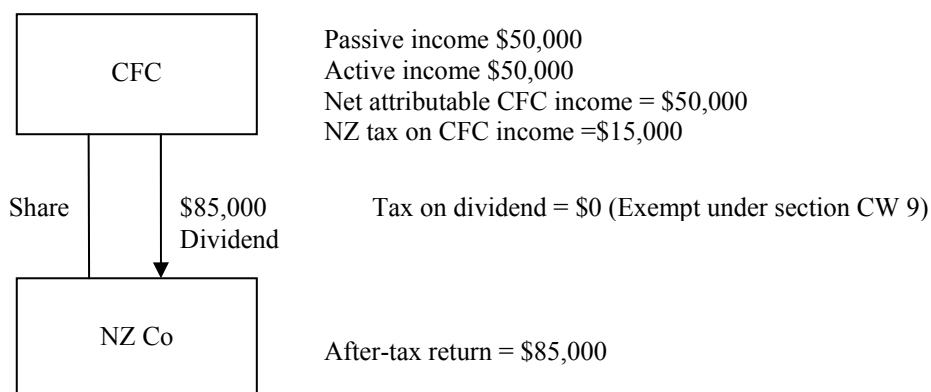
Qualifying companies are not be permitted to hold attributing interests in CFCs or non-portfolio FIFs. If a qualifying company holds such interests in any income year beginning on or after 1 July 2009, it will cease to be a qualifying company.

### Detailed analysis

If a foreign company pays a dividend to a company that is resident in New Zealand that dividend will in most cases be treated as exempt income of the New Zealand company under section CW 9.

#### Example

A CFC (or FIF) pays an ordinary dividend to a New Zealand company.



However, the foreign dividend exemption in section CW 9 only applies to companies. Other New Zealand taxpayers are taxable on their foreign dividends. Some types of foreign dividend are also excluded from the exemption and are described below.

***New Zealand taxpayers to which the foreign dividend exemption does not apply***

Foreign dividends that are received by a portfolio tax rate entity will be subject to income tax as subsection CW 9(3) excludes these companies from the exemption.

Foreign dividends that are received by non-companies (such as individuals or trustees of a trust) are also subject to income tax. However, it should be noted that if a foreign dividend is received by a company that is acting in its capacity as a trustee of a trust, that foreign dividend will be subject to income tax. Branch equivalent tax accounts have been retained for non-companies (sections OE 17 to OE 22) to relieve any double taxation.

Under new section HA 8B, qualifying companies are not permitted to hold CFC income interests or interests in a FIF that are a direct income interest of 10 percent or more. This ensures that qualifying companies cannot be used as intermediaries to distribute untaxed foreign income to New Zealand shareholders (as dividends from qualifying companies are exempt under section CW 15 to the extent to which they are not fully-imputed). If a qualifying company holds a CFC income interest or non-portfolio FIF interest in any income year beginning on or after 1 July 2009 it will immediately cease to be a qualifying company.

***Certain foreign dividends are subject to income tax***

Certain types of foreign dividends are explicitly excluded from the section CW 9 foreign dividend exemption. These are listed in subsection CW 9(2) and are as follows:

- dividends from a less than 10 percent interest in a FIF described in sections EX 31, EX 32, EX 36, EX 37, EX 37B or EX 39. These comprise shares in ASX-listed Australian companies, Australian unit trusts with adequate turnover or distributions, certain venture capital investments into New Zealand companies that have since migrated to a grey list country, and shares in Guinness Peat Group plc;
- dividends from fixed-rate foreign equity; and
- dividends from deductible foreign equity.

Income tax is payable on the foreign dividend in these cases.

If a person holds an attributing interest in a FIF that is calculated using the comparative value, deemed rate of return or fair dividend rate methods, any dividends from this FIF will be exempt. This is because these FIF interests have no income other than FIF income under section EX 59(2).

Fixed-rate foreign equity and deductible foreign equity are defined in section YA 1.

Fixed-rate foreign equity includes foreign dividends that are a specific, fixed percentage of the amount paid for the equity (as well as variations on this) and any dividend that is regarded as equivalent to payment for money lent.

