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Tax Update

Proposed reform of the CFC regime

Under current law, a controlled foreign company (CFC) is required to attribute a proportion of its offshore income to its NZ investors who are taxed on that income as it accrues unless the CFC is resident in a grey-list jurisdiction. The proposed reforms will replace the current grey-list system with a broad exemption for all the active income of a CFC regardless of where it is located.

The objective of the reform is to bring New Zealand's CFC regime in line with that of our major trading partners (particularly Australia) and to remove current disincentives for New Zealand based companies to invest in overseas markets. The Government believes that these reforms will make it easier for NZ companies to secure the economic benefit of investing in low-tax jurisdictions while, at the same time, minimising the incentive for NZ investors to shift portable "passive income" into offshore tax havens.

Officials took another significant step towards this goal in mid-October when they unveiled their proposals for the design of the new "active business income" exemption, which will form the keystone of the new CFC regime. Officials have proposed a narrow definition of "passive income" which should ensure that the profits a CFC derives from carrying out an active business in their country of residence will generally be exempt from NZ tax.

While the Paper deals with a significant number of complex issues, much of the overall picture still remains incomplete. Proposals dealing with the removal of the conduit regime, transitional matters such as the treatment of foreign dividends, existing attributed CFC net losses, and carried forward foreign tax credits will be included in a subsequent discussion document intended to be released at the end of November. Discussion and consultation on withholding taxes, foreign

branches, non-portfolio investments in non-controlled foreign companies will take place next year, mostly likely in March. Whether there should be special interest allocation rules for financial intermediaries is likely to be considered in a further document. This drip-feeding of proposals makes it difficult for taxpayers trying to come to grips with the new changes particularly in the short time frame allowed. Submissions in respect of this Issues Paper are due by 30 November and the Government expects to introduce legislation in respect of the issues in this Issues Paper as part of the 2008 May Bill (with application from the beginning of the 2009–10 income year).

The "active business" test

Under the new "active business test" the attribution rules will only apply to an investor in a CFC when 5% or more of the CFC's gross income is "passive". If the passive income exceeds the active business test threshold, the CFC's net passive income (i.e. passive income after allowable deductions) will be attributed to its NZ investors as it accrues and in proportion to their ownership of the CFC.

The use of financial accounts

Commendably, the legislation will allow the financial accounts of the CFC to be used in order to determine whether its passive income exceeds the 5% threshold. However, Officials insist that those accounts should be audited and prepared in accordance with IFRS in order to ensure their integrity. Officials consider that the differences between IFRS and various local accounting standards (such as US GAAP) could undermine the reliability of the active business test. Inevitably, Officials also consider that certain adjustments may be required to those accounts to take account of intra-group transactions or the gain or loss from an investment or a financial hedge.

The decision to allow investors to use the CFC's financial accounts is intended to achieve simplicity and lower the compliance costs for taxpayers with offshore operations; requiring those accounts to be audited in compliance with IFRS and then requiring that "appropriate" adjustments be made, threatens to undermine this objective. We would like to see more flexibility in the kinds of material a CFC may use for determining whether it meets the active business test.

If the financial accounts of the CFC cannot be relied upon, the investor will be required to restate the CFC's income for New Zealand tax purposes and determine which income items meet the technical legislative definition of "passive". NZ investors that hold a minority interest in a CFC may be unable to secure the information that would make such a calculation possible.

Intra-group transactions

Officials have expressed concern that intra-group transactions from active business activities will have the effect of inflating the aggregate amount of active gross income derived by a CFC, thereby increasing the total amount of gross passive income the group can earn offshore while remaining within the 5% active business threshold. To address this, CFCs will be required to consolidate their accounts or otherwise adjust the income calculation to eliminate the effect of transactions between CFCs in the same jurisdiction. A targeted anti-avoidance provision will be introduced to deal with cross-border transactions between related CFCs.

The definition of "passive income"

The categories of income classified as "passive" include; interest, dividends, rents, royalties and insurance premiums plus a few other types of income considered sufficiently portable to be brought within the regime (for example, income from personal services companies and base company services income, discussed below).

