New Zealand's International Tax Review: a direction for change

A government discussion document

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First published in December 2006 by the Policy Advice Division of the Inland Revenue Department, PO Box 2198, Wellington.

New Zealand's International Tax Review: a direction for change: a government discussion document.
ISBN 0-478-27149-2

CHAPTER 1

Introduction

1.1 The government is committed to creating an environment that enables New Zealand businesses to thrive in the global economy. The International Tax Review is linked to the government's Business Tax Review, the aim of which is to facilitate economic transformation by improving incentives for productivity gains.

1.2 New Zealand's tax system plays an important role in fostering a competitive business environment. It sits alongside other elements such as infrastructure, skills and education, and research and development that are a key focus of the government within its Economic Transformation agenda.

1.3 It is important that New Zealand's tax system is not out of line with systems in comparable jurisdictions, particularly Australia. Within an increasingly borderless global economy, New Zealand must be able to attract and retain capital, and our businesses must be able to compete effectively in foreign markets.

1.4 New Zealand's rules for taxing offshore investment through controlled foreign companies (CFCs)[1] are more stringent than those of other countries. Since 1988, New Zealand residents have been taxed on all income earned by their CFCs[2] at the time that income is earned (accrual taxation). Other countries limit accrual taxation of offshore income to passive income and certain special categories.[3] Active income is generally exempted or taxation is deferred until the income is returned in the form of dividends.

1.5 Concern has been expressed by the Tax Review 2001[4] and other commentators that the current system could inhibit the internationalisation of New Zealand business.

1.6 This discussion document deals with the taxation of outbound, non-portfolio investment by focusing on:

- relaxation of the current CFC rules by introducing an active/passive distinction – offshore active income would be exempted from accrual taxation, and passive income would continue to be taxed as it accrues;

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[1] A controlled foreign company is essentially a company resident in a foreign jurisdiction that is controlled by a small number of New Zealand residents.

[2] The main exception being CFCs resident in eight grey list countries. This exclusion is described further in chapter 2.

[3] Passive income includes investment income such as interest, dividends, royalties and rents. The concept is often extended to other transactions which could erode the domestic tax base, so-called base company income. Together, such income is often referred to as "tainted" income and is subject to accrual taxation.

[4] The independent Tax Review 2001, under the Chairmanship of Robert McLeod, commissioned to undertake a broad review of the tax system and to develop proposals to guide the future direction of New Zealand tax policy. It made its final report to the government in October 2001.

- the implications for other aspects of our international tax rules to protect the New Zealand domestic tax base; and
- possible changes to New Zealand's tax treaty policy on non-resident withholding tax (NRWT) on dividends, interest and royalties.

1.7 An exemption for the active income of CFCs would put New Zealand companies on a more equal footing internationally by removing an additional tax cost not faced by firms based in comparable jurisdictions, such as Australia.

1.8 Lower treaty limits for NRWT would also reduce tax barriers to offshore investment. New Zealanders receiving payments sourced in countries with which New Zealand has a double tax agreement would enjoy lower rates of foreign withholding taxes.

1.9 Bringing our international tax rules into line with international norms would reduce the barriers faced by New Zealand-based firms, under the current tax rules, to exploiting the benefits of operating offshore. These changes would encourage businesses with international operations to remain, establish and expand.

Links with the Tax Review 2001

1.10 The issues canvassed in the discussion document were raised in the Tax Review 2001 and then, more recently, by other commentators such as the New Zealand Institute.

1.11 Indeed, international tax reform has been on the government's agenda since the release of the *Final Report* of the Tax Review in 2001. Many of the recommendations of the Review centred on proposals to reform the taxation of inbound and outbound investment. As a result, the government has considered the following issues:

- ***A major reduction in taxes imposed on inbound foreign direct investment (FDI) to increase levels of FDI in New Zealand.*** As the government announced in September 2003, it had decided not to proceed with this proposal because the expected spill-over benefits would be outweighed by substantial fiscal costs.
- ***A temporary tax exemption on the foreign income of new migrants, to facilitate the migration of skilled labour to New Zealand.*** The government agreed with the Tax Review's recommendation and has since passed legislation implementing a four-year tax exemption on foreign income for both new migrants and returning New Zealanders.

- ***Examination of a risk-free return method (RFRM) for taxing income from offshore portfolio investments.*** The government has proposed new tax rules for offshore portfolio investment that are broadly consistent with this proposal. The measures examined in this discussion document do not affect those proposed rules.

1.12 The other important recommendation of the Tax Review was that the government explore the merits of adopting an active/passive distinction in our CFC rules. The Tax Review expressed the broad concern that our comprehensive taxation of CFC income was out of step with international norms.

1.13 The New Zealand Institute echoes the Tax Review's concerns. In its 2006 discussion paper, *The Flight of the Kiwi*, the Institute argues that the current CFC rules generate "real economic costs in terms of aspirational companies being lost to the New Zealand economy rather than electing to go global from a New Zealand base (or deciding not to venture abroad at all)."

1.14 The government shares these concerns. Providing an exemption for offshore active business is intended to help retain dynamic companies in New Zealand. Otherwise, there can be economic costs from migration of existing businesses or the establishment offshore of potential businesses, or by inhibiting the expansion of existing business into offshore markets.

Key features of the reform

1.15 The central feature of the reform described in the discussion document is to provide an exemption for *offshore active* income. Consequently, new rules will need to ensure the exemption does not extend to passive or domestic income.

1.16 New Zealand can benefit from extensive international experience in distinguishing between active and passive income. Even so, international experience can take us only so far. In the end, New Zealand's international tax rules need to be developed to reflect the realities of our business environment and other features of our tax system.

1.17 A critical issue informing the development of a new system will be the compliance and administrative burden imposed by new rules. While the rules themselves will inevitably be complex, reflecting the complexity of international business arrangements, the government believes that the system described here could be much simpler in actual operation than the current system.

1.18 While the discussion document expresses a clear preference on the direction for change, many important issues of implementation remain open. Final decisions will be made only after consultation with the businesses that will have to apply the new rules. In the process, trade-offs between the scope of the active income exemption and the implementation of the various base maintenance measures will be inevitable. Submissions will be important in evaluating those trade-offs.

SUMMARY OF POSSIBLE CHANGES

A new direction for taxing CFC income

Possible changes

1. Under a new active/passive distinction, offshore active income would be exempted from accrual taxation, and passive income would be taxed as it accrues.

2. Complementary changes to other aspects of our international tax rules, in particular, the thin capitalisation rules, would be needed to protect the New Zealand domestic tax base.

3. New Zealand's tax treaty policy on non-resident withholding tax could also change.

Implementing an active/passive distinction

Possible changes

1. Offshore active income would be exempt.

2. The broad international consensus to define passive income positively would be adopted, leaving active income as the residual undefined concept.

3. Passive income and base company income (collectively called "tainted income") would continue to be taxed on accrual.

4. The main categories of tainted income would include:

   - ***Passive income***: dividends, interest, royalties and rents. It could include income which is passive in form but the derivation of which involves certain activity.
   - ***Base company income.*** Base company rules would be designed to counter situations where domestic income is shifted offshore to benefit from the active income exemption.

The transactional and entity approaches

Possible approaches

The government could adopt one of two approaches to attributing the income of a CFC to its resident shareholders:

- The *transactional approach* examines each item of income derived by a CFC to determine whether it produces tainted income or non-tainted income. Accordingly, different income streams of the CFC attract different treatment depending upon their category; or
- The *entity approach* looks at whether the company is active or passive. Once categorised, then all of the income of the company is taxed in the corresponding manner, regardless of the nature of the income derived.