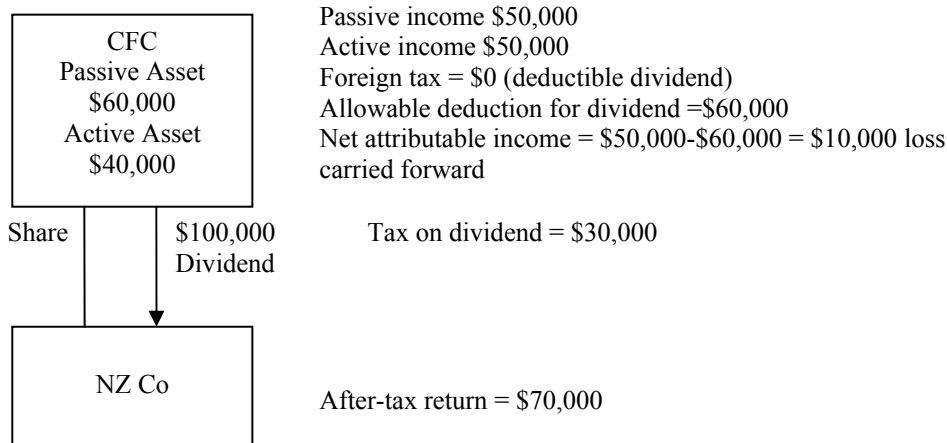
A deductible foreign equity distribution is a dividend where the foreign company paying the dividend (or a company in the same group or further up the chain as the foreign company) is allowed a deduction for the payment of the dividend against foreign income tax.

To prevent double taxation on fixed-rate foreign equity and deductible foreign equity a deduction will be available under section EX 20C(2) to a CFC in determining its net attributed CFC income in cases where the CFC pays these dividends to a New Zealand company or another CFC.

The deduction is apportioned to the extent to which the CFC has active assets to account for the fact that active CFC income is not attributed. More specifically the deduction is calculated according to the *fraction* found under section EX 20C(8).

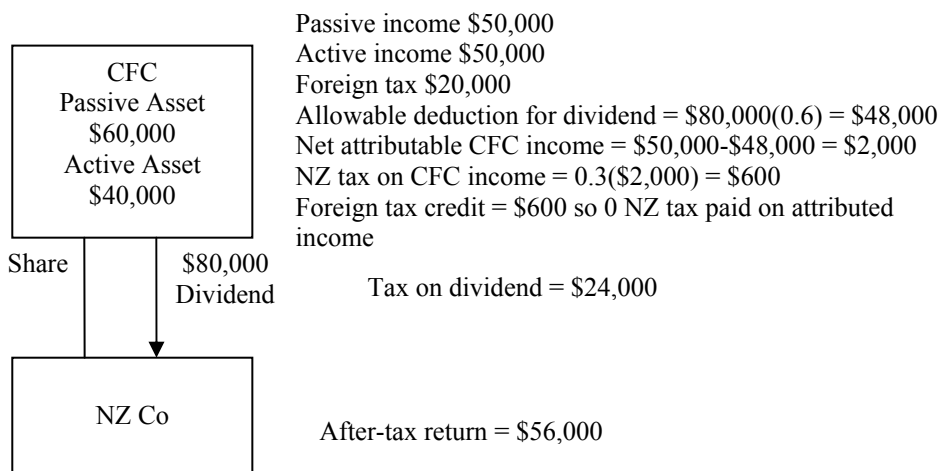
**Example 1**

A CFC pays a deductible dividend of \$100,000 to a New Zealand company.



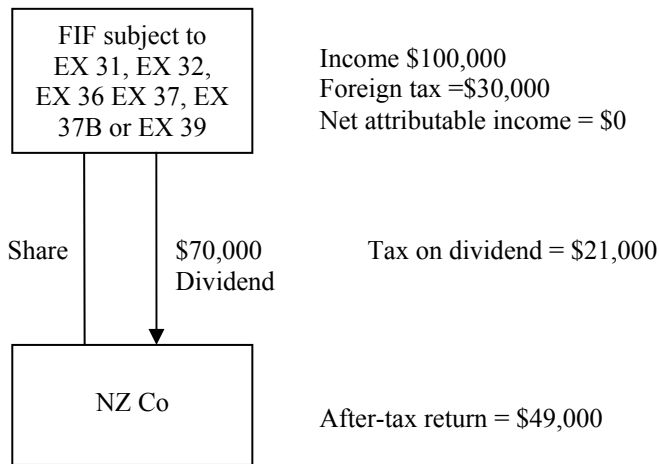
**Example 2**

A CFC pays a fixed-rate dividend of \$80,000 to a New Zealand company.



