

**A HISTORICAL REVIEW OF
THE CFC & FIF REGIMES: PART ONE
1987 TO 1 DECEMBER 2003.**

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Abstract

The CFC & FIF regimes were originally enacted to prevent New Zealand taxpayers using tax havens to avoid or defer their New Zealand tax obligations. However both regimes contain a number of provisions that have not been adopted by any of the major OECD countries or any of NZ major trading partners. For example, the CFC regime does not contain an active income exemption and the FIF regime often taxes unrealised capital gains. Those features have led to widespread criticism and a range of taxpayer responses to ameliorate the negative impact the current rules have on legitimate off shore trade and investment decisions. Part one of this article examines:

- the tax planning opportunities which both regimes were designed to curtail,
 - the behavioural responses of taxpayers to the perceived harshness of the current law, and
 - the McLeod Committee recommendations, which were designed to achieve a more appropriate balance between taxpayers, legitimate commercial offshore investment decisions and the ongoing threat posed by tax havens.
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- DAVID DUNBAR.
 - MARCH 2004.

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An historical review of the CFC and FIF regimes: Part one 1987 to 1 December 2003.

1. Introduction

1.1 A review of the FIF regime

On 6 August 2003 the Minister of Revenue¹ announced that:

... an issues paper will be released in October [2003] for consultation on proposals to deal with this and other problems that arise under the foreign investment fund rules. One of the options canvassed will be a version of the McLeod Review's risk-free rate of return method.

The problem that the Minister was referring to was a scheme that enabled a New Zealand resident taxpayer to avoid paying New Zealand income tax on New Zealand Government Stock (NZGS). According to the Minister, New Zealand resident taxpayers were investing in Australian unit trusts that in turn acquired the NZGS. Under the current New Zealand and Australian tax regimes the Australian unit trust could "convert" what would otherwise have constituted gross interest income into a tax-free receipt in the hands of the New Zealand resident investor.

1.2 Alternative tax efficient investments

The Minister's announcement was confined to Australian unit trusts. There are at least two other well-known tax effective investments structures that are widely offered within New Zealand that were not discussed by the Minister. They are:

- Open ended investment companies (OEIC's)
- Unit trusts such as Schroder Asia Pacific Fund PLC (Schroder) and Foreign & Colonial Euro Trust PLC (Foreign & Colonial).

Both of these investment trusts are listed on the London stock exchange. From a tax perspective, the advantage of both of these funds is that they are resident in a grey list country, i.e. the United Kingdom. However, both of the funds hold a significant percentage of their investments in companies that are resident in non-grey list countries. If a New Zealand individual shareholder had directly invested in any of those non-grey list country investments, then prima facie the FIF regime would apply. From a New Zealand tax perspective, an OEIC offers similar tax advantages.

¹ The Hon Dr Michael Cullen's announcement is available at www.taxpolicy.ird.govt.nz/index.php?view=248. The Issues Paper, entitled "Taxation of non-controlled offshore investment in equity" was released on 16 December 2003.

1.3 Scope of this article

New Zealand's international tax regime was designed to prevent New Zealand resident taxpayers from avoiding or deferring New Zealand income tax by establishing offshore entities in low tax jurisdictions. If there were no controlled foreign corporation (CFC), foreign investment funds (FIF) and trust regimes it would be a comparatively simple exercise for New Zealand resident individuals and companies to divert income which would otherwise have been derived by them into a foreign entity.

The CFC regime was enacted in 1988 and the FIF regime finally came into force in 1993. Neither regime has been significantly amended since they came into force. In late 2001 the McLeod² Committee highlighted a number of important issues concerning the appropriateness of the two current regimes and recommended a number of alternative options. The Committee did not explicitly focus on the range of tax effective investment products such as Australian unit trusts that have prompted the Minister into action.

This article examines:

- the background to the enactment of both the CFC and FIF regimes
- problems that have arisen since their enactment (including submissions to the McLeod Committee)
- the behavioural responses to the CFC and FIF regimes
- the McLeod Committee criticism and recommendations
- future reform, where to from here?

A subsequent article will examine the implications of the significant changes to the current FIF regime that are proposed in the Issues Paper released on 16 December 2003 on the "Taxation of non-controlled offshore investment in equity". That document was prepared by the Inland Revenue Department (IRD) and the Treasury as a response to a recommendation made by the McLeod Committee that the current FIF regime needed to be reformed. For this reason, the law as at 1 December 2003 forms the basis of this article.

The December Issues Paper did not consider any of the McLeod Committee recommendations for reforming the current CFC regime. However there have been a number of recent developments in Australia, which provide an interesting alternative to the McLeod Committee's recommendations. A subsequent article will also consider:

- the review of Australian international taxation arrangements and the options for reform that were contained in the August 2002 consultation paper prepared by the Australian Treasury

² <http://www.treasury.govt.nz/taxreview> 2001. The final report is no longer on the IRD web site.

- the report of the Australian Board of Taxation to the Australian Treasurer released in February 2003 on international taxation
- the Australian government announcement in May 2003 of significant changes to the CFC regime, which represent a major shift in the underlying policy of the Australian CFC regime.

2. The objectives of a CFC/FIF regime

2.1 Tax planning opportunities

If there was no CFC/FIF regime then New Zealand resident taxpayers could avoid or defer the payment of New Zealand income tax by establishing entities in well-known tax havens such as the British Virgin Islands, Bermuda, and the Bahamas. Alternatively they could support New Zealand's South Pacific neighbours such as the Cook Islands, Western Samoa, or Vanuatu.

2.2 The Income tax Act 1976

Prior to the enactment of the current CFC and FIF regimes there were a number of features in the Income Tax Act 1976 (the 1976 Act) which assisted the New Zealand taxpayers to minimize their tax liability. These are discussed in the following paragraphs.

2.2.1 Corporate residence

The first such aspect was a narrow definition of corporate residence. Cases such as *New Zealand Forest Products Finance NV v CIR*³ demonstrate how it was possible to effectively control a foreign corporation without bringing the foreign entity within the definition of a resident company for New Zealand tax purposes.

2.2.3 Section CB 10

Before the enactment of the foreign dividend withholding payment regime (FDWP) all inter-company dividends were exempt from New Zealand company tax. Accordingly, it was possible for a New Zealand parent company to incorporate a foreign subsidiary that could be used to divert income, which would otherwise have been derived, by the New Zealand parent company. The accumulated tax-free income could then be paid out as a dividend to the New Zealand parent company. Tax would only become payable if the New Zealand parent company distributed the foreign source income to a New Zealand resident individual shareholder.

2.2.3 Section 106(1)(h)(iii)

Section 106(1)(h)(iii) of the 1976 Act permitted a parent company to claim an interest deduction in respect of interest paid on borrowed money which was used by the

³ (1995) 17 NZTC 12,073.

parent company to subscribe for shares in a New Zealand subsidiary. There was nothing in that provision which prevented the New Zealand subsidiary from using the proceeds from the share issue to its New Zealand parent company to subscribe for equity in a foreign company. This provision effectively provided for a “mismatch” against the New Zealand revenue base.

The three building blocks (in 2.2) enabled New Zealand resident companies to set up the following “tax efficient” structures.

2.3 “Tax efficient” structures

2.3.1 “Money-go-rounds” and “dividend trap” companies

The intercompany dividend exemption and section 106(1)(h)(iii) enabled a New Zealand parent company to incorporate a “money box” company in a tax haven which would undertake investments that the New Zealand parent company would otherwise have made. Any income arising from the investment avoided both the New Zealand source rules and any New Zealand tax which would otherwise have been payable if the foreign subsidiary were a New Zealand resident for tax purposes.

An alternative structure would be to interpose between the New Zealand parent and its overseas trading subsidiaries, a dividend trap company located in a tax haven. Dividends derived by the tax haven company, could then be used to fund investments that would ordinarily have been undertaken by the New Zealand parent company.

2.3.2 “Captive insurance companies”

Another form of passive investment that could be made via a tax haven was the creation of a “captive insurance company”. In the absence of a CFC/FIF regime, a captive insurance company could play a useful role in cases where a corporate group decide to self-insure some or all of its risk. Premiums paid by a New Zealand subsidiary to a foreign subsidiary will generally speaking satisfy the ordinary test of deductibility for New Zealand tax purposes. However, unlike a “money box” or “dividend trap” company, there is an element of tax leakage because section 209 of the 1976 Act provided that premiums paid in respect of New Zealand risk are subject to a flat rate of tax at 10%.⁴

2.3.3 Intellectual Property

A third form of passive income which could be trapped in a tax haven were royalties arising from intellectual property rights held by a “patent holding” company. However, there was a similar degree of tax leakage because the royalty payment would satisfy the definition of a royalty in section 2 of the 1976 Act that would trigger a liability to Non Resident Withholding Tax (NRWT) under section 311 of the 1976 Act.

⁴ However section 209 of the 1976 Act did not apply to a contract of reinsurance, and section 210 only applied to underwriters carrying on the business of reinsurance in New Zealand. One way of avoiding the 10% tax leakage was to establish a New Zealand resident captive insurance company who reinsured with a capture non resident reinsurance company.

2.3.4 Active income

Similar structures could be used to trap “active income” in a tax haven. A common example would be the incorporation of a foreign sales or distribution subsidiary that was interposed between the New Zealand parent company and the ultimate third party customers of the parent company. Profit that would ordinarily have arisen in New Zealand is diverted to the foreign subsidiary via transfer pricing strategies.