Interest allocation and transfer pricing rules

Possible changes

1. The current thin capitalisation rules would be:
    - extended to cover all New Zealand entities with outbound investments, taking into account the compliance cost considerations;
    - modified to deal with outbound investments in CFCs; and
    - reviewed to ensure that the safe harbour ratio is appropriate.
2. Technical aspects of the thin capitalisation rules would be reviewed to make them consistent with the minimum capital requirement rules for banks.
3. The transfer pricing rules would be strengthened by shifting the burden of proof on transfer pricing matters from the tax administration to taxpayers.

Implications for the taxation of dividends and other international tax rules

Possible changes

1. A key issue is whether dividends from CFCs should continue to be taxed. The government is more attracted to the exemption method provided such an exemption would not lead to erosion of the New Zealand tax base.
2. Repeal of the grey list exemption and conduit rules would be consistent with an active/passive distinction that focuses on exempting active income rather than whether the income has been comparably taxed in the host country.
3. Consideration should be given to whether the active/passive distinction should apply in respect of foreign branches and non-portfolio interests in foreign investment funds (FIFs).

Non-resident withholding tax

Possible changes

1. NRWT on dividends could be lowered through bilateral treaty negotiations, although the case for this is stronger for non-portfolio dividends. The changes would have implications for the foreign investor tax credit (FITC) rules.

2. Reducing NRWT on either interest or royalties is a possibility but may not be justified.

3. A number of technical changes to the NRWT and approved issuer levy (AIL) rules would rationalise information requirements and withholding arrangements across different payments.

How to make a submission

1.19 The government invites submissions on the issues raised in this discussion document. Submissions should be made by 16 February 2007 and be addressed to:

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

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

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

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

1.22 In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document, including detailed design issues, with key interested parties.

CHAPTER 2

A new direction for taxing CFC income

Possible changes

1. Under a new active/passive distinction, offshore active income would be exempted from accrual taxation, and passive income would be taxed as it accrues.

2. Complementary changes to other aspects of our international tax rules, in particular, the thin capitalisation rules, would be needed to protect the New Zealand domestic tax base.

3. New Zealand's tax treaty policy on non-resident withholding tax could also change.

Details of how the rules within this general framework might work are the subject of consultations and submissions.

2.1 How best to tax income on outbound direct investment is one of the most vexed tax policy issues.

2.2 New Zealand's current system of international taxation is to tax offshore income as it accrues, with credits given for foreign taxes that have been paid. No other OECD country has adopted this approach. All other OECD countries either defer taxing offshore active income or exempt it altogether. Since New Zealand taxes the income of its CFCs more heavily than other countries, it can be attractive for innovative and dynamic firms to migrate from New Zealand, establish themselves in other countries or simply stay small and local.

2.3 Since New Zealand's rules applying to CFCs were introduced in 1988, other countries, including Australia, have liberalised their tax rules for the active income of their CFCs. Moreover, it has become easier for both firms and workers to shift across international borders.

2.4 For these reasons, the government supports a change to New Zealand's paradigm of comprehensive taxation of CFC income toward providing an exemption for offshore active income. Other measures, to protect the domestic tax base, would form an integral part of the new system.

Current approach to taxing CFC income

2.5 New Zealand generally taxes both active and passive offshore income of its CFCs as it accrues, with a credit for foreign taxes. As a departure from this comprehensive taxation, income from CFCs in eight grey list countries[5] is exempt. The policy motivation for the grey list is to reduce compliance costs. Income earned in a grey list country is considered to be taxed comparably to New Zealand-earned income, so there would be negligible New Zealand tax to pay after allowing foreign tax credits.[6]

2.6 It is sometimes argued that despite New Zealand's tax treatment of the income of its CFCs being relatively stringent by world standards, it is not stringent enough. Standard economic analysis would suggest that there is a case for taxing on a pure residence basis. Under a pure residence basis, foreign taxes would be treated as a cost just like other costs of doing business, and deductions rather than credits would be allowed for foreign taxes. Such a tax system is, under strong assumptions, said to promote national welfare maximisation. It would provide incentives for investing abroad only if the benefits to New Zealand (which are net of any foreign taxes) exceed the benefits from investment in New Zealand.[7]

2.7 Even so, under international tax treaties and in practice, countries of residence relieve double taxation by either providing credits for foreign taxes or exempting foreign-source income.

2.8 A system of comprehensive taxation of CFC income, with credits for foreign taxes paid, is sometimes advocated on the grounds of "capital export neutrality". Other things being equal, it provides incentives for capital to be allocated around in the world in ways which lead to the highest, risk-adjusted, pre-tax returns. This is consistent with promoting the global efficiency of capital allocation.[8] In practice, it makes very little sense for a small, open economy like New Zealand's to "go it alone" in promoting capital export neutrality. New Zealand is much too small to do anything significant to promote global efficiency in the way that worldwide capital is allocated.

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[5] "Grey list" countries are those considered to have tax systems similar to that of New Zealand. They are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.

[6] Tax preferences available abroad or asymmetries in tax systems may mean that income sourced from these eight grey list countries need not necessarily be comparably taxed. This is discussed further in chapter 3.

[7] While standard analysis suggests a "first-best" case for full taxation of outbound investment, the see-saw principle suggests that there can be a "second-best" case for a lower tax on outbound investment. If, for some reason, an economy is constrained to levy a higher than optimal rate on inbound investment, there can be a case for a somewhat lower tax rate on outbound investment.

[8] If instead the income of CFCs is exempt or taxed with a credit only when dividends are remitted, this can lead to investment in low-tax jurisdictions being more attractive on an after-tax basis than domestic investments, even when the pre-tax returns are lower than those obtained on domestic investments.

2.9 The main argument in favour of New Zealand's current approach to taxing the income of its CFCs would appear to be that while it falls short of the pure residence base which might be advanced on grounds of national welfare maximisation, it is the nearest internationally acceptable alternative. A secondary attraction of New Zealand's current approach is that it avoids any need to distinguish between active and passive income. Other countries cope with such a distinction, although there are inevitably contentious borderlines.

2.10 The key argument against New Zealand's current approach is the disincentive it provides New Zealand-based companies to internationalise their businesses from a New Zealand base when other countries offer much more lenient rules for CFCs. This will be explored in greater detail in the next section.

2.11 There is a second concern. A foreign tax credit system can provide incentives for domestic firms to channel offshore investment into higher-tax foreign countries in ways which are not in New Zealand's best interest. This is illustrated in Table 2.1. In the example, investment into Country A, a higher-tax country, provides a higher pre-tax return than an investment into Country B, a low-tax jurisdiction. From New Zealand's perspective, it would be better if the investment were channelled into the low-tax country B as there is a higher net return of 990 to New Zealand, split 737 to the investor and 253 to the government. However, under a foreign tax credit system, the investor ends up preferring the investment in Country A on an after-tax basis. Thus investment into higher-tax countries can displace investment into low-tax countries even though New Zealand as a whole would be better off from investment into the low-tax countries.

TABLE 2.1
Investments in high-tax and low-tax countries – an example

	Country A High-tax	Country B Low-tax
Gross Return	1200	1100
Host Country Tax	300	110
New Zealand Tax[9]	96	253
Return to Investor	804	737
Return to New Zealand	900	990

[9] New Zealand tax is net of foreign tax credits. In Country A, the potential New Zealand tax of 396 (.33x1200) is reduced by a tax credit for the 300 of foreign tax paid; in Country B, the potential New Zealand tax of 363 (.33x1100) is reduced by a credit of 110.