### Example 3

A non-attributing portfolio FIF pays a dividend of \$70,000 to a New Zealand company.



## Transitionals, consequentials and repeals

*Sections EX 22, GZ 2, IQ 2B, LK 5B, LQ 1 to LQ 4, RG, OC 4, OC 5, OC 6, OC 8, OC 9, OC 10, OC 30 to OC 34, OD 4 to OD 8, OD 11, OD 23, OE 12 to OE, 16B, OP 56, OP 61, OP 62 and OP 105 to OP 108B of the Income Tax Act 2007*

Provision has been made to deal with various transitional and consequential matters arising from the new rules for CFC income and foreign dividends. The changes are discussed below.

### Key features

#### *CFC net losses and foreign tax credits*

Sections IQ 2B and LK 5B set out transitional rules to deal with attributed CFC net losses and foreign tax credits. In broad terms, the effect of these rules is that attributed CFC net losses and foreign tax credits accrued under the old rules can be carried forward into the new system, but will continue to be reduced by reference to total CFC net income (including non-attributable income).

#### *Repeal of foreign dividend payments*

Subpart RG has been repealed to remove the liability for resident companies to pay foreign dividend payments on dividends they receive from foreign companies.

Sections OC 4, OC 5, and OC 30 to OC 34 have been amended to replace “further FDP” with “further income tax.”

Sections OC 6, OC 8, OC 9, OC 10, OP 56, OP 61 and OP 62 have been repealed to prevent new FDP credits from being generated.

### ***Branch equivalent tax accounts***

Sections OE 12 to OE 16 and OP 105 to OP 108 have been repealed to prevent branch equivalent tax accounts (BETA) debit balances from increasing under the new rules.

Sections OE 16B and OP 108B provide a BETA debit to extinguish any existing BETA credit balances as BETA credits are no longer required to relieve FDP once FDP has been repealed.

### ***Repeal of the grey list exemption for CFCs***

The exemption for CFCs resident in eight grey list countries available under the previous rules has been replaced with an exemption for a CFC resident in Australia. This is achieved by a modification to section EX 22.

### ***Repeal of conduit tax relief***

Sections LQ 1 to LQ 4 have been repealed to prevent further conduit tax relief (CTR) arising.

Section OD 4(3) has been amended so that a CTR company that elects to cease being a CTR company stops being a CTR company the day after the election is made (rather than at the beginning of the next tax year).

Sections OD 5 and OD 8 have been repealed to prevent new conduit tax relief credits from arising from conduit tax relief on attributed income or dividends.

Section OD 11 has been repealed as this square-up is obsolete now that FDP is no longer paid when a CTR credit is generated.

Section OD 23 has been repealed to remove the tax liability that can arise from CTR debits. In other words, CTR credits will cease to be a contingent liability unless the anti-avoidance rule in section GZ 2 applies.

Section GZ 2 claws back conduit tax relief from conduit arrangements that previously provided a tax benefit to New Zealand-resident shareholders (aside from the CTR company or a CTR holding company for that company).

### **Detailed analysis**

#### ***Transitional loss carry-forward rules***

A net loss incurred by a CFC is attributed to holders of non-portfolio income interests under subpart DN. FIF losses are likewise attributed to interest holders under subpart DN. A person may set an attributed CFC loss or a FIF loss from a given jurisdiction against attributed CFC income or branch equivalent FIF income from the same jurisdiction. Any excess becomes an attributed CFC net loss or a FIF net loss, which may be carried forward and used against future profits. Losses attributed from CFCs and branch equivalent FIFs are ring-fenced by jurisdiction, which means that a loss which arose in a given jurisdiction may only be set against CFC income or branch equivalent FIF income from the same jurisdiction.

Transitional rules are needed to deal with attributed CFC net losses and FIF net losses carried forward from the previous rules. This is because the measure of attributable income against which those losses can be set is narrower than that which applied at the time the losses accrued. The value of these historical losses should therefore be restricted under the new rules. This is achieved through section IQ 2B.

Subsection (1) provides that the amount of attributed CFC net loss or FIF net loss from a jurisdiction that a person has carried forward from the previous rules is the person's *available BE loss* for that jurisdiction. Subsection (2) provides that each year, some or all of this available BE loss is converted into an *equivalent CFC loss*, which is effectively an ordinary attributed CFC net loss under the new rules. The amount of available BE loss converted each year is the *converted BE loss*.