Dividends and gains on the disposal of investments

Dividends will not be regarded as passive income of a CFC where the relevant equity interest is taxed directly to the NZ investor. Generally, therefore, foreign company dividends and fully imputed dividends paid by a NZ company will be disregarded under the CFC income calculation rules. Officials also propose treating revenue account gains derived from the disposal of certain shares as passive income of a CFC. We are concerned about some aspects of these proposals as it does not appear that they are fully aligned with the new foreign investment fund (FIF) rules (which have largely eliminated the importance of the distinction between income and revenue gains in this area).

Interest

A key area of sensitivity is likely to be the definition of "interest" for the purposes of the passive income test. Officials have proposed using the financial arrangements rules as a starting point for determining whether a CFC has interest income in a

given year. Using the financial arrangement rules to distinguish active from passive income has the potential to create significant difficulties for taxpayers. The literal scope of the "financial arrangement" definition is extremely wide and has the potential to capture any exchange of value between two or more parties where there is a deferral in the provision of consideration.

The ability to use IFRS as a spreading method under the financial arrangement rules is unlikely to simplify their application in the CFC context. Under current proposals taxpayers will not apply an IFRS spreading method to a financial arrangement that has an equity component, and it would appear there may be a significant gap between the accounting and tax treatment of hybrid instruments.

Rents and royalties

Rental income will be treated as passive unless it is derived from leasing real property or equipment situated in the same jurisdiction as the CFC. The thinking behind the same-jurisdiction exception is not entirely clear but it may be based on the assumption that a CFC will not be subject to net tax on rental income in a jurisdiction other than its jurisdiction of residence. This assumption may not always prove to be true. While, in principle, there should be no material difference between the taxation of a CFC or a branch of a CFC we must await the release a subsequent Issues Paper to see what Officials are contemplating in this area.

Officials propose that royalty payments will be treated as active income if the CFC developed the intellectual property (IP) associated with the royalty payment or added substantial value to it, provided that the IP did not originate in New Zealand. This appears to be a sensible compromise between treating all royalties as passive and preventing locally developed IP from being removed from the country at the expense of the NZ tax base.

Base company services income and related party payments

The base company rules will convert what would otherwise be active income of a CFC into passive income if it is derived from the performance of services for a related party in another jurisdiction. The base company rules will not apply to the provision of goods, or services related to goods, and they will not apply if the service is performed in the jurisdiction of the CFC. Officials have also suggested an exception to the base company rules where services performed in another jurisdiction are actually performed by residents of that jurisdiction.

We think that a robust transfer-pricing methodology would be a simpler mechanic for addressing the same concerns as the base company rules. We are pleased, however, that the Issues Paper proposes restricting the application of the base company rules to the supply of services unconnected with the supply of goods. NZ companies may, in the future, have the option to site marketing and support services in low tax regional hubs without triggering adverse tax consequences under the CFC regime. The Inland Revenue have indicated that it is likely to monitor this aspect of the rules closely.

Interest, rents and royalties will not be treated as passive income if they are paid by one CFC to another related CFC in the same jurisdiction. This mechanism prevents active income of one CFC effectively being converted into passive income of another CFC. The related party rules will not extend to cross-border payments of passive income. Some commentators have argued that this restriction unnecessarily limits the ability of NZ investors to engage in offshore tax planning and is likely to negatively impact the licensing of intellectual property or the supply of other services from regional hubs. However, in our view, a careful application of the base company services rules and the provisions dealing with active royalty income should address many of these concerns.

Calculating and taxing the “net passive income” of a CFC

This Issues Paper indicates that the Government has decided to tax only the net passive income of a CFC where it fails to satisfy the active business test. However, based on current design proposals, determining what the net passive income of the CFC actually is may not be an easy task.

The current regime requires a CFC to calculate its income as if it were a NZ taxpayer and attribute that income to its investors in proportion to their ownership of the company. Officials have assumed that the same basic approach can be applied to the new CFC environment. They suggest that the core provisions of the Act, which taxpayers use for calculating their net income, can be adapted so that they apply separately to the CFC's active (i.e. exempt) and passive (i.e. assessable) income-earning activities.