2.12 Finally, a number of taxpayers have commented that not only are New Zealand's tax rules for CFC income comparatively harsh, the associated compliance costs can also be high, with firms required to restate the accounts of non-grey list CFCs under New Zealand tax rules. This can be very difficult when foreign accounting and tax rules are substantially different from New Zealand's, the degree of control is limited, and the CFC's financial accounts are prepared in a different language. There are also aspects of the CFC rules that are extremely complex and difficult to comply with. As the Tax Review 2001 concluded, it is important to take these into consideration when framing any new rules.

Pressures caused by tax treatment in other countries

2.13 In contrast to New Zealand, other OECD countries either exempt offshore active income or defer taxation of the active income of CFCs until the time that dividends are remitted by the CFCs to their parents. Some non-OECD countries, such as Singapore, have territorial systems which exempt all forms of offshore income from domestic taxation (see Table 2.2). This means that companies with active business subsidiaries in low-tax jurisdictions may pay little or no tax on this income for long periods of time. Even then, tax minimising strategies may reduce the effective tax rate further.

TABLE 2.2
Taxation of outbound investment in other countries

	Accrual taxation of income		Treatment of dividends	
	Active	**Passive**	**Exempt**	**Tax with deferral**
Australia	X	√	√	
United States	X	√		√
United Kingdom	X	√		√
Singapore	X	X	√	
Japan	X	√		√
New Zealand (non-grey list)	√	√	NA[10]	NA

[10] New Zealand taxes dividends under the DWP rules but there is no deferral as offshore income is taxed as it accrues.

2.14 Australia's tax rules are particularly important. The proximity of Australia to New Zealand as a choice for a multinational's regional headquarters, the ease of migration, the integration of imputation systems and the large levels of FDI between the two countries make Australia the most likely destination for migrating firms.[11] Greater alignment of New Zealand's tax rules with those of Australia can only enhance and deepen trans-Tasman integration. Such alignment is consistent with the government's wider set of single economic market initiatives.

2.15 If New Zealand taxes offshore income more heavily than other countries (especially Australia), a company planning to expand into active businesses in third countries has a tax incentive to relocate its headquarters outside of New Zealand. If it retains its headquarters in New Zealand, it is taxed on active income from the third-country CFC as the income accrues. This could lead to a substantial tax impost if the third country has low tax rates on active income. If, however, it relocates its headquarters to a country offering an exemption or deferral of taxation on offshore income, no tax need be paid on the income accruing in the CFC.

2.16 There are many commercial factors that influence where firms choose to locate their operations. Firms may be attracted to deeper capital markets, proximity to global markets, and the access to skilled labour and global stocks of knowledge in other countries. Relocation may be the best way to benefit from having a presence in such markets. Given the strength of these factors, some migration of New Zealand firms is likely to continue regardless of tax changes. Nevertheless, it is unattractive for New Zealand's tax treatment of CFC income to inhibit the retention or establishment of New Zealand-based multinational businesses.

2.17 Migration of even one or two of New Zealand's large dynamic firms could have a substantial negative effect on the economy. Such firms help New Zealand to maintain close connection with new ideas and commercial developments in other countries. They also help maintain a base of intellectual property within New Zealand. Not only would migration lead to jobs within head offices being shifted offshore, so too would be the demand for associated professional services.

2.18 Firm migration also reduces the extent to which New Zealand could benefit from cluster effects. When a number of firms locate near each other, or cluster, they can attract higher levels of skilled labour and customers than a single firm could. Once a critical number of firms locate in an area they can become a cluster, and benefits of economies of scale may be available to them. Within New Zealand, potentially in Auckland, clusters involved in specialised areas of R&D could be envisaged. It is important therefore that policies do not prevent the achievement or the maintenance of clusters.

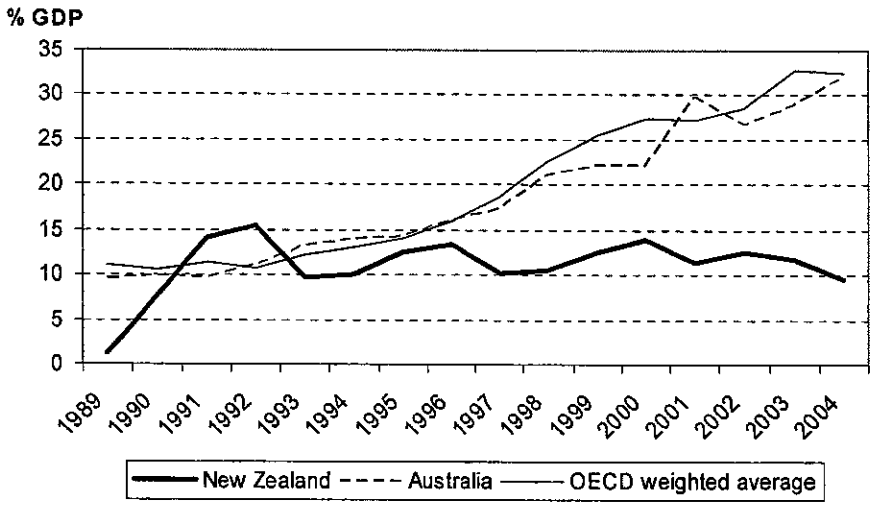
[11] Australia represents New Zealand's most significant source of foreign capital, contributing 46 percent of inward FDI.

2.19 Finally, higher taxes on offshore income may also make it difficult for New Zealand-based firms to expand out of local markets; so, if they stay in New Zealand, they may stay small. For example, a New Zealand-based company which seeks to exploit lower cost production in a non-grey list country might be disadvantaged relative to other companies operating in that jurisdiction.

New Zealand's outbound FDI performance

2.20 It is of interest to examine how New Zealand's level of outbound FDI has compared with that of other countries in recent times. The stock of outbound direct investment from New Zealand has remained relatively constant as a share of GDP, fluctuating between around 10 to 15 percent of GDP over the period since the early 1990s. In contrast, the stock of outbound direct investment in OECD countries increased steadily from around 10 percent of GDP in 1990 to around 30 percent of GDP in 2002 (see figure 1).

FIGURE 1
Outbound FDI stock[12]

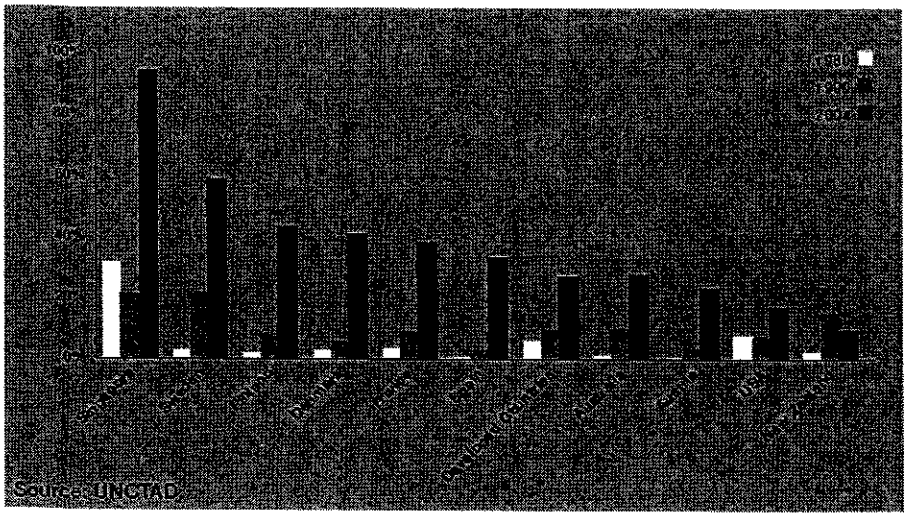


Source: IMF, UNCTAD

2.21 The relative change between 1990 and 2004 in outbound investment as a percentage of GDP is shown for selected OECD countries in figure 2. The data, reported by the New Zealand Institute, show that New Zealand is the only country that has experienced a drop in the intensity of outbound FDI.