The amount of losses converted each year, and the rate of conversion, is determined under subsections (4) to (7). Separate calculations are required for each relevant jurisdiction. The rate of conversion depends on the relationship between a person's *jurisdictional attributed income* and the person's *jurisdictional BE income*. These terms are defined in subsection (9). The key difference is that jurisdictional attributed income only includes income from CFCs which is attributed under the new rules, whereas jurisdictional BE income includes the full branch equivalent income from CFCs that would have been attributable under the old rules. (Full branch equivalent FIF income is included under both terms.)

Subsection (4) deals with the typical scenario, in which a person's jurisdictional BE income is greater than jurisdictional attributed income. In that case, the converted BE loss is equal to the person's jurisdictional BE income (or to the available BE loss if this is lower). The equivalent CFC loss is equal to the person's jurisdictional attributed income (or the amount calculated under paragraph (b)(ii) if this is lower). What this means in practice is illustrated by the following example.

**Example**

In 2010–11, a person has jurisdictional attributed income of \$75, jurisdictional BE income of \$150 and an available BE loss for the jurisdiction of \$210. The person must use \$150 of the available BE loss to offset the jurisdictional attributed income of \$75, giving \$1 of historical loss an effective value in that year of 50 cents and leaving an available CFC loss of \$60 to carry forward to 2011–12.

In 2011–12, the same person has jurisdictional attributed income of \$80 and jurisdictional BE income of \$120. The person sets the remaining \$60 of the available CFC loss against the jurisdictional attributed income, its effective value being \$40 (determined under paragraph (b)(ii) according to the relationship between jurisdictional attributed income and jurisdictional BE income in that year). This leaves jurisdictional attributed income of \$40 still subject to New Zealand tax.

Subsection (5) deals with the less common situation in which jurisdictional attributed income exceeds jurisdictional BE income. In that case, the equivalent CFC loss is equal to the converted BE loss (giving \$1 of historical loss an effective value of \$1). The available BE loss to be converted is the amount needed to offset the person's jurisdictional attributed income for the year, assuming there are sufficient losses available.

Subsections (6) and (7) make equivalent provision for interest holders who are members of wholly owned groups that include other resident members. For a member of a wholly owned group, the conversion of historical losses to an equivalent CFC loss is done by reference to the *jurisdictional income ratio* of the group.

A person or a wholly owned group may elect, under subsection (8), to fix the jurisdictional income ratio using the average ratios over a two-year period, provided they had jurisdictional BE income in each of those years. A person may also elect, under subsection (3), not to carry forward historical losses from a given jurisdiction.

To minimise compliance costs, subsection (10) allows a person or a wholly owned group to use the net profit or loss from financial accounts as a proxy for the branch equivalent income or loss of a CFC for the purposes of calculating their jurisdictional BE income.

### ***Transitional rules for foreign tax credits***

Subpart LK makes provision for tax credits relating to attributed CFC income. A person who has attributed CFC income for an income year is allowed a tax credit for income tax and foreign income tax paid in relation to that income by the person or by the CFC. Surplus credits may be carried forward or transferred within the same wholly owned group, subject in both cases to jurisdictional ring-fencing. The tax credit rules for CFCs in subpart LK are applied to branch equivalent FIFs by section EX 50(8) and (9).

Equivalent transitional issues arise for subpart LK credits carried forward from under the previous rules as losses. These credits are therefore subject to similar restrictions, in this case under section LK 5B.

Subsection (1) provides that the credit relating to a jurisdiction carried forward from under the previous rules is the *available BE credit* for that jurisdiction. Subsection (2) provides that each year, some or all of this available BE credit is converted into an *equivalent tax credit*, and is effectively treated as an ordinary credit under subpart LK. The amount of available BE credit converted each year is the *converted BE credit*.

The credits converted each year, and the rate of conversion, is determined under subsections (4) to (7). The approach is the same as that taken for losses under section IQ 2B. An election to fix the jurisdictional income ratio using the average ratios over a two-year period under section IQ 2B(8) will also apply for the purposes of this section.

As for losses, a person may elect not to carry forward historical credits from a given jurisdiction (subsection (3)). Likewise, there is the same scope for a person to use net profit or losses from accounts, instead of BE income or loss, when determining the jurisdictional BE income (subsection (10)).



### ***Repeal of foreign dividend payments***

As a result of the exemption for most foreign dividends received by companies, foreign dividend payments (FDP) have been repealed and foreign dividend payment accounts will be gradually phased out.