We doubt this mechanism will be as simple to apply as Officials suggest. There is currently no concept of passive income in NZ tax law and no established principles for apportioning expenditure based on this concept. It is not clear that the familiar techniques for apportioning expenditure based on its connection with deriving assessable or exempt income will operate well in the CFC context.

Interest deductions

Officials acknowledge that interest apportionment has historically proven to be a difficult exercise for taxpayers “involving significant compliance costs” and often producing “arbitrary results”. Nevertheless, in order to tax the net passive income of a CFC, there needs to be a mechanism for attributing (and restricting) deductions of interest against attributed income of the CFC. Officials have tentatively proposed a pro-rata apportionment of the CFC's interest expense based on the asset values of the CFC. Officials consider that an asset based apportionment will better reflect how the capital has been deployed in the business. It is not clear however why Officials wish to use current asset valuations rather than historical cost, or how a taxpayer is supposed to determine whether an asset is active or passive (or what it is supposed to do when it is both). Officials also do not consider whether the Act should allow a deduction for all debt funding provided from New Zealand. Arguably the interest on such debt should be fully deductible if it is subject to NZ tax.

The apportionment of interest deductions is further complicated because a CFC may derive exempt income in one year and taxable income in the next by virtue of crossing over the 5% threshold in the active business test. In an attempt to make things easy, Officials have proposed a binary approach; allowing interest expenses as a deduction against the passive attributed income of the CFC in years when the active business test is not met and disallowing interest deductions in those years when the CFC meets the active business test.

Extension to the thin-cap rules

Officials have a further concern when it comes to interest expenditure. The active income exemption will, it appears, encourage investors to overload their taxable (domestic and foreign) operations with debt; routing interest deductions into those parts of their business where they will produce the greatest tax benefit. Officials accordingly propose expanding the existing thin capitalisation (thin-cap) regime so that it applies to NZ investors with foreign operations. Fortunately Officials have dropped their initial suggestion that the current thin-cap rules be tightened, but they have suggested including fixed rate shares issued to NZ investors as part of the debt calculation despite the fact that the returns on these shares will be taxable in New Zealand.

Even with the existing thresholds, there remains significant potential for a taxpayer to inadvertently trigger the denial of a domestic interest deduction. Recognising that expanding the thin-cap rules will impose further compliance costs on NZ businesses, a de minimus exclusion from the regime has been suggested (90% of assets in NZ or less than \$250,000 of interest deductions). Expect there to be some argument around the margins of this exclusion.

A fungible approach to interest deductibility

When looking at the issue of interest deductibility (or indeed deductibility issues in general) it is difficult to see why so many overlapping regimes are really necessary. Granted the issues are complex, but, if Officials are prepared to accept that the active business test can be calculated on a gross income basis, the next logical step would be to allow deductions to be apportioned across the business along similar lines. This would eliminate the need for thin-cap adjustments at the shareholder and CFC level and the need to apportion between active and passive assets of the business. Taxpayers should, in our view, have the option of taking the same robust approach to net passive income as they have for determining gross passive income.

A policy of regime change

The objectives of the CFC reform are laudable: New Zealanders, we are told, have one of the lowest levels of foreign investment in the OECD. Punitive rules that have taxed CFC income on accrual have damaged our international competitiveness and created distortions in the way we invest. If these reforms

operate in the way they are intended, they should go some way to addressing these problems. However, as we have learned from previous regime changes, a noble idea that is poorly implemented can quickly prove to be a disastrous intervention. Now is the time for interested parties to voice any concerns. Officials are engaging in an extensive round of consultation with taxpayers and they are genuinely interested in getting industry feedback on these reforms. We encourage anyone with international operations to take some time to consider what the potential impact of these changes will be on their business. Minter Ellison Rudd Watts will be making a submission to Officials before 30 November. We would be happy to discuss these proposals with you and feed any comments you may have back into the review process. There has never been a better time to come and speak to us.

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