[12] Figure 1 illustrates total outbound direct investment, which includes both debt and equity. Ideally, the comparison would focus on outbound direct equity investment only. However, the outbound direct equity investment series for New Zealand is affected by a large structural break in 2001 which makes comparisons difficult.

FIGURE 2
Level of outward FDI as a % of GDP



2.22 There are many factors which may be affecting the evolution of outbound FDI in different countries. Commercial factors such as closeness to markets may be more important influences than taxation.[13] However, over the time that New Zealand's comprehensive international tax rules have been in place, New Zealand has been exceptional in not having the same strong growth in FDI that has been evident in other OECD countries. New Zealand's tax rules may have been a contributing factor on the margin.

Implications for GDP growth and labour productivity

2.23 Any relaxation of New Zealand's CFC rules could increase outflows of FDI from New Zealand. At first sight, this would appear likely to reduce New Zealand's capital stock, thereby reducing labour productivity and GDP growth.

[13] These figures should be interpreted cautiously for a number of reasons:
- Investment that is taxed under New Zealand's CFC rules is not the same as direct investment as measured by statistical agencies.
- The data are not always comparable – both across time (for example, a methodological change affects the New Zealand data from 2001 onwards), and across countries (for example, countries may use different methodology in compiling the data).
- Tapping into offshore markets and access to offshore distribution channels may be more or less important for firms in different industries. For example, in some industries it may be more important to access offshore distribution channels. Different levels of outbound direct investment across countries may, in part, be explained by differences in industry structure across countries.
- Different levels of outbound direct investment across countries could, in part, be explained by distance from other countries, as this could make it more difficult to invest offshore.

2.24 There are a number of important offsetting factors which can work in the opposite direction. First, New Zealand is a net capital importer. To the extent that some firms invest capital abroad that would otherwise have been located in New Zealand, this provides scope for other firms to profitably increase their investment in New Zealand. Moreover, investment abroad and domestic activity in New Zealand are not necessarily substitutes. Investment abroad can be complementary with the demand for products from New Zealand. Moreover, there can a upgrading of the types of jobs being undertaken, with lower value-added tasks being moved offshore while R&D and higher value-added tasks increase in New Zealand.

2.25 For these reasons, the government believes that there is no strong reason to expect that measures to liberalise the tax treatment of outbound CFC income would reduce capital and productivity in New Zealand. Indeed, to the extent that they provide incentives for firms to locate or stay in New Zealand and to expand to exploit opportunities offshore, they are likely to have the opposite effect.

2.26 Even if New Zealand wanted to prevent outflows of capital from New Zealand, it is unclear that an internationally stringent tax treatment of outbound CFC income is in its best interests, given the real world flexibility for companies and workers to migrate to other countries. Put bluntly, firms can always choose to escape New Zealand tax by moving overseas (or perhaps never coming).

A new paradigm for New Zealand

2.27 In the almost twenty years since New Zealand's rules for taxing CFCs were developed, the world of international finance, investment and production has evolved considerably. FDI and exports of most OECD countries have increased significantly as a percentage of GDP, but New Zealand has not kept pace. There are many reasons for this situation. However, New Zealand stands out as the only country to tax offshore active income on accrual.

2.28 As noted by the Tax Review 2001, while the current system is conceptually attractive, its lack of conformity with international taxing norms puts pressure on the New Zealand tax system. There is a concern that it inhibits the internationalisation of New Zealand business. The current system risks inducing New Zealand businesses with significant international operations to migrate, and it could inhibit the development of multinational enterprises based in New Zealand.

2.29 On balance, the government believes that the current tax rules applying to CFCs are no longer well adapted to the world of international business. Accordingly, the government supports the introduction of an exemption for the offshore active income of CFCs.

2.30 There are two ways of implementing the exemption:

- by deferring taxation of active income earned offshore until the profits are repatriated, with a credit for foreign taxes paid; or
- by allowing a permanent exemption for offshore active income, with no taxation of subsequent dividends.

2.31 The Tax Review recommended a deferral, with credits for investments made outside of the grey list. However, there is considerable debate as to the effectiveness of the deferral-with-credit approach relative to the exemption method. Taxes that are imposed only when the dividend is repatriated may not be particularly effective because imposition is at the discretion of the company distributing the dividend. Attempts by countries to shore up their dividend taxation rules have been sources of tax system complexity and have been of limited effectiveness.

2.32 An exemption system would be simpler. It would go further in improving incentives for New Zealand-based firms to take advantage of international opportunities while remaining in New Zealand, and, it would go further in ensuring that such firms are able to compete and succeed on the world stage.

2.33 There is greater attraction to a permanent exemption for active income earned offshore. Adoption of this approach would require adequate confidence that it would not endanger the taxation of domestic-source income. Otherwise the taxation of dividends with credit might need to be examined further.

2.34 The Tax Review noted that an active income exemption should be enacted in a manner that does not jeopardise New Zealand's domestic tax base. The government agrees.

2.35 A number of measures which are intended to ensure that the active income exemption did not result in an inappropriate reduction of New Zealand's domestic tax base would form an integral part of any package introducing it.

2.36 The Tax Review referred specifically to an enhancement of the thin capitalisation rules as an area for development, and the discussion document examines some significant changes in this area. Consistent with the practice of many other OECD countries, offshore passive income would continue to be taxed on accrual, and its taxation could be extended with the elimination of the grey list exemption for such income.

CHAPTER 3

Implications for the international tax system of an active income exemption

3.1 A move to an exemption for active income earned offshore would represent a major shift in New Zealand's international taxation paradigm. This chapter provides an overview of the implementation issues of such a shift.

3.2 The fundamental implementation concern is to ensure that the exemption is targeted to offshore active income in a manner which does not impose an undue compliance burden on New Zealand businesses. Rules to measure such income properly would form an integral part of providing the exemption. For example, rules would be required to distinguish active income from passive income and the thin capitalisation rules would have to be extended and amended.

3.3 A change in the paradigm would have significant implications for other features of the rules for taxing offshore income. Affected areas would include the taxation of dividends, the grey list, the conduit rules, the treatment of foreign branches and non-portfolio FIFs and the calculation of foreign tax credits.

3.4 Choices among alternative implementation options would involve trade-offs, as the various features are inter-related.

Current approach to taxing offshore income

3.5 New Zealand's current international taxation paradigm is based on comprehensive accrual taxation of offshore income. In principle, to the extent all income is considered to be taxable, all costs are deductible.[14]

3.6 In practice, there are exceptions, and not all income is subject to full New Zealand taxation:

- The grey list effectively exempts income earned in grey list countries from New Zealand taxation.
- Application of foreign tax credits has the effect of removing some foreign income from taxation in New Zealand.
- The conduit and DWP rules effectively lower the rate of tax applied to the offshore income of foreign-owned companies.