Subpart RG has been repealed to remove the liability for resident companies to pay foreign dividend payments on dividends that they receive from foreign companies. As a result, most foreign dividends received by companies will be wholly exempt, but in some cases, income tax will be payable (see the section on “foreign dividend exemption” for details and examples).

If a company had an FDP debit at the end of the tax year (section OC 30) or when it migrates offshore (section OC 31) “further FDP” was payable under the previous rules. Under the new rules, this liability has been replaced with a liability to pay further income tax. Consistent with this change, section 140B of the Tax Administration Act has been amended so that imputation penalty tax is payable when further income tax is payable under section OC 30.

Several sections in subpart OC that give rise to FDP credits have been repealed as these sections are redundant with the repeal of the FDP liability in section RG. The repealed provisions are: section OC 6, which provided an FDP credit for FDP being paid, sections OC 8 and OC 10, which provided FDP credits when FDP was payable as a result of a CTR debit or CTR debit balance, and section OC 9, which allowed companies to convert any imputation credits earned on attributable foreign income into FDP credits. The repeal of section OC 6 only applies to dividends received after the new international tax rules came into force.

#### **Example 1**

NZ Co has a balance date of 30 June. It receives a foreign dividend on 20 June 2009 on which it is liable to pay FDP of \$30. On 10 July 2009, NZ Co pays the \$30 of FDP and has 30 FDP credits added to its FDP account balance.

#### **Example 2**

NZ Co receives a second foreign dividend on 1 July 2009. This dividend is wholly exempt so no FDP is paid and no FDP credit arises.

Companies will have five years to distribute their existing FDP credit balances to shareholders before any remaining balances are converted into imputation credits. This will be legislated for as part of a subsequent tax bill.

### ***Branch equivalent tax accounts***

The exemption for most foreign dividends received by companies means that branch equivalent tax accounts (BETA) for companies will be phased out. As income tax will continue to apply to foreign dividends received by non-companies, BETA accounts will be retained for non-companies.

Companies with BETA debit balances will be able to continue to use these debits to relieve any double taxation on attributed income for a two-year period. Any remaining BETA debits will then be extinguished. This will be legislated for as part of a subsequent tax bill.

The transitional period for BETA debits is intended only to prevent double taxation in the rare cases in which dividends have been paid significantly in advance of attributed passive income arising.

**Example 1**

Company C has a BETA credit balance of \$200. At the beginning of its income year this balance is extinguished as BETA credits are no longer required with the repeal of FDP (BETA credits can only be used to relieve FDP).

**Example 2**

Company D has a BETA debit balance of \$30. From the beginning of its income year, no more BETA debits will be generated. The company has \$100 of net attributed (passive) CFC income it can use its BETA debit balance to relieve the \$30 of income tax that would otherwise be payable on this income.

***Repeal of the grey list exemption for CFCs***

Taxpayers with a greater than 10 percent interest in a CFC that is resident in a grey list country will have to calculate their attributable CFC amount from the CFC unless it qualifies as a non-attributing active CFC under section EX 21B or is a non-attributing Australian CFC under section EX 22B.

The eight-country grey list for 10 percent or greater interests in FIFs in section EX 35 will be retained for the time being, while the possibility of extending the active income exemption to these entities is considered.

**Example 1**

NZ Co has a CFC that is resident in the UK. From the beginning of its income year on 1 August 2009, it will be required to attribute passive income from the UK CFC unless that CFC qualifies as a non-attributing active CFC under section EX 21B.

**Example 2**

NZ Co has a greater than 10 percent interest in a FIF that is resident in the UK. Because the section EX 35 grey list exemption still applies, NZ Co will not be required to attribute income from this FIF.

***Repeal of conduit tax relief***

Under the new rules, no further conduit tax relief will arise under the conduit mechanism. The conduit mechanism removes income tax on income that a New Zealand company receives from its CFC interests to the extent that the New Zealand company is owned by non-residents.

Section OD 23 has been repealed to remove the tax liability that can arise from CTR debits. In other words, CTR credits will cease to be a contingent liability. An exception to this is if the anti-avoidance rule in section GZ 2 is found to apply.

**Example**

CTR Co has a balance date of 31 July 2009. From 1 August it will no longer receive conduit tax relief on its CFC income and no new conduit credits will be added to its existing pool of \$2 million CTR credits.