A second variation on this general theme is the incorporation of an offshore service subsidiary which arranges for the provision of corporate services that are often unnecessary, or provided at over inflated prices.

2.4 Overseas Experience

At the time the CFC regime was enacted, six other countries had been sufficiently concerned about these types of tax driven strategies to enact controlled foreign corporation legislation. It is significant to note that none of those countries had the additional problem of an inter-corporate dividend exemption and an interest deduction provision comparable to section 106(1)(h)(iii). By 1988, Canada, France, Japan, West Germany, United Kingdom and the United States of America had all adopted a similar legislative format in that controlling resident shareholders were taxed on their pro rata share of the CFC’s income. Some of the important attributes of these regimes are summarised in Table A.

Table A: Summary (as at 1988) of selected CFC Legislative Solutions

	Scope	Low tax rates	Listed countries	Exemptions
France	- 25% ownership - no limit to number of shareholders - direct and indirect tracing rules	Foreign tax <66% French tax rate	Unofficial blacklist	- Active business exemption - Foreign tax credit
Japan	- 50% ownership - designated tax havens - direct and indirect tracing rules	Foreign tax <50% Japanese tax rate	Unofficial blacklist	- Active business exemption - Foreign tax credit
West Germany	- 50% ownership - designated tax havens - direct and indirect tracing rules	Foreign tax rate <30% West German tax rate	Unofficial blacklist	- Active business exemption - Foreign tax credit
United Kingdom	- 50% ownership - designated tax havens - direct and indirect tracing rules	Foreign tax <50% UK tax rate	Unofficial blacklist	- Active business exemption - Foreign tax credit

Canada and the USA have been excluded from Table A. Those two countries adopted the transactional approach. This technique involves specifying the specific types of income that will be attributable to the resident controlling shareholders. The specified types of income are subject to the regime regardless of the jurisdiction in which the CFC is located. This approach was not adopted by New Zealand and for that reason it is not considered in this article. The second method that was adopted by New Zealand and the four countries in Table A is known as the jurisdictional approach to CFCs. Under that approach, the emphasis is placed on the location of the CFC as opposed to the transactions or type of income derived by that entity. The jurisdictional approach usually involves the publication of lists of countries that are either included or excluded from the legislation.

For reasons which will become apparent later in this article, it is significant to note that each of the four countries all contain an active business income exemption. This exemption is usually justified on the grounds of corporate competitiveness.

3. Pre CFC/FIF Tax Planning Opportunities

3.1 Introduction

The necessity for a robust CFC/FIF is demonstrated by the facts of *Europa Oil (No 1)*,⁵ *Europa Oil (No. 2)*⁶ and the recent decision of the Court of Appeal in *Dandelion Investments Limited*.⁷ An interesting question (which will not be explored in this article) is why it took fourteen years for a legislative response to the significant risk to the New Zealand domestic tax base that was identified in the two *Europa Oil* decisions.

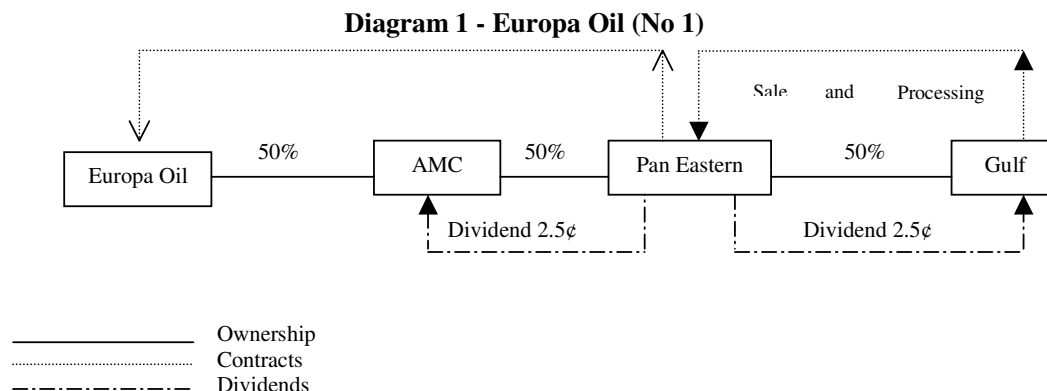
⁵ *Europa Oil (NZ) Ltd (No 1) v CIR* [1971] NZLR 641 (*Europa Oil (No 1)*)

⁶ *Europa Oil (NZ) Ltd (No 2) v CIR* [1976] 2 NZTC 61,006 (*Europa Oil (No 2)*)

⁷ *CIR v Dandelion Investments Ltd* (2003) 21 NZTC 18, 013 (*Dandelion Investments*)

3.2 Europa Oil (No 1)

For the purposes of this article the important relationship between the New Zealand entities and the offshore entities is shown in Diagram 1.



By way of background it should be noted that the structure was not designed to manufacture a tax advantage associated with the absence of a CFC/FIF regime. Although the structure, which was ultimately created by the parties, had all the hallmarks of a classic reinvoicing operation, the commercial objectives were to disguise from other interested parties, the provision of a discount.

The taxpayer Europa Oil was a member of an associated group of companies, which marketed and distributed petrol throughout New Zealand.⁸ Europa's main competitors were all controlled by multinational corporations, which enabled them to obtain long term, secure sources of raw materials from the Middle East. Europa Oil had no interest in any similar fields. Consequently it had to purchase its stock in trade from one of the major international oil companies.

An American company (Gulf Oil Corporation (Gulf)) did not have a sufficient international market for what was known as "light end products" and no outlet for those products in New Zealand. Accordingly, Gulf and Europa Oil entered into an arrangement, which suited their mutual interests. The taxpayer needed a secure source of light end products, and Gulf was in a position to meet all of the taxpayers needs.

The commercial problem was that bulk supplies of crude oil and refined products were sold at "posted prices" which were designed to prevent offering discounts. In order to secure an assured outlet in New Zealand for its surplus light end products, Gulf agreed to forego a proportion of the refiner's profit, which was reflected in the posted prices. Accordingly, the structure summarised in Diagram 1 was primarily designed to disguise the fact that Gulf was prepared to offer a discount equal to 2.5¢ per gallon of gasoline supplied to the taxpayer.

⁸ For further details refer to *Europa Oil (No 2)* judgment of the Court of Appeal (1974) 1 NZTC 61,169 and the judgment of the Privy Council (1976) 2 NZTC 61,066.

Gulf however was for business reasons unwilling to depart from the establish system of posted prices by making this concession in the form of a reduction in the price at which it sold the refined products to the taxpayer company. So the benefit of the concession of 2.5¢ had to be given by Gulf to the Todd Group in some other form.

That form was Pan Eastern a company incorporated in the Bahamas. Pan Eastern was a classic letterbox company. It did not undertake any refining. Under the processing contract between Pan Eastern and the Gulf group, the refining was undertaken by Gulf on behalf of Pan Eastern, in a way in which enabled Pan Eastern to derive a profit of 5¢ per gallon. That profit was split between Gulf and Pan Eastern's other shareholder Associated Motorist Company Limited (AMC). The dividend of 2.5¢ per gallon was derived by AMC free of New Zealand tax by virtue of the inter-company dividend exemption.

The insertion of Pan Eastern into the commercial relationship between Europa Oil and Gulf created a classic tax mismatch against the CIR. Europa Oil sought to claim a deduction for the full price paid to Pan Eastern without adjusting for the tax-free dividend of 2.5¢ per gallon. In the absence of a CFC/FIF regime the CIR could only attack the arrangement under the general deduction provision or the anti avoidance provision. He was successful under the former and consequently the application of the latter did not arise.

In relation to the predecessor to sec. BD 2(1)(b)⁹ of the Income Tax Act 1994 (the 1954 Act) the majority of the Privy Council held at p. 6,019:

For a claim to disallow a portion of expenditure incurred in purchasing trading stock to succeed, the Crown, in their Lordships' judgment, must show that, as part of the contractual arrangement under which the stock was acquired some advantage, not identifiable as, or related to the production of, assessable income, was gained, so that a part of the expenditure, which can be segregated and quantified, ought to be considered as consideration given for the advantage. Taxation by end result, or by economic equivalence, is not what the section achieves.

The Diagrammatic summary of the relationship between the parties strongly suggests there was an interdependence of commercial obligations and benefits that flowed from the contracts which, though written as separate documents, represented a single contractual whole. The expenditure had to be apportioned because:

To their Lordships it appears that the conclusion can only be in favour of the Commissioner. The integration of Europa's agreement to buy gasoline, at posted prices, with Gulf's agreement to provide earnings for Pan Eastern, is far too close, and far too carefully worked out, to permit the isolation of the agreement for sale (products contract) and the treatment of the expenditure incurred under it as incurred exclusively for the purchase of trading stock. (p. 6,020)

⁹ Section 108 of the Land and Income Tax Act 1954 (the 1954 Act)

Having found for the Commissioner under the predecessor to section BD 2(1)(b), the majority did not consider the potential application of the predecessor of section BG 1 of the Act.