[14] For example, in the thin capitalisation rules, which seek to protect the New Zealand base from excessive leveraging by foreign controlled companies, no adjustment is made to New Zealand equity for offshore investments by the New Zealand subsidiary.

3.7 As a consequence, limitations on the deduction of interest expenses are provided for in certain situations:

- A limitation is imposed on foreign tax credit claims to ensure credits do not shelter domestic income from tax. In principle, the limitation is intended to restrict the claiming of interest deductions or foreign tax credits when money is borrowed to fund offshore investment giving rise to foreign tax credits.
- Special thin capitalisation rules, which are intended to ensure that a disproportionate share of the interest costs are not applied against New Zealand-sourced income, apply to conduit and DWP companies. Thus interest costs are restricted when tax-reduced offshore investments are made.

3.8 In practice, however, these limitations to interest deductions are not particularly effective, given the safe-harbours and technical deficiencies in the rules.

3.9 On the other hand, no restriction on interest deductions applies with respect to dividends benefiting from the grey list underlying foreign tax credit (UFTC) rules.

3.10 Furthermore, it is a reality of international taxation that there are, inevitably, asymmetries between the tax systems of different countries. These provide opportunities for deducting offshore financing costs from New Zealand income, while the foreign income is not subject to effective New Zealand taxation. For example, asymmetries can arise when countries have different definitions of "debt" and "equity". Dividends arising from preferred shares may be treated as dividends receiving conduit relief in New Zealand, while being treated as interest and deductible in another country. The current system is vulnerable to such exploitation.

3.11 Therefore, while the current system has in place rules that are designed to attribute interest costs to foreign income when it faces lowered levels of New Zealand tax, they are not comprehensive and not particularly effective in practice.

Considerations in designing an active income exemption

3.12 The change to an exemption for active income earned offshore would mean that borders would need to be defined between active and passive income, and between domestic and offshore income. Such distinctions inevitably involve a degree of complexity. In developing the rules, it would be necessary to make trade-offs between those protecting the tax base and maintaining a reasonable compliance burden for firms. The government's ability to achieve the policy goal of exempting active business income from taxation would depend upon attaining an assurance that there were robust rules to prevent the erosion of the domestic tax base.

3.13 The different aspects of the tax system are linked and must be conceptually consistent for it to function properly. Decisions to relax the rules in one area implies that other features would need to be correspondingly tighter.

3.14 The crucial implementation trade-off would seem to be the precision with which the rules attempt to target the exemption to offshore active income versus the complexity of the rules. A more precise system would require more detailed and potentially more complex rules. A looser system, say, one using higher thresholds, might impose a lower compliance burden, but would be less cost-effective in delivering the intended policy as more room would be available for passive or domestic income to receive the benefit of the exemption intended for active offshore income.

Lessons from international experience

3.15 There is considerable international experience in designing and implementing tax rules that distinguish between active and passive income. New Zealand can learn from that experience.

3.16 All OECD countries, except New Zealand, provide some form of tax relief for active business income that is earned abroad. In most cases, this treatment is not extended to passive income, and considerable efforts are made to ensure comprehensive domestic taxation of such income as it accrues.

3.17 The detailed features of the CFC rules of different countries vary considerably, as can be seen in the Appendix.[15] They have been developed over time and reflect trade-offs that responded to pressures and concerns which existed at that time and place. No single approach is clearly superior on all counts.

3.18 Therefore, while international experience and norms can greatly inform the New Zealand exercise, there is no consensus on the details of taxation of offshore income. New Zealand's system will need to be developed to reflect the realities of its business environment and other features of its tax system. Decisions will be a pragmatic compromise between the policy goals of the new approach, protecting the New Zealand revenue base and keeping the administrative and compliance burden to a minimum. Moreover, as New Zealand's economy and business activity evolves, any rules will need to be monitored to ensure that they remain appropriate for the changing environment in which New Zealand business operates.

[15] The Appendix outlines the systems of a number of New Zealand's major trading and investment partners. They demonstrate the variety of ways that different countries have chosen to deal with the implementation of an active income exemption. Reference to other countries' rules throughout the discussion document have been chosen on the basis of interesting features of their taxation of offshore income. The description of CFC rules in different countries is based on a mixture of publicly available information (such as the websites of revenue agencies in Australia and the United Kingdom); *OECD Studies in Taxation of Foreign Source Income – Controlled Foreign Company Legislation*, OECD (1996); and *Studies on International Fiscal Law*, International Fiscal Association (2001).

Compliance concerns

3.19 Rules to tax and/or exempt offshore income are irreducibly complex, given the variety and complexity of international business arrangements. The rules must be written so that they can be applied to the myriad of transactions and business forms that firms adopt in relation to particular business situations. Therefore a new paradigm, with borders between active and passive income, together with other rules needed to target the exemption appropriately, would be unlikely to result in legislative simplification, indeed, it might result in the reverse.

3.20 In actual application, however, an active/passive distinction could be much simpler for the types of firms and activities which it seeks to benefit. A firm with genuinely active operations abroad would no longer need to face the calculation burden that exists under the current branch-equivalent rules. If dividends could be exempted, the firm would not need to comply with the DWP rules. The one area of extra complexity could be the extension of the thin capitalisation rules, although these rules would rely on domestically available information, and are reasonably straightforward.

3.21 Under the transactional method described in chapter 5, considerably more complexity would be faced by firms with a mix of active and passive income in a single subsidiary. Even so, they would have the opportunity to reduce this potential complexity by arranging their affairs accordingly – for example, by placing passive investments in separate, special purpose vehicles. In this way, the more complex aspects of the rules would provide a precautionary function, rather than being an integral part of most firms' tax compliance.

Major implementation concerns

3.22 The fundamental implementation concern is to ensure that the exemption is appropriately targeted to offshore active income and does not allow tax on domestic New Zealand income to be reduced. As noted earlier, the New Zealand tax system already faces challenges in fully taxing New Zealand-source income. Nevertheless, a general active income exemption would make resolving this problem more critical. Accordingly, the major design challenges (refer to figure 3, at the end of this chapter) are distinguishing active and passive income and ensuring the appropriate allocation of income and expenses between the domestic tax base and offshore.

Distinguishing active and passive income

3.23 Most countries distinguish between the active and passive income of their CFCs. To protect the domestic taxation of investment income, passive income is commonly taxed as it accrues, with a credit for foreign taxes. The rationale is that offshore passive income is easily substituted for domestic investment income, with no fundamental change in the economic characteristics of the investment. Accrual taxation of passive income would be an essential part of protecting the New Zealand tax base.

3.24 Different approaches can be taken to distinguishing active from passive income. One approach, in principle, would be to define "active income" conceptually, based on criteria relating to the nature of the activities performed within the business. International experience suggests that this is a difficult border to police, creating uncertainty for businesses and exposing the tax system to significant erosion, as a small amount of activity can be attributed to what is, in fact, a passive investment.

3.25 New Zealand would adopt the international norm of defining passive income directly, by listing investments which are passive in nature. Other types of income could also be taxed on accrual – for example, some "active" income – so-called base company income – which could otherwise erode New Zealand's tax base.

3.26 A critical question is whether passive income would be taxed on a transaction-by-transaction basis or by the characteristics of the entity (such as having a level of passive income above a prescribed amount). The former method is more consistent with the policy of restricting any exemption to active income. On the other hand, the entity approach appears, at first sight, to be simpler; particularly when it allows generous thresholds for passive income in "active" entities. However, a level of threshold under an entity approach which is too high could expose the New Zealand tax base to erosion.