On 1 December 2009, CTR Co is bought by a NZ-resident company, which results in a change of more than 34 percent in its resident shareholding status. This will cause \$2 million of CTR debits to arise under section OD 16 (extinguishing the CTR credit balance). Under the previous rules, this break in shareholder continuity would have generated an FDP liability under section OD 23, but no liability arises under the new rules unless the anti-avoidance rule in section GZ 2 is found to apply.

Section GZ 2 is intended to claw back conduit tax relief from arrangements that were entered into in anticipation of the repeal of section OD 23 that had the effect of reducing the tax liabilities of New Zealand shareholders. This reflects the fact that conduit tax relief was designed to relieve tax on non-residents investing through New Zealand into CFCs. Conduit tax relief was not intended to apply to income that was ultimately owned by New Zealand residents. Section GZ 2 applies to arrangements that generated conduit tax relief credits between 4 December 2008 (when an issues paper announcing this policy was released) and the date from which conduit tax relief was repealed. Section GZ 2 does not apply to conduit tax relief received by the conduit tax relief company itself, or by a CTR holding company for the CTR company.

**Example**

CTR Co has a balance date of 30 April. In the period from 4 December 2008 to 30 April 2010, CTR Co receives \$1 million of conduit tax relief in respect of its CFC.

On 1 May 2010, CTR Co passes \$0.5 million of conduit-relieved income through to its non-resident shareholders. Section GZ 2 would not apply to this amount.

On 1 June 2010, CTR Co ceases to be a conduit tax relief company and distributes the remaining \$0.5 million of conduit-relieved income to a resident shareholder who is not a CTR holding company in the CTR Co. Section GZ 2 is likely to apply to this amount.

CTR companies will be able to continue to attach CTR credits to any dividends they distribute to their non-resident shareholders, for a period of two years. This provides time for conduit-relieved income (represented by CTR credits) to be channelled to non-residents and any CFC income on which New Zealand tax has been paid (represented by FDP credits) to be channelled to New Zealand residents.

**Example**

CTR Co has 42 CTR credits and 42 FDP credits. It pays a dividend of \$100 to a non-resident to which it attaches the 42 CTR credits and pays a dividend of \$100 to a New Zealand resident to which it attaches the 42 FDP credits. This is in accordance with the original policy intent for how income would be distributed from CTR companies.

CTR companies that do not wish to distribute their foreign income in this way, can, under the new rules, elect to cease to be a CTR company under section OD 4 and have their CTR credits extinguished with no liability. Subsection OD 4(3) has been amended to make it so this election will take effect from the day after the election was made as this allows companies to convert FDP credits into imputation credits (under the previous rules, these companies would have had to wait until the next tax year before the election took effect).

#### **Example**

CTR Co has 30 CTR credits and 30 FDP credits. On 1 August 2009 it elects to cease being a CTR company. From 2 August 2009 it is no longer a CTR company so the 30 CTR credits are extinguished (with no FDP liability). The company can choose to convert the 30 FDP credits into 30 imputation credits. If the company pays a dividend it will have no CTR credits to distribute to non-residents so if FDP credits (or imputation credits) were attached to a dividend it would have to attach these in the same ratio to all of its dividends.

Another option is for CTR companies to simply retain their CTR credits for the two-year transitional period, after which these credits will be extinguished with no tax liability.

The legislation for this final repeal of CTR accounts will be introduced as part of a subsequent tax bill.

## **Disclosure requirements for CFCS**

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### ***Consequential changes as a result of amendments to CFC rules***

Residents must disclose an income interest of 10 percent or more in a CFC. To disclose an interest after the revised CFC rules apply, the new electronic IR 458 form on Inland Revenue's website ([www.ird.govt.nz](http://www.ird.govt.nz)) must be used. To disclose an interest before the revised CFC rules apply, the IR 477 or IR 479 forms must be used.

Residents with an income interest of 10 percent or more in a foreign company that is not a CFC are still required to disclose that interest using a FIF disclosure form, an IR 477 or an IR 479, as applicable. Residents with an income interest of less than 10 percent in a CFC may be required to disclose the interest in a FIF disclosure form. Further information about these existing disclosure requirements is contained in 2009 International Tax Disclosure Exemption ITR20 ([www.ird.govt.nz/technical-tax/determinations/other/other-int-tax-itr20.html](http://www.ird.govt.nz/technical-tax/determinations/other/other-int-tax-itr20.html)).