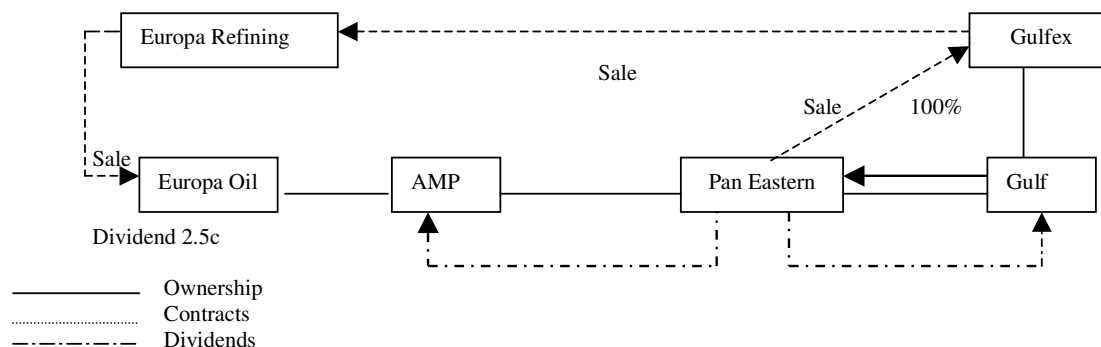
The approach of the Privy Council and the outcome suggested that the existing law could cope with offshore letterbox companies and re-invoicing arrangements. However that was all about to change.

3.3 Europa Oil (No 2)

The 1956 contracts (the subject of Europa Oil (no.1)) reflected the fact that at the time they were entered into New Zealand did not have any ability to refine petroleum products. In 1964 the Marsden Point Refinery was completed which meant that Europa Oil no longer required fully refined product. It did however need semi-refined feedstock.

The 1964 contractual relationship between the parties is summarised in Diagram 2. A comparison between Diagrams 1 and 2 indicates that two new companies were introduced into the arrangement. The first was Gulfex, a subsidiary of Gulf and the second was Europa Refining, which was a New Zealand resident company that was a member of the Todd group of companies.

Diagram 2: Europa Oil (No 2)



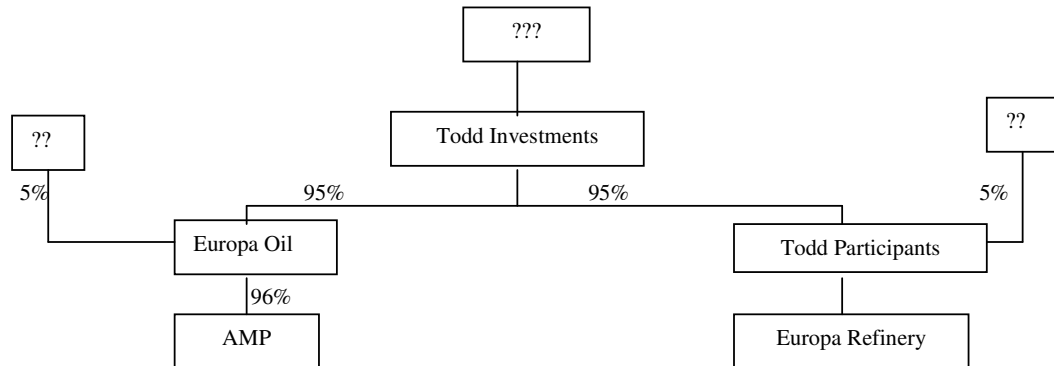
In view of the approach taken by the Court of Appeal and the majority of the Privy Council, it is important to understand the relationship between Europa Oil and Europa Refining.

Lord Diplock delivered the advice of the majority of the Privy Council. He noted that the relationship between Europa Oil and Europa Refining was that Europa Refining was not a subsidiary of Europa Oil and that neither company was a subsidiary of the same parent company in the Todd group.¹⁰ Further details of the shareholding and ownership of the Todd group is contained in the judgment of McCarthy P.¹¹ Based on the information contained in these two judgements, it would appear that the ownership structure was as follows:

¹⁰ Per Lord Diplock (1976) 2 NZTC 61,066, p61,069

¹¹ Per McCarthy P (1974) 1 NZTC 61,169, p61,177

Diagram 3: Ownership structure of Europa Oil Ltd



Diagrams 2 and 3 demonstrate the legal correctness of the proposition that the legal effect as distinct from the economic consequences of the arrangement was that whenever Europa Oil ordered goods from Europa Refining and accepted the obligation to pay the sum stipulated in that contract as the purchase price, Europa Oil only acquired a legally enforceable right to the delivery of the goods and did not obtain any other benefit or moneys worth.¹² This conclusion followed from the fact that Europa Oil was under no contractual obligation to purchase its requirements for feedstock from Europa Refining. The dividend of 2.5¢ per gallon derived by AMP arose from a different set of contractual relationship between inter alia Europa Refining and Gulfex, between Gulfex and Pan Eastern, and between Pan Eastern and inter alia Gulf. Accordingly:

It follows that that whenever the Taxpayer Company entered into a contract with Europa Refining for the sale and delivery of one or more cargo lots of feedstocks and thereby accepted an obligation to pay the sum stipulated in that contract as the purchase price, the only right that it thereby acquired which was legally enforceable against anyone was the right to delivery of the feedstocks by Europa Refining.¹³

Accordingly Europa Oil was permitted to claim the full amount under the predecessor to section BD 2(1)(b).

The approach of the majority of the Privy Council in *Europa Oil No 2* demonstrated the necessity for a CFC/FIF regime to protect the New Zealand tax base from offshore re-invoicing operations. There was nothing in principle to prevent a New Zealand exporter from devising a similar structure to trap a proportion of the profit.

The symbiotic nature of the economic relationship between Europa Oil and Europa Refining is demonstrated by the fact that Mr Brian Todd exercised effective control over the operations of both companies. Europa Refining was a paper company with

¹² *Europa Oil (No 2)* (1976) 2 NZTC 61,169. Per Lord Diplock p61, 072

¹³ See note 7, p61, 074.

no separate staff and a minimal organisational structure. According to Lord Wilberforce it took no financial risks and made no profit.¹⁴

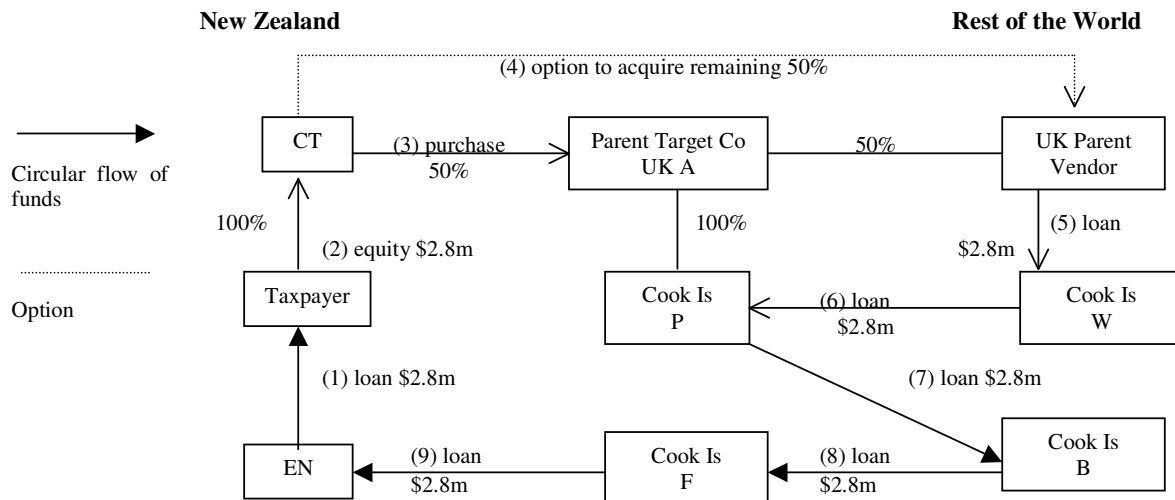
The same was the case with Pan Eastern. The five cents a gallon profit derived by Pan Eastern was not earned in respect of any commercial activity or effort undertaken by Pan Eastern. That company was incorporated in the Bahamas and likewise had no staff and did not undertake any commercial risk. The refining undertaken was performed by Gulf on behalf of Pan Eastern. Pan Eastern’s role was to merely disguise the fact that a discount was being paid to Europa Oil.

The relationship between Europa Oil and the Gulf group was primarily driven by commercial considerations. Gulf had a surplus of “light end” products and no outlet in New Zealand, whereas Europa Oil was looking for a secure supply of products from the “light end” of the refining process. Both parties set up a structure to disguise from other competitors the fact that Gulf was prepared to pay a discount. Pan Eastern’s primary role was to facilitate the payment of a discount in a way, which did not depart from the established system of posted prices. The facts of the two Europa Oil decisions illustrate the potential difficulty of distinguishing between active and passive income. This is an issue discussed in the McLeod Committee’s Report.

3.4 Passive Investments : Dandelion Investments Ltd

The approach taken by the High Court and the Court of Appeal in this case¹⁵ prima facie suggests that section BG 1 of the Act can in some circumstances protect the tax base. The following Diagram summarises the main entities and the transactions, which they entered into.¹⁶

Diagram 4 : The investments



¹⁴ Per Lord Wilberforce, p61,077.