3.27 These issues are discussed in chapters 4 and 5.

Allocation of expenses

3.28 The appropriate measurement of offshore active income requires that costs which are associated with that income should be deducted against it and should not reduce income that is subject to tax in New Zealand.

3.29 The most significant example of this in the New Zealand tax system is the allocation of interest expense between taxable and tax-exempt activities. The rules applied to tax-reduced conduit income and the new minimum capital rules applied to foreign-owned banks provide a framework for how rules of more general application could be designed. With the provision of an active income exemption to all businesses, it would be appropriate to extend similar rules to all businesses making offshore investments. What level of safe-harbouring to provide would involve a trade-off between the proper measurement of New Zealand and offshore income and minimizing compliance burdens of businesses.

3.30 These issues are discussed in chapter 6.

Other implications of the new approach

Taxation of dividends

3.31 The government favours an active income exemption without taxes being levied on subsequent dividends. However, it would proceed in this direction only if confident that the non-taxation of dividends would not lead to an erosion of tax on New Zealand-sourced income. If this confidence cannot be achieved, it would be necessary to determine whether taxation of repatriated dividends would continue to be required.

Grey list

3.32 The repeal of the grey list exemption would be more consistent with active/passive CFC rules that focused on exempting active income rather than whether the income has been comparably taxed in the host country. On the other hand, a number of countries, including Australia, provide some form of grey list exemption for passive income.

Conduit rules

3.33 The conduit rules were introduced in 1998 to remove the income tax liability of New Zealand companies on foreign income to the extent of their non-resident ownership. These rules were introduced as a result of the comprehensive nature of our CFC rules.

3.34 If foreign active income is no longer subject to accrual taxation, there will be no need for the conduit mechanism in relation to such income. At the same time, there is a strong case for removing the conduit mechanism in relation to foreign passive income, while subjecting it to accrual taxation.

Taxation of foreign branches

3.35 A move to an active/passive distinction to the CFC rules may have implications on the way foreign branches should be taxed. A key consideration is trying to ensure that New Zealand-resident investors are not influenced by tax considerations in deciding whether to operate in a foreign jurisdiction through a subsidiary or a branch.

Treatment of non-portfolio FIFs

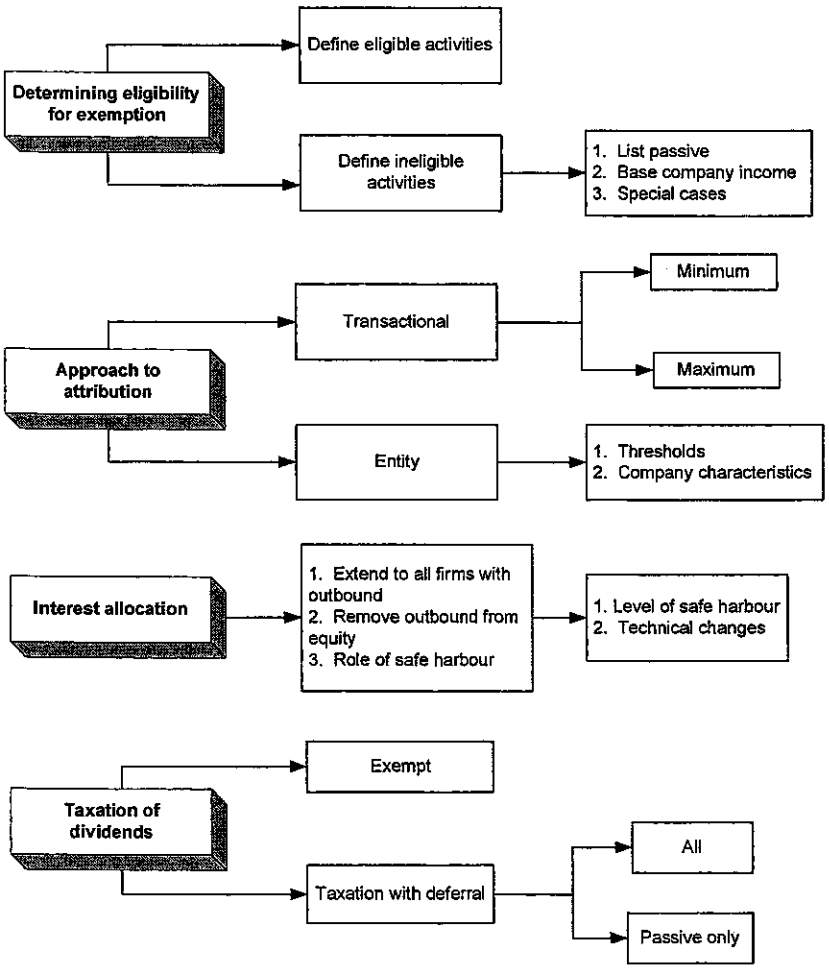
3.36 Changes to our CFC rules are likely to have implications for the tax treatment of New Zealand residents who hold non-portfolio interests in FIFs. Ideally, non-portfolio investors in either CFCs or FIFs would all be subject to the same accrual rules. However, international practice is to distinguish between FIF and CFC interests in terms of implementing an active/passive distinction.

3.37 The tax treatment of offshore portfolio investments (with investor interests of less than 10 percent) is currently being reviewed. The possible changes described in this discussion document would not affect reforms that are already under way.

Calculation of foreign tax credits

3.38 While active business income earned in CFCs would be exempt, some categories of income, such as passive income and income of foreign assets not held through an offshore branch, would continue to be taxed domestically. In that case, foreign tax credits would be provided. An important area for examination would be the allocation of costs to the foreign income for purposes of the limitation rules on foreign tax credits, to ensure that the credits did not effectively offset tax on domestic income.

FIGURE 3
Implementing an active income exemption: major design considerations



CHAPTER 4

Implementing an active/passive distinction

Possible changes

1. Offshore active income would be exempt.

2. The broad international consensus to define passive income positively would be adopted, leaving active income as the residual undefined concept.

3. Passive income and base company income (collectively called "tainted income") would continue to be taxed on accrual.

4. The main categories of tainted income would include:

   - ***Passive income***: Dividends, interest, royalties and rents. It could include income which is passive in form but the derivation of which involves certain activity.
   - ***Base company income***: Base company rules would be designed to counter situations where domestic income is shifted offshore to benefit from the active income exemption.

Details of how the rules within this general framework might work are the subject of consultations and submissions.

Distinguishing between active and passive income

4.1 Passive income generally comprises investment income which the investor does not actively participate in earning.

Approach to defining the active/passive boundary

4.2 There is a question as to how the boundary should be defined. The general approach of many countries is to define passive income positively, with active income defined by default as any income falling outside the passive income definition.

4.3 The challenge of using a positive definition of passive income is that any item which is inherently passive but is omitted from the list will not be passive income for the purposes of the CFC rules, and will therefore be exempt from attribution. There may be drafting techniques, such as the use of an inclusive definition augmented by examples, which would minimise this risk.

4.4 The alternative, a positive definition of active income, may provide legislators with less control and certainty over the scope of the active income exemption than would occur under a positive definition of passive income. That is because even a small amount of "activity" associated with an inherently passive transaction would bring the transaction within the active income net.

4.5 On balance, the government considers it preferable to define passive income positively.

Types of passive income

4.6 The following income types are generally considered to comprise passive income and would generally form part of any definition introduced in New Zealand. Potential exceptions to this approach are discussed later.

Interest

4.7 Interest is generally considered to be part of passive income.

4.8 As a general proposition, a wide definition of "interest" would be required in this context – including income derived from a finance lease or other financial arrangements.