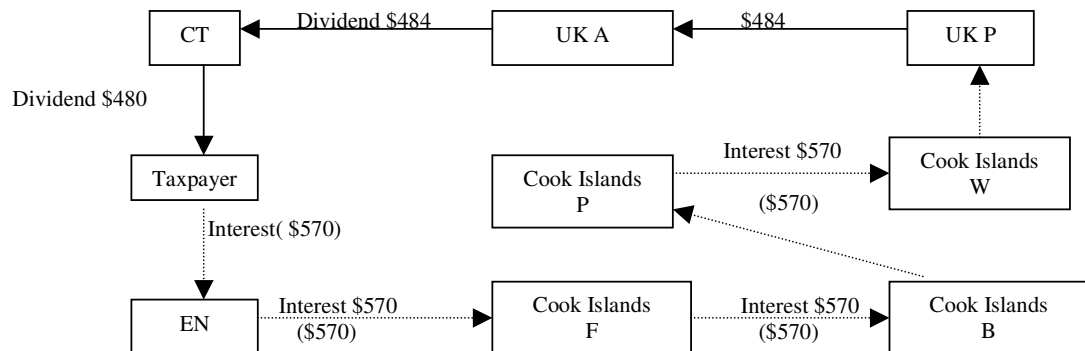
¹⁵ *Commissioner of Inland Revenue (CIR) v Dandelion Investments Ltd* (2001) 20 NZTC 17,293 (HC) and (2003) 21 NZTC 18,013 (CA).

¹⁶ This Diagram is based on the summary contained in the judgment of the TRA reported as *Case U11* (1999) 19 NZTC 9,100 at p9,127 and Appendix A attached to the judgement of Tompkins J reported in *Commissioner of Inland Revenue (CIR) v Dandelion Investments Ltd* (2001) 20 NZTC 17,293 at p17,309.

Briefly Dandelion Investments was a profitable manufacturing company, which prior to entering into the above arrangement derived substantial assessable income. The taxpayer entered into a transaction in 1986 that involved the purchase of all of the share capital in a UK company (UK A) through CT, which was financed by a loan of \$2.8m. The UK vendor of the target company lent the money to a Cook Islands company (W), which in turn lent the \$2.8m to three other Cook Island companies (P, B, F). Ultimately the loan finance was returned to a New Zealand company controlled by Euro National (EN), which had originally lent the \$2.8m to the taxpayer.

The tax advantage sought from the arrangement arose from the cash flows shown in Diagram 5:

Diagram 5 : The tax mismatch



Dividend	484
Interest	(570)
Cash Loss	(86)
Tax benefit 48%	274
Net benefit	<u>188</u>

If one stands back from the series of individual transactions that made up the arrangement, the net effect was that for income tax purposes the taxpayer paid interest of approximately \$570,000 which it sought to deduct from its other income. That expenditure was partly funded by the tax-free dividend of approximately \$484,000, which was used to pay most of the interest. The remaining interest was effectively paid from the tax saving associated with the interest deduction. The tax benefit converted what was otherwise a cash loss into a net benefit for the taxpayer of \$188,000.

The reasoning of the High Court was very brief and Tompkins J concluded that the respondent had not discharged the onus of proving the arrangement was not within the 1976 Act equivalent to section BG 1. Tompkins J formulated the issues as follows:

The real issue is whether one of the purposes or effects of the arrangement (not being a merely incidental purpose or effect) was tax avoidance. This is not affected by some other provision in the Act that may make the interest payable deductible. [Emphasis added]¹⁷

¹⁷ (2001) 20 NZTC 17,303 p7,307, paragraph 83.

McGrath J delivered the judgment of the Court of Appeal. He said:

In reality there was no true business purpose to be achieved by the appellant in entering into the transaction other than to obtain the benefit of a deduction of an interest expense of \$570,080 by making a payment of that sum which was to be offset by a tax-free dividend receipt of \$484,000. The transaction was circular in its inception and unwinding. Once unwound after the 12 months term of the loan it had no financial effects for the appellant, other than its net outlay of \$86,080 and, presumably a liability for the fees of its advisers. There was no risk to the appellant during that period. No element of business dealing other than tax avoidance can be identified as a purpose of the arrangement. It is an artifice involving pretence and not a real group investment transaction at all. The concessional treatment of interest expenses under s106(1)(h)(ii) of the 1976 Act for borrowings to acquire shares in what would be a group company was not, on its true construction, intended to give the taxpayer the opportunity of obtaining a deduction in this way. It is the type of arrangement which s99 was enacted to counteract in terms of the approach taken to the provision by the Privy Council in O'Neil at para 10 and by this Court in BNZ Investments Ltd at para 40. In those circumstances we agree with the High Court Judge that the purpose and effect of the composite arrangement was one of tax avoidance. The arrangement was accordingly void under s99(2).¹⁸

3.5 Can section BG 1 protect the New Zealand domestic tax base?

In *Dandelion* the High Court upheld the IRD application of the predecessor to section BG 1 whereas in *Europa Oil No 2* the Court of Appeal and Privy Council held that the equivalent to section BG 1 could not apply. The majority of the Privy Council in *Europa Oil No 1* did not need to consider this issue, whereas the minority held that the Commissioner's argument was hopeless.

3.5.1 Europa Oil (No 2)

The Court of Appeal did not consider the application of section BG 1.¹⁹ Nor did Lord Wilberforce in his dissenting judgment.²⁰ The observations of the majority of the Privy Council were made in respect of the old section BG 1 (section 108 of the 1954 Act) which was amended in 1974. In the context of both the 1956 and 1964 contracts and the predecessor to section BG 1, the majority made a number of observations which indicate the type of difficulties the IRD would face in trying to use section BG 1 to attack offshore structures.

¹⁸ (2003) 21 NZTC 18,013 pp18,030-31. The facts of *Dandelion* are extreme and are far removed from the type of scenario, which is illustrated by *Europa Oil* that is more representative of the traditional role played by tax haven companies. In the author's view, *Dandelion* does not provide a lot of meaningful insight into how section BG 1 could be used to combat tax haven companies.

¹⁹ (1974) 1 NZTC 61,169 McCarthy P p61, 198; Richmond J p61, 206; Beattie J p61, 209.

²⁰ (1976) 2 NZTC 61,066 at p61,080.

Lord Diplock identified three well-known deficiencies in the old section 108.²¹ The first was the then new source of income rule.

Lord Diplock said:

*The section [now section BG 1] does not strike at new sources of income or restrict the right of the taxpayer to arrange his affairs in relation to income from a new source in such a way as to attract the least possible liability to tax.*²²

Despite the 1974 amendment which introduced a new definition of “tax avoidance”, “tax avoidance arrangement” and “liability”, Richardson J noted in *CIR v Challenge Corporation Ltd*²³ (Challenge Corporation) that the new definition of “liability” does not apply to a “potential or prospective liability to future income tax”. Those three definitions do not ipso facto repeal the new source of income rule discussed in *Europa Oil No 2*. For example, Richardson J said in *Challenge Corporation* (at p. 5,021):

A complicating fact is that every financial transaction of the taxpayer may effect a tax change and it is not to be supposed that a potential or prospective liability in respect of future income to which the definition refers, was intended to have that reach. On the contrary, if the analysis of which I have been speaking leads to the conclusion that there is no room for the application of [now section BG 1], that is because the tax change, which has occurred, has not affected the liability to income tax, which the Act itself contemplates.

The second deficiency identified by Lord Diplock was the proposition that the references in the definition of “tax avoidance” to a liability to pay income tax are references to New Zealand income tax. His Lordship noted that the old section 108 did not contain any extra territorial scope. It did not apply to any arrangements involving entities located in offshore jurisdictions.

Finally Lord Diplock noted that the old section 108 was an annihilating provision and that it did not contain a power of reconstruction. This well known deficiency was corrected in the 1974 amendment, which is reflected in the current section GB 1(1) that enables the Commissioner to adjust the taxpayer’s income in any manner, which will counteract the tax advantage obtained by the taxpayer from the arrangement.

3.5.2 Dandelion Investments

From a tax perspective the investment in the UK target company only worked because of the inter action between predecessors to sections CB 10 and DD 1(1)(b)(iii) and the company tax rate of 48%. The tax saving associated with an interest deduction of \$570,000 was \$274,000 which taken in conjunction with a tax-free dividend of \$484,000 converted a pre-tax loss of \$86,000 (\$484,000 minus \$570,000) into a post-tax benefit of \$188,000. The Taxation Review Authority, the High Court and Court

²¹ See note 8 above at p61,074-75.

²² See note 8 above at p61,074.

²³ *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 at p5, 021.

of Appeal concluded there were few, if any, commercial reasons (apart from the income tax benefit), which would have justified the taxpayer acquiring the UK target company. According to Tompkins J:

*At the end of the arrangement after it had been unwound, there was nothing of any value left. The [taxpayer] owed its subsidiary \$2.8m and held shares in that company for exactly the same amount.*²⁴

Accordingly, His Honour held that the respondent had not discharged the onus of proving that the arrangement was not within the predecessor to section BG 1 (Section 99 of the 1976 Act).

Were the courts correct in holding that the application of the equivalent provisions to section BG 1 was not affected by the equivalent section to DD 1(b)(iii)? This approach calls into question the correctness of the decision of the majority of the Privy Council in *Challenge Corporation* that was recently criticised by the Privy Council in *O’Neil v CIR*²⁵. In reaching its conclusion, neither the High Court nor the Court of Appeal discussed the following cases that strongly suggest that approach of Privy Council in *Challenge Corporation* was conceptually incorrect.

3.5.3 O’Neil v CIR

Despite the fact that the CIR won this case²⁶, there were at least two observations made by the Privy Council, which strongly suggest a broad analytical approach is not always correct.