Rents and royalties

4.9 Rent and royalties are generally considered to be passive income.

Dividends

4.10 Dividends received by a CFC are generally considered to be passive income.

4.11 Australia excludes non-portfolio dividends paid to a CFC by a non-Australian resident company. It considers this exclusion to be a natural consequence of the general exemption for participation dividends.[16] If New Zealand exempted dividends (see chapter 7) it would be necessary to consider whether we should also follow the Australian approach to non-portfolio dividends earned by a CFC.

[16] A participation dividend is a dividend paid by a foreign company to an Australian-resident company that has a 10 percent or greater interest in the voting power of that company.

Other passive income

4.12 In addition to the preceding categories of income, the following categories of income could be treated as passive:

- ***Gains from commodities transactions.***[17] The United States includes gains from commodities transactions unless they are part of hedging transactions connected to the CFC's business. Australia also includes such gains, but there is an exception for CFCs that produce or process the commodity, or use the commodity as a raw material (and other conditions are satisfied).
- ***Foreign currency gains.*** Australia, however, treats such gains as active in certain limited circumstances – for example, if the CFC was carrying on the business of currency trading and no other party to the transaction was an associate or Australian resident.
- Income from annuities and insurance products.

Base company income – active in form but subject to accrual taxation

4.13 CFCs engaged in nominally active business could be used to divert income that should properly be taxable as domestic income. The response of many countries (for example, Australia, the United States and the United Kingdom in the context of their active business exemption) has been to carve out "base company income" from their active exemption.

4.14 Generally speaking, "base company income" refers to income derived by a CFC from selling property or providing services on behalf of the group of companies in a manner intended to avoid or defer domestic tax. An example would be a CFC of a New Zealand company that simply processed the paperwork for a sale from New Zealand to some third market, but captured a "marketing" margin which consisted of the bulk of the profits from the sale. The concern would be that the CFC had been established to avoid New Zealand tax. With a base company rule, the margin captured in the CFC would be "base company income" and would be attributable to the controlling New Zealand shareholders on accrual.

4.15 In principle, base company income rules should not apply to commercially driven transactions between New Zealand companies and their CFCs. It would be difficult to draw an appropriate boundary between legitimate commercial transactions and those that should be included within base company income.

[17] Commodities transactions and foreign currency transactions fall within our financial arrangements rules. As such, any gain derived would be "interest", and thus passive income, even in the absence of a specific rule related to these transactions.

4.16 Following international best practice, it would appear to be preferable for New Zealand to have base company income rules as part of a system having an active/passive distinction. There is, however, considerable variation in the design and implementation of base company rules internationally.

4.17 Generally, two major factors are relevant to the determination of base company income: the first is the geographical location of the transaction, and the second is the relationship of the parties to the transaction.

Transactions with the domestic jurisdiction

4.18 Transactions by a CFC with the domestic jurisdiction of its controlling shareholder can clearly reduce the domestic tax base. For example, when a CFC provides services or sells property in the country in which its controlling shareholder is resident, the arrangement could result in an artificial reduction of domestic tax. The income derived by the CFC, unless the CFC has a permanent establishment in the domestic jurisdiction, will not be subject to any domestic tax. The concern is that the sale or services are, in reality, made or provided by the controlling shareholder, or other domestic subsidiary, and income which would be taxable in the domestic jurisdiction has been inappropriately converted to exempt foreign income.

4.19 The United Kingdom's rules focus on transactions in the domestic jurisdiction. Under the United Kingdom's rules, the active business exemption is denied if the CFC performs services in the United Kingdom. Furthermore, a CFC whose main business consists of dealing in goods for delivery to or from the United Kingdom, unless the goods are physically delivered into the CFC's country of residence, is excluded from the United Kingdom's active business exemption.

4.20 Australia's base company income definition is also focused on transactions in the domestic jurisdiction. These rules require income from the supply of services by a CFC to an Australian resident, or Australian permanent establishment of a non-resident, to fall *prima facie* within the definition of base company income. This is true whether the supply is to related or unrelated parties. In addition, in relation to sales transactions, Australia includes income derived when a related Australian resident or an Australian permanent establishment of a related non-resident either purchases the goods from the CFC or supplies goods to the CFC as *prima facie* base company income.

Related party transactions

4.21 Some countries use their base company income concept to supplement their transfer pricing rules. When that happens, the focus is on transactions between related parties.

4.22 Countries vary, however, over whether income derived from related party transactions in a CFC's local market should be outside the concept of base company income. Some countries consider that income from transactions in a CFC's local market should be exempt because current domestic taxation on such income would adversely affect the ability of the CFC to compete there. However, when a CFC derives income outside its local market, current domestic taxation would not affect its ability to compete in its local market.

4.23 Under the United States' rules, if a CFC purchases goods from a related party and sells the goods to any person, or purchases goods from any person and sells to a related party, the sales income will be *prima facie* base company income. However, the income derived will be excluded from base company income if the property purchased was manufactured, used or consumed in the CFC's local jurisdiction.

4.24 Australia's rules similarly provide an exemption for related party sales income. As already noted, income from the sales of goods is included within base company income when a related party resident in Australia or an Australian permanent establishment of a related non-resident is involved. However, the income derived will not be base company income if the CFC substantially alters, manufactures or produces the goods sold.

4.25 The United Kingdom takes a different approach. Under its rules, whether a transaction takes place in the CFC's local market is irrelevant. If a CFC is primarily engaged in a wholesale, distributive, financial or service business, income from related parties could cause the CFC to be ineligible for the active business exemption, whether or not the transactions take place in the CFC's local market.

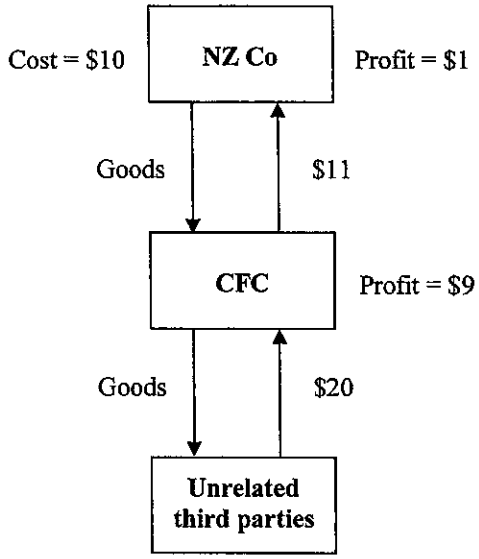
4.26 It is reasonable that income derived by a CFC from related party transactions should be exempt if that income is a reflection of genuine business activity in the CFC's local market. Even so, care must be taken in designing a test which cannot be easily manipulated.

Interaction with transfer pricing rules

4.27 A key issue is how the base company income concept interacts with a country's transfer pricing rules. Transfer pricing applies to transactions between related parties and seeks to determine correct prices with precision on a transaction by transaction basis. The base company rules apply to a wider set of circumstances, to groups of transactions, and have an anti-avoidance purpose. Base company income rules are generally viewed as a necessary reinforcement of the transfer pricing rules.

4.28 Take the example of NZ Co, a New Zealand-resident company which manufactures goods costing $10 (see figure 4). NZ Co sells the goods to its CFC, resident in a low-tax jurisdiction, for $11. The CFC then sells the goods to unrelated third parties for $20.