Lord Hoffman noted (p. 17,057) at paragraph 9:

... the distinction between tax litigation and tax avoidance is unhelpful : as the Judge said it “describes a conclusion rather than providing a signpost to it”. ... The other is that they doubt the wisdom of using the concept of “impropriety” instead.

This strongly suggests that the approach taken by the majority of the Court of Appeal in *Challenge* is now the correct way of reconciling the relationship between section BG 1 and a specific provision such as sections CB 10 and DD 1(1)(b)(iii).

After noting the highly artificial nature of the “Russell template” and how it applied to the circumstances of the O’Neils, Lord Hoffman said in paragraph 10:

Their Lordships consider this is to be a paradigm of the kind of arrangement which [Section BG 1] was intended to counteract. On the other hand, the adoption of a course of action, which avoids tax, should not fall within [section BG 1] if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way.

²⁴ (2001) 20 NZTC 17,293 p17,308 paragraph 92.

²⁵ (2001) 20 NZTC 17,051 p17,056-57.

²⁶ (2001) 20 NZTC 17,051.

Section DD 1(1)(b)(iii) governs the deductibility of interest in the context of a group of companies. It is difficult to escape the conclusion that this provision is designed to encourage a parent company to use borrowed finance to subscribe for equity in a group company. It is significant to note that there is no statutory requirement that either the group company or the parent company must demonstrate that the borrowed finance produced gross income for either member of the group. Clearly this section contemplates that a subsidiary can be interposed between the parent company and the ultimate investment. In view of section CB 10 of the Act, there can be no other interpretation than the analysis summarised above, because section CB 10 provides that certain inter company dividends pass free of tax. Accordingly, there could never be an explicit requirement in section DD 1(1)(b)(iii) that the borrowed money must produce gross income given that section CB 10 exempts from tax the anticipated income flow associated with any downstream investment made by the group company.

In view of the clear statutory language it is difficult to see, in the words of McGrath J, why the true construction of this provision meant the taxpayer in *Dandelion Investments* had not satisfied the statutory test simply because the investment in the final company in the chain was not commercial.

3.5.4 CIR v BNZ Investments Limited

A similar approach was taken by Richardson P in this case²⁷ which is also consistent with his Honour's judgment in *Challenge Corporation* Richardson P said (at paragraph 41) p.17, 115:

The function of [Section BG 1] is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objections. Clearly the legislature could not have contended that [section BG 1] should override all provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself. Equally the general anti avoidance provision cannot be subordinated to all the specific provisions of the tax legislation. ... The general anti avoidance section thus represents an uneasy compromise in the income tax legislation."

This observation is significant because it was made in the context of an arrangement, which was conceptually similar to *Dandelion Investments*. The Court of Appeal was asked to consider inter alia the relationship between predecessors to section BG 1, on the one hand and sections CB 10 and DD 1(1)(b)(iii) in the 1976 Act. This question was not considered in any detail, because the majority of the Court of Appeal held there was no relevant "arrangement" within the meaning of the equivalent to section OB 1 of the 1976 Act and accordingly section 99 of the 1976 Act (now section BG 1) did not apply.

²⁷ (2001) 20 NZTC 17,103.

It is also significant to note that both the majority and minority judgements of the Court of Appeal in this case confirmed that the redeemable preference share transactions were regarded as commonplace and widespread and that the mandatory convertible note transactions were regarded as genuine involving actual fiscal consequences.

It is difficult to escape the conclusion that what occurred in both *BNZI* and *Dandelion Investments* is, in the words of Richardson P, a classic example of a structural choice. Sections CB 10 and DD 1(1)(b)(iii) do not outline any criteria from which an underlying assumption as to the intended scope of those two provisions can be derived. Both sections clearly envisage a statutory mismatch, e.g. the derivation of an exempt dividend funded in part by an allowable interest deduction. Secondly, neither provision contains any statutory language, which indicates that the ultimate derivation of gross income is an essential pre-requisite. This is hardly surprising given that there is always an element of commercial risk and a positive requirement that gross income must be produced would be inconsistent with the approach taken in cases such as *Grieve*²⁸, *Pacific Rendezvous*²⁹ and *Brierley*³⁰. Thirdly, it should be noted that paragraph (i) and (ii) of section DD 1(1)(b) both contain a statutory requirement that the borrowed money and interest must produce gross income, whereas there is obviously no such similar requirement in paragraph (iii). Finally the “new” section DD 1(3) does not refer to the derivation of gross income for a deduction to be claimed.

3.5.5 CIR v Challenge Corporation Limited

McGrath J's failure in *Dandelion Investments*³¹ to consider the implications of Richardson J's approach to the equivalent of section BG 1 is a significant weakness in the Court of Appeal judgment. His (McGrath J's) approach mirrors the dicta cited from *BNZI* discussed above. *Challenge Corporation* is also significant in that the Court of Appeal were asked to consider the relationship between a specific provision that governs the grouping and offsetting of company losses and the predecessor to section BG 1 of the Act. The grouping provisions are conceptually similar to sections CB 10/DD 1(1)(b)(iii).

The basic problem that was ignored by McGrath J is succinctly summarised by Richardson J in the following five propositions in *Challenge*:

“Clearly the legislature could not have intended that [section BG 1] should override all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself.” (p5,019)

“Seeking and taking advantage of incentives provided through the tax system designed to encourage particular economic activities should not be rejected out of hand as contravening the section. Yet in many cases, but for the anticipated availability of the tax benefit, the taxpayer

²⁸ (1984) 6 NZTC 61,812

²⁹ (1986) 8 NZTC 5,146

³⁰ (1990) 12 NZTC 7,184

³¹ (1986) 8 NZTC 5,001

would never have entered into the activity or transaction. In more general terms such basic features as depreciation and trading stock valuations, which are not tied for tax purposes to accounting or economic concepts clearly allow for the deliberate pursuit of tax advantage.” (P5, 020)

“It is the principle which is important and Keighery provides powerful support for the proposition that to do no more than adopt a course which the Act specifically contemplates as affecting a tax change does not affect the taxpayer’s ‘liability’ for income tax in the statutory sense and does not result in an alteration in the incidence of income tax contemplated by the Act.” (P5, 023)

“Thus, the concepts of tax grouping and carry forward of losses employed in sections [IG] and [IF] respectively of [the Income Tax Act 1994] must be characterised as tax concepts. They have no reality under the statute except in relation to income tax.” (P5, 023)

“On the analysis of the role of [sections IG and IF] in the statutory scheme and of the terms of the provision itself, I am satisfied that to treat the arrangement carried through in this case as tax avoidance within [section BG 1] would defeat, not promote, the legislative purposes involved. The tax changes achieved in the transactions did not alter the incidence of income tax which the Act itself contemplated or affect Challenge’s liability for income tax in the sense indicated by the statute.” (P5, 026)

Each of the above observations is directly applicable to sections CB 10 and DD 1(1)(b)(iii). As noted above, both provisions contemplate a statutory mismatch against the New Zealand revenue base. Secondly, neither provision contains any requirement that the underlying investment must produce gross income. In most situations that would be impossible in view of section CB 10. Both provisions clearly have no other purpose than to create a statutory mismatch and they can accordingly be categorised as pure tax concepts because they have no reality except for tax purposes. It is simply not possible to compare them with any other commercial norm.

3.5.6 Westmoreland Investments v MacNiven

In view of the fact that the United Kingdom income tax legislation does not contain a general anti avoidance provision this decision is not directly relevant. However, the facts and approach of the House of Lords³² are consistent with *O’Neil, Challenge Corporation* and *BNZI*.

The taxpayer Westmoreland Investments (WIL) was owned by a tax-exempt pension scheme. WIL was used as the vehicle for undertaking property developments on behalf of the pension scheme. The developments were financed by way of money lent to WIL by the scheme. The investments failed. At that time there was a market for companies with established tax losses, which could be sold to a purchaser who would

³² [2001] 1 All ER 865

then transfer income-earning assets into the loss company. However, for UK tax purposes the accrued interest was not deductible until it was paid.

Accordingly, the pension scheme and WIL entered into a round robin transaction, which was designed to satisfy the technical requirement of the payment of interest. Briefly, the pension scheme lent WIL a sum of money, which was used to pay the accrued interest of over £40m. It would appear that the UK revenue attacked the scheme because of the classic mismatch created by the allowable deduction and the corresponding exemption of interest income in the hands of the tax-exempt pension scheme. Subsequently the pension scheme sold WIL to a purchaser for approximately 2p in the £. The pension scheme receives £2m for the sale of WIL.

It is clear from the speeches delivered in the House of Lords that their Lordships accepted the transaction involved a circular flow of funds and that the payment of interest had no purpose other than to achieve a tax advantage.

Counsel for the Inland Revenue Commissioners submission is outlined in paragraph 28 (p.874) of Lord Hoffmann's speech. It was very similar to counsel for the CIR's submission in *Auckland Harbour Board*³³. Both submissions were asking the court to ignore the scheme of the Act and the specific statutory test and invoke either a general anti avoidance provision or a general principle of interpretation, to strike down a transaction that otherwise satisfied the statutory test. In paragraph 28 and 29 of his speech, Lord Hoffmann reiterated at page 874 that this has never been the role of the English courts:

Everyone agrees that the W T Ramsay case is a principle of construction. The House of Lords said so in IRC v McGuckian [1997] 3 All ER 817, [1997] 1 WLR 991. But what is that principle?

But [Counsel for the IRC] formulation looks like an overriding legal principle, superimposed upon the whole of revenue law without regard to the language or purpose of any particular provision, save for the possibility of rebuttal by language, which can be brought within its final parenthesis. ... But the courts have no constitutional authority to impose such an overlay upon the tax legislation and, as I hope to demonstrate, they have not attempted to do so.

Lord Hoffmann's approach to anti avoidance is consistent with the observations of Richardson P in *BNZI* and his Honour's earlier judgment in *Challenge* Lord Hoffmann noted that income tax legislation often distinguishes between commercial and legal concepts. The fiscal nullity principle of statutory construction could only apply (if at all) to commercial concepts.

*For the present purposes, however, the point I wish to emphasise is that Lord Brightman's formulation in Furniss' case, like Lord Diplock's formulation in the *Burmah Oil* case, is not a principle of construction. It is a statement of the consequences of giving a commercial construction to a fiscal concept. Before one can apply Lord Brightman's words, it is first necessary to construe the statutory*

³³ (2001) 20 NZTC 17,008, 17,11

language and decide that it refers to a concept, which Parliament intended to be given a commercial meaning capable of transcending the juristic individuality of its component parts. But there are many terms in tax legislation, which cannot be construed in this way. They refer to purely legal concepts, which have no broader commercial meaning. In such cases, the Ramsay principle can have no application.”³⁴

Finally, Lord Hoffmann noted that even if a statutory provision is being interpreted having regard to business concepts it is still possible for the taxpayer to enter into a transaction for purely tax reasons. The only issue is whether the taxpayer has satisfied the specific statutory test:

“Even if a statutory expression refers to a business or economic concept, one cannot disregard a transaction which comes within the statutory language, construed in the correct commercial sense, simply on the ground that it was entered into solely for tax reasons. Business concepts have their boundaries no less than legal ones.”³⁵

3.5.7 Dandelion Investments revisited

It would appear that McGrath J was concerned about the absence any “real investment” financed from the borrowed money. Throughout his judgement his Honour stresses the mismatch between the deductible interest and the non-assessable dividend and the fact that the tax saving associated with the interest deduction converted a cash loss into an after tax net gain. His Honour also stresses the fact that the subsidiary company, which was used to acquire the UK target company, was an empty shell. The case raises a numbers of questions including how would His Honour have approached the question of the application of section BG 1 if the facts had been slightly different? For example, it is not difficult to envisage a scenario where the borrowed money is used to fund a real investment.

3.6 A double dip

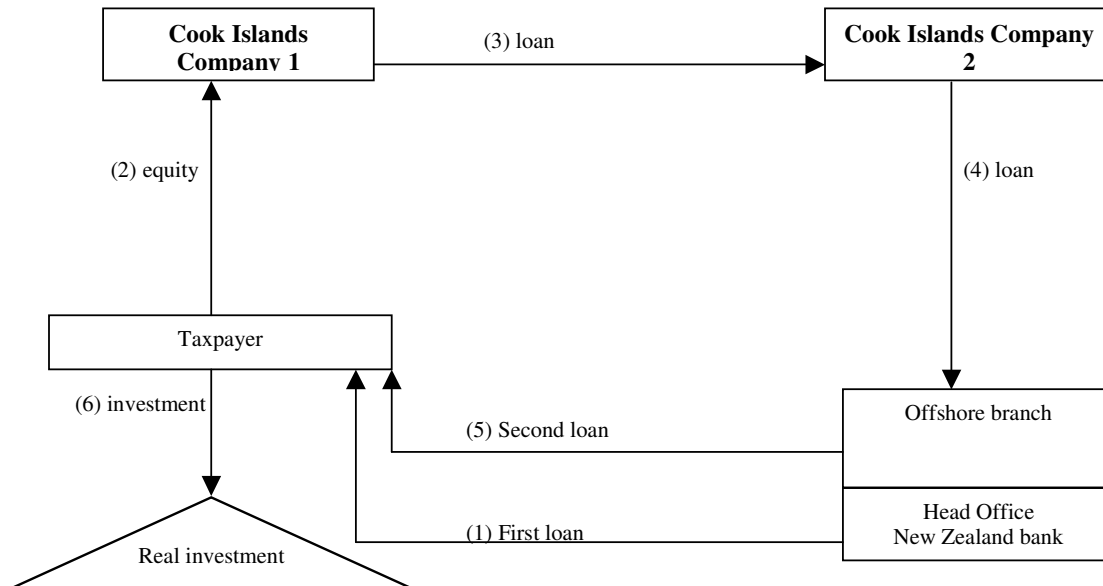
3.6.1 The structure

The following Diagram illustrates how it is conceptually possible for a New Zealand company to incorporate two Cook Island subsidiaries. The first Cook Island subsidiary would be funded fully with equity capital from the parent (2). That equity capital would be financed by the first loan borrowed from a New Zealand bank (1). An interest deduction would be available because the borrowed funds were used to subscribe for capital in the first Cook Island company. The proceeds of the share issue would be used by the first Cook Island company to lend the money to the second Cook Islands company (3). That company would then on-lend the funds back to the New Zealand bank (4). However, the loan would be deposited with the offshore branch of the New Zealand bank. The offshore branch would use the loan to make a second loan to the taxpayer (5), who used the proceeds to fund a real investment (6).

³⁴ See n32 p880 (paragraph 49).

³⁵ See n32 p883 (paragraph 59).

Diagram 6: A Double Deduction



3.6.2 Tax saving and cost of funds

Assuming the taxpayer (1) borrowed \$100,000 @ 10% (2) receives a dividend from Cook Islands company equivalent to the interest on the first loan, and (3) is subject to a tax rate of 48% (the rate applicable in 1984) the net result of the scheme from the taxpayer's viewpoint is:

Interest paid on first loan	\$10,000
Interest paid on second loan	<u>\$10,000</u>
Total tax deduction	(\$20,000)
Less tax at 48%	<u>\$(9,600)</u>
After tax interest cost	\$10,400
Less inter-company dividend (exempt)	<u>(\$10,000)</u>
Net borrowing cost	\$400
Effective tax rate	0.004%

Thus the above scheme has reduced the cost of borrowing in a completely artificial manner, at the expense of the New Zealand tax base.

3.6.2 Would Dandelion strike down this structure?

How would McGrath J react to this hypothetical structure? Would his Honour allow an interest deduction and if so, how much? Presumably his Honour would allow the second interest deduction because the funds can be traced to the real investment, and therefore the criteria of section DD 1(1)(b)(i) is satisfied.

But what about the first loan? Once again any attempt to disallow that deduction would be based on a reading into (via section BG 1) section DD 1(1)(b)(iii) of an additional criteria that is simply not apparent from the statutory test. Would it make any difference if the taxpayer could demonstrate that but for the double deduction and the positive impact it had on the cost of funds, the investment would not have proceeded? In other words, the investment is not financially viable at an implicit interest rate of 10% whereas it could only be undertaken at an effective interest rate of 0.004%. Lord Hoffmann's observation in *MacNiven* seems applicable:

But when the statutory provisions do not contain words like 'avoidance' or 'mitigation' I do think that it helps to introduce them. The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not.

4. An historical overview and summary of the current CFC/FIF regime

4.1 Introduction

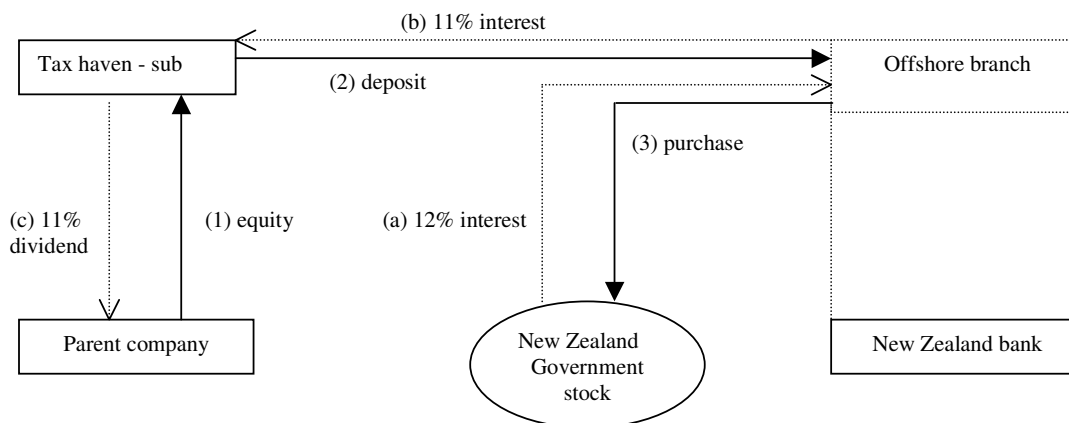
Prior to 1 April 1988 New Zealand resident companies and individuals were only liable to pay New Zealand income tax on overseas sourced income if and when they derived it. Taxpayers were not liable to pay tax upon the income derived (and returned) by a non-resident entity, even if that entity was under the complete control of a New Zealand taxpayer and that taxpayer was the only person entitled to receive or use that foreign sourced income.

Accordingly, it was a relatively simple exercise for a New Zealand resident company and/or individual to accumulate income in an offshore entity and pay little (if any) New Zealand income tax on that offshore income. However, the New Zealand resident was able to enjoy the benefit of that income in a tax free form, for example by selling the shares in the company.