FIGURE 4
Example of base company income



4.29 One dollar of the profit from the sale is sourced in NZ Co, and $9 in the CFC. However, assume very little activity took place in the CFC to justify the profit sourced there. Say, for example, the arm's length consideration for the supply by NZ Co to its CFC is determined to be $17. The result of the application of the transfer pricing rules, then, is that $7 of the profit will be taxable in NZ Co (and $3 in the CFC). Under the CFC rules, however, all the income derived by the CFC ($9) would be base company income and taxable on attribution to NZ Co in New Zealand.

4.30 The appropriate interaction between the base company income concept and New Zealand's transfer pricing rules will have to be determined.

Special cases – passive in form but with activity

4.31 The approach that New Zealand takes to various boundary issues should have regard for the New Zealand business environment. There may be times when it is appropriate for the new rules to depart from international norms. On the one hand, this may give rise to concerns that an over-cautious approach could inhibit the establishment of some new offshore activity that might otherwise develop. There are risks, however, associated with instituting an exemption that tries to anticipate changes to the current business environment. This section explores the question of when it might be appropriate to limit the active income exemption, recognising, however, that the active/passive boundary will need to evolve over time as New Zealand business conditions change.

4.32 One issue on which New Zealand might depart from international norms is whether a CFC that is actively engaged in the business of earning a category of income that is typically passive (the classic example being interest earned by banks) should qualify for the active exemption. This issue is particularly problematic and is dealt with by countries in different ways for different types of passive income.

4.33 This section examines areas where businesses which arguably are active earn income which is passive in form. The question is whether the active income exemption should be extended to them.

Banks and financial institutions

4.34 In the case of banks and other financial institutions, interest often would constitute active business income and should therefore be excluded from the definition of passive income. The problem is that interest earned by a CFC of a bank might be passive in nature. Therefore treating all interest of a bank as active income creates potential for an erosion of tax revenues because banks can be established in low-tax jurisdictions with minimum capital or presence in that jurisdiction.

4.35 For example, a bank could put a portfolio of its loans to non-residents into a CFC, effectively moving such loans out of the domestic tax base. Identifying such arrangements can be difficult, particularly if the CFC carries on some legitimate active banking business of its own.

4.36 A few countries attribute income derived by banks and other financial institutions. For instance, in Denmark, the CFC rules are targeted at income from financial activity (including insurance). An entity will be a CFC if its financial income is in excess of 33 $^{1}/_{3}$ percent of its gross income or its financial assets are in excess of 33 $^{1}/_{3}$ percent of its total assets.

4.37 Other countries provide exemptions for interest earned by banks. Australia exempts interest derived by financial institutions in principle, although such interest might still be attributable if it falls into the definition of base company income. Similarly, the United Kingdom exempts CFCs dealing in banking, deposit-taking, money-lending or similar activities in principle, but requires them to satisfy a complex capital structure test (as well as satisfying minimum presence and effective management requirements) in order to be eligible for the active business exemption.

4.38 If New Zealand had a local retail banking industry that operated offshore through CFCs there could be merit in extending the exemption to interest earned by these CFCs. However, it is difficult to design an appropriate exemption in anticipation of such an industry development. Moreover, there is a fiscal risk that such an exemption would be used to exempt interest not intended to be covered by the exemption. It is possible that the problems associated with attempting to design and institute a suitable exemption in a vacuum outweigh any potential benefits from providing such an exemption.

Inter-affiliate financing

4.39 Multinational groups will often be organised in such a way that one subsidiary operates as an intra-group financial centre, with loans from third parties channelled through the subsidiary to other group members. Those subsidiaries can be used to consolidate financial expertise in one specialist centre and manage intra-group financing transactions. In such situations, they might receive interest payments from other members of the group which are then consolidated and used to pay interest on the loans from third parties.

4.40 Without an exception to the general rule, those subsidiaries would be considered to be earning passive income and potentially taxed in New Zealand.

4.41 To relieve this taxation, it is sometimes suggested that the treatment of income received by a CFC from a related party borrower should be dependent on the origin of that income. Under this principle, interest that is received by a CFC from a loan to a related party borrower and deducted against active income of the borrower should be treated as active income of the recipient CFC.

4.42 The United States has an exclusion from passive income for inter-affiliate financing if certain "same country" (and other) conditions are met. Other countries (including Australia) always treat interest on loans to related parties as passive income. Implementing an inter-affiliate financing exception would necessarily be complex, given the fungibility of money and the complexity of intra-group financial arrangements. As such, the government does not favour exempting interest derived from inter-affiliate financing from accrual taxation.

Income from insurance

4.43 Many countries consider the insurance industry to be another special case. As with banks and other financial institutions, countries vary in the way they treat the business of insurance.

4.44 The United Kingdom's rules, in broad terms, provide that a CFC whose main business is insurance cannot be eligible for exemption unless less than 50 percent of its business is derived from the risks of related parties. Japan's rules also require a CFC whose main business is insurance to conduct more than 50 percent of such business with unrelated parties for the CFC to be eligible for exemption. In Canada, income from insurance is *prima facie* attributable, but will qualify for exemption, if not related to the insurance of Canadian risks, if the CFC's business is conducted principally with arm's-length persons and more than five individual employees are employed full-time in the active conduct of the business. Australia has special rules for calculating the passive income of life assurance and general insurance CFCs. The effect of these rules, in broad terms, is to require attribution for income from assets held to meet liabilities on policies held by associates or Australian residents or that are in excess of the assets required to meet the liabilities referable to policies. Income from insurance can also fall within the definition of base company income in certain circumstances.

4.45 Concerns particularly arise when companies use offshore captive insurance companies to provide "insurance" for their operations. As the premiums for such insurance are deductible against domestic income, such companies can be used to shift income out of the domestic tax base.

Management of real and other property

4.46 There is an argument that rent derived by a company actively engaged in owning and managing commercial property should be excluded from attribution. Similarly, royalties derived by a company engaged in owning and managing intellectual property could be said to constitute active business income and, arguably, should be excluded from attribution.

4.47 Countries vary in the way they treat rents and royalties derived from active management in their CFC rules.

4.48 The United Kingdom takes a strict approach and treats rent and royalties as always passive: a CFC whose main business is holding intellectual property or leasing any property or rights will not qualify for exemption.

4.49 The United States treats rents and royalties as active if they are:

- derived by a CFC in the active conduct of a business, if derived from unrelated parties; or
- for the use of property within the CFC's jurisdiction, if derived from related parties.

4.50 Australia provides an exemption for property in the same jurisdiction as the CFC. However, to be exempt, a substantial part of the rental income must be attributable to the provision of labour-intensive property management services in connection with the land by the CFC. Australia also provides an exemption for royalties received from unrelated parties if derived in the course of carrying on a business and either the property or right in respect of which the royalty is consideration originated with the CFC, or the CFC substantially develops, alters, or improves the property or right for which the royalty is paid.

4.51 While there is a conceptual argument to exempt rents and royalties that are actively managed, it would be extremely difficult to administer a boundary that has the more general "active business" exemptions used in the United States and Australia. (There is already concern that intellectual property is being moved offshore to reduce New Zealand taxation.) It would appear preferable to follow the United Kingdom's approach and treat all rent and royalties as passive.

Submission points

Submissions are sought on the following matters, in particular:

- whether positively defining passive income, with active income defined by default as the remainder, is appropriate;
- the appropriate scope of the definition of "tainted income":
  - the list of passive income to be included (interest, dividends, royalties and rent);
  - treatment of a CFC which is actively engaged in the business of earning a category of income that is typically passive; and
  - extent of base company rules.