The ability of New Zealand resident companies to defer or avoid the payment of income tax ended on 1 April 1988 when the original CFC and FIF regimes came into effect. The original CFC regime applied to a list of 61 low tax jurisdictions and specified types of companies in nine other jurisdictions. The current regime came into effect on 1 April 1993. The original FIF regime was also enacted with effect from 1 April 1988. However, it was deferred until 1993 when it was replaced with the current FIF regime.

4.2 Passive income companies

Diagram 7 - Passive income : companies

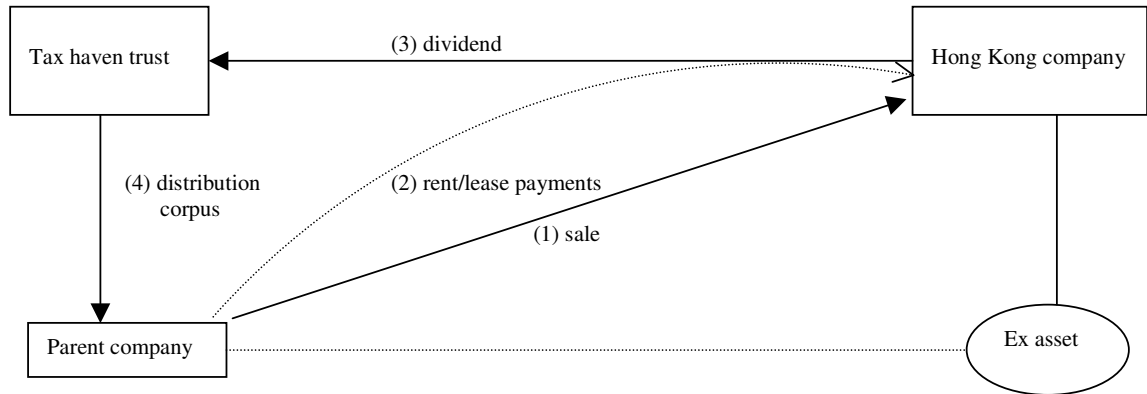


A typical example of how easy it was for a New Zealand company to avoid New Zealand income tax on a passive source of income prior to CFC/FIF regime is outlined in the scenario summarised in Diagram 7. Briefly, the parent company wishes to invest surplus funds in New Zealand government stock (NZGS). Clearly the net interest income is subject to corporate income tax because it has a source in New Zealand. However, it is possible for the parent company to eliminate the prima facie income tax expense by using the funds to subscribe for share capital in a tax haven subsidiary (1). The tax haven subsidiary could use the proceeds of the share issue to its parent company, to deposit the funds with the offshore branch of a New Zealand bank (2). That branch would use the funds to acquire the NZGS (3).

Briefly, the income tax consequences of the transaction are as follows. The payment of any interest and discount (a) arising from the NZGS is income, which clearly has a New Zealand source and is paid to a New Zealand resident taxpayer. There is no obligation to deduct NRWT, because section OE 4(1)(n)(i) of the Act (and the equivalent to the 1976 Act) specifically provides that the ordinary source rule contained in section S OE 4 (1)(h) does not apply in the case of interest derived by the offshore branch of a New Zealand taxpayer, provided that the interest was derived in the course of the business carried on by that taxpayer. The net income derived by the offshore branch (in this example 1%) is subject to New Zealand income tax. The payment of interest (b) and principal by the offshore branch to the tax haven subsidiary is a transaction, which does not create any New Zealand source income and involves a non-resident taxpayer. Accordingly, that aspect of the transaction is not subject to New Zealand tax. The final step of the transaction is the payment of a dividend by the tax haven subsidiary to its New Zealand parent (c). That dividend was exempt from income tax under the inter company dividend as it existed prior to the 1992 amendments to the equivalent of section CB 10 in the 1976 Act. There can be little doubt that the above sequence of events is detrimental to the New Zealand corporate tax base and remedial legislation was clearly required.

A variation on a theme is summarised in Diagram 8.

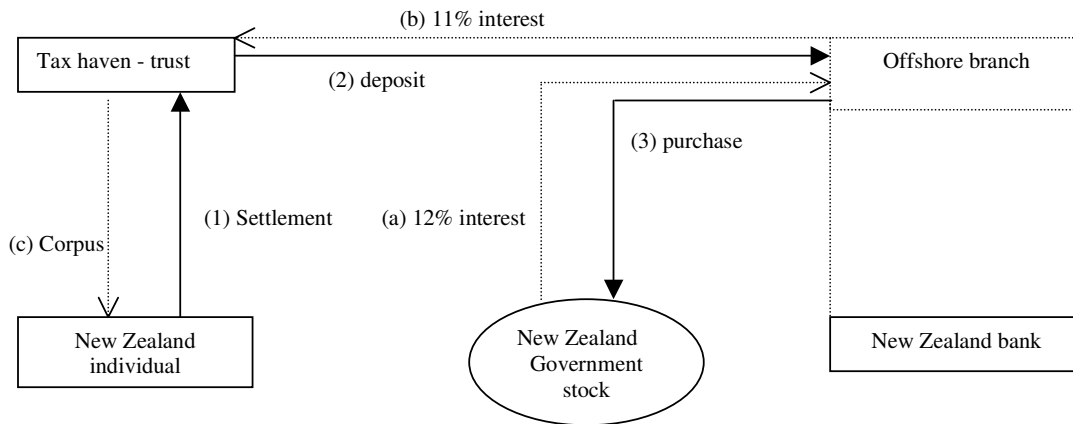
Diagram 8 – Passive income companies



Briefly, the parent company could establish a trust located in a tax haven, which in turn established a subsidiary in a tax haven. That subsidiary would then purchase New Zealand based assets from the parent company (1). The purchase would be funded by an interest free loan repayable on demand. That loan did not create any deemed dividend implications. Subject to the general anti avoidance provision, any payment by the parent company for the use and enjoyment of the asset (2) would create an allowable deduction and depending on the nature of the asset, may not create a liability to NRWT.

4.3 Passive income individuals

Diagram 9 - Passive income : individuals



So long as the tax haven trust did not distribute any current year income (sourced from the dividend received from the Hong Kong subsidiary (3)) to the parent company, the distribution was not subject to New Zealand income tax. Cases such as *Lutterill*³⁶ established that income that was not distributed to a beneficiary formed part of the trust's corpus (c). Prior to the introduction of the current trust regime, distributions of corpus were not subject to income tax and therefore the parent company could derive in a tax free form the deduction originally paid to the Hong Kong company.

Following the repeal of exchange control, there were no tax or regulatory barriers to prevent an individual from setting up a trust located in a tax haven. The individual could become the settlor and one of the beneficiaries. Often a related party would undertake the functions of the trustee. The proceeds from the settlement could be used by the tax haven trust to invest in NZGS via the offshore branch of the New Zealand individual's New Zealand bank. The tax consequences were in substance the same as for the transaction outlined in para 4.2. Alternatively, an individual could undertake the same transaction via the incorporation of a tax haven company. The opportunity to incorporate a non-resident trust clearly justified the enactment of the current trust regime, which focuses on the role played by a New Zealand settlor. This article does not examine the current effectiveness of the settlor regime.

4.4 Objectives of a CFC regime

The scenarios outlined in paragraphs 4.2 and 4.3 provide a helpful backdrop to identify the range of attributes that a robust CFC regime should contain if it is to successfully counter those types of tax strategies.

There is a large body of international tax precedent to choose from. According to Arnold and Dibout³⁷ as at 1 January, 2001 23 countries had adopted CFC regimes. They include most members of the OECD and the major capital exporting countries. Contrast the current position with the state of affairs, which existed 15 years earlier. In 1986 only seven countries had enacted comprehensive CFC regimes.³⁸

One of the common objectives of all CFC regimes is to prevent a resident from deferring or postponing tax on foreign sourced income. Most countries, which have enacted CFC regimes, tax their residents on their worldwide income. Secondly, those countries treat non-resident entities and controlled foreign entities as separate from the resident shareholders, which creates the opportunity for residents to defer or postpone resident country taxation on foreign source income.

Finally it should be noted that a CFC regime is only part of a comprehensive legislative solution. Many countries have also enacted transfer pricing, thin capitalisation and FIF rules. There are often exchange controls restrictions, in

³⁶ [1949] NZLR 823

³⁷ Cahiers-de droit fiscal International. International Fiscal Association 2001 San Francisco Congress Vol LXXXVII (2001). "Limits on the use of low tax regimes by multinational business. Current measures and emerging Trends", p38.

³⁸ "The Taxation of Controlled Foreign Corporations" by John Prebble, Victoria University Press for the Institute of Policy Studies 1987, p5.

addition to general anti avoidance provisions and a comprehensive corporate residence test.

4.5 Design Parameters for a CFC regime

Most countries, which have enacted CFC regimes, use the following three features to determine which CFCs should be subject to domestic legislation.³⁹

- Does the CFC subject to a lower rate of foreign tax derive the income?,
- Does the CFC primarily passive as opposed to active or business income derive the income?,
- Does a resident control the CFC?.

The legislative answers to these three questions reflect a wide range of possible solutions. For example in relation to the first attribute how should the tax comparison be undertaken? The simplest approach would be to base the comparison on nominal rates of tax. If, for example, the rate of tax in the foreign country was less than 75% of the home country corporate rate, then the regime could apply. At the other end of the spectrum countries such as France and the United Kingdom have attempted to base the comparison on the actual tax burden of the foreign company and what would have been the tax payable if French and United Kingdom domestic law applied to that entity.

Similar issues arise in relation to the second common attribute, i.e. the active/passive distinction. Passive income is the primary focus of all CFC regimes that target interest, dividends, royalties, rent, and capital gains. However passive income can be defined in numerous ways, which reflect the difficult issues that arise at the margin. Is interest earned by a financial institution and rent derived by a property owning company active or passive income? Similar issues arise in relation to capital gains. Some countries distinguish between gains associated with an active business as opposed to gains arising from the disposal of marketable securities. The concept of 'base company income' also creates problems. This phrase refers to income derived by a CFC from providing services or selling property outside the home country to related parties.

The third design parameter has also created a wide range of legislative responses. The primary question is what level of shareholder participation or control in the CFC is required before the legislation applies. Secondly, if the CFC is subject to domestic legislation, what level of shareholding is required before the shareholder must include

³⁹ For descriptions of the CFC rules of several countries, see Brian J Arnold *The Taxation of Controlled Foreign Corporations: An International Comparison*, Toronto, Canadian Tax Foundation, 1986 (describes and compares in detail the rules of six countries); OECD, *Controlled Foreign Company Legislation*, Paris, OECD, 1996 (referred to as OECD CFC Report) (14 countries); Hugh J Ault, *Comparative Income Taxation: A Structural Analysis*, The Hague, Kluwer, 1997, pp.413-22 (7 countries); and Daniel Sandler, *Tax Treaties and Controlled Foreign Company Legislation*, 2nd edn., Deventer, The Netherlands, Kluwer, 1998, pp.23-37 (brief description of 19 countries).

in their domestic income, income from the CFC. Finally the scope of constructive ownership rules also creates a divergence in legislative approaches.

How then were these issues dealt with in the New Zealand context?

4.6 Objectives and design parameters for a FIF regime

Similar considerations arise in relation to the FIF regime that was designed to complement the CFC regime. For example, both regimes share a common grey list of seven countries and both regimes are supported by the trust rules. Furthermore, both regimes are part of a wider international tax package which now includes thin capitalisation, interest allocation rules, transfer pricing, foreign dividend withholding payment rules, underlying foreign tax credit, and the approved issuer levy regime.

There are two broad approaches⁴⁰ to defining the objectives of a FIF regime. The first approach views an FIF regime as an extension of the relevant CFC rules in that it is targeted at reducing the scope for possible tax deferral. The alternative view is that the FIF regime is part of an all-inclusive system that is targeted at taxing passive income. The Australian equivalent regime is aimed at ensuring an equal treatment between foreign passive income and Australian passive income, whereas the Canadian regime contains an anti avoidance focus in that it only applies if there is an intention to avoid Canadian income tax. The New Zealand experience with FIFs suggests that elements of both objectives were included in the design parameters.

Another important issue is the scope of the regime. Which of the following categories of offshore investment should be subject to a FIF regime,

- Interests in offshore investments such as unit trusts, mutual funds, and entities such as open ended investment companies.
- Non controlling interests in companies resident in low jurisdictions.
- Non-controlling interests in companies resident in high tax jurisdictions.

The latter two categories of investment are likely to pose a greater threat than the third. That category would not appear to justify the administration and compliance costs of an FIF regime.

A third issue is the taxation of a New Zealand resident's investment in the FIF. The taxpayer does not have control over the FIF and therefore will experience difficulties in obtaining information. What type of surrogate or proxy should be developed to approximate the tax consequences of a comparable domestic investment?. The range of possibilities includes an imputed or deemed rate of return, taxing the change in value, or merely taxing distributions and/or realised gains on disposal.

⁴⁰ "Taxing Portfolio Income in Global Financial Markets" by Doran Herman, Volume 2, Doctoral Series International Bureau of Fiscal Documentation, p198.

4.7 History of the regimes

A lengthy consultative process and the deferral of the FIF regime preceded the current international tax regime. The transactions and structuring summarised above clearly demonstrated how it was possible to effectively trap offshore income in a tax haven, which was not subject to New Zealand income tax.

Diagrams 6, 7, 8, and 9 demonstrate the consequences of financial deregulation. This created opportunities for companies and individuals to avoid New Zealand income tax via the use of non-resident entities located in tax havens. The introduction of the taxation of financial arrangements on an accrual basis meant that international structures were the only effective way of avoiding New Zealand income tax on, for example, the discount associated with an investment in NZGS which prior to the enactment of the accrual regime was exempt from New Zealand income tax. Those types of structure were also used to avoid the adverse impact of changes to the taxation of superannuation funds and life insurance companies.

4.7.1 22 December 1986

The consultative process began with an announcement by the then Minister of Finance (the Honourable R O Douglas) that the existing penalty regime would be amended to apply to offshore transactions, which were caught by the predecessor of section BG 1 of the Act. The applicable penalty would be calculated at twice the normal rate with effect from the date the tax liability would have been payable if the avoidance arrangement had not been entered into. The new proposed penalties would apply from the 1985 income year although no penalty would be imposed on taxpayers who disclosed any tax avoidance arrangements prior to 31 March 1987.

4.7.2 The 1987 budget

The 1987 budget was delivered on 18 June. The government outlined a number of proposals, which were aimed at tax havens. The legislation would be based on the provisions, which were in force in other countries. The general thrust was that passive investment income and income from transactions with related parties would be subject to New Zealand income tax in the same year in which the transaction occurred. The Minister stated that avoidance of New Zealand income tax from the use of tax haven entities was “one of the most serious remaining problems with existing income tax provisions. ... [that legislation] would be aimed at arrangements where there is a strong presumption that they would not exist if it were not for tax avoidance considerations”.⁴¹

To achieve these objectives, the budget proposed to tax New Zealand residents on their share of “tainted income” of foreign companies where that income was subject to tax at a rate that was significantly lower than the New Zealand applicable tax rate. Tainted income would include passive investment income and income associated with transactions entered into with related parties. The budget statements specifically noted that the proposals “would not affect companies in countries having moderate to high corporate tax rates, nor certain active income derived from certain operations (eg

⁴¹ Hon. R O Douglas, Minister of Finance, **Budget – 1987**, Annex 4 18 June 1987.

manufacturing) in low tax countries”. The budget statement indicated that the applicable legislation would be based on the experience of other comparable countries, which had enacted comprehensive anti tax haven legislation, which was effective in preventing the worst and most visible forms of international tax avoidance.

The proposed measures would apply to a controlled foreign company, which was defined as an entity in which five or fewer New Zealand residents owned more than 50%. Those shareholders would be taxed on their proportionate share in the controlled company’s income calculated in accordance with New Zealand principles. This became the “branch equivalent” method.

Finally, the budget statement noted that the government was preparing a consultative document, which would be considered by a consultative committee that would hear submissions from interested parties and advise the government on the implementation of the reforms.

4.7.3 Consultative document, December 1987

The consultative document (CD) broadened the original objective announced in the 1987 budget. In the preface to the CD, the Minister of Finance stated that the reforms were designed to achieve two inter-related objectives:

- protection of the New Zealand tax base by preventing residents from avoiding or deferring tax on their foreign source income, and
- to remove artificial incentives for taxpayers to invest offshore, and/or to invest in a particular form of offshore investment.

The first objective (protecting the New Zealand domestic tax base) was a restatement of the June budget announcement. The second objective was designed to include questions of economic efficiency. If the New Zealand tax system favoured offshore investment over an equivalent domestic investment there would be an artificial incentive for New Zealand residents to invest offshore.

A second underlying objective was to ensure that any investment decision was based on commercial considerations rather than the comparable income tax treatment. This principle would apply to both active and passive forms of income. The CD noted that both objectives would be achieved via two methods of taxation, the branch equivalent (BE) method and the comparative value method.

4.7.4 Branch equivalent method

The BE method would tax taxpayers on their pro rata share of the income derived by a non-resident company in which they had a direct or indirect interest. Affected taxpayers would be required to calculate their assessable income in accordance with applicable New Zealand tax principles.

4.7.5 The comparative value method

If a taxpayer could not obtain sufficient information to undertake a BE calculation, the CD proposed taxing them under the CV method. The proposal would tax a taxpayer on their net cash withdrawals from the foreign entity plus the difference between the market value of the entity at the beginning and end of the income year. Accordingly, the CV approach would impose a form of taxation on accrued capital gains irrespective of any underlying cash flow received by the taxpayer.

Clearly the CV method would impose a higher effective rate of tax than the BE method. This followed from the fact that the CV method would include all accrued gains whereas the BE method only included capital gains that would have been taxed under comparable New Zealand principles. A second significant difference between the two methods related to the proposals on foreign tax credits. Under the CV method, a New Zealand resident would only receive the benefit of a deduction for any foreign income tax paid. Under the BE proposal taxpayers could claim a credit for any foreign tax paid by the entity.

4.7.6 The March 1988 Report of the Consultative Committee

The Committee endorsed the anti avoidance and economic utility objectives which were two of the guiding principles reflected in the Consultative Document.⁴² The Committee agreed that in the long run New Zealand would be best served by an efficient tax system, which was neutral as between domestic and foreign investment. The Committee accepted the designed parameters outlined by an earlier Consultative Committee which had considered the taxation of controlled entities via the BE method.

However, the Committee strongly criticised the proposed CV method because it was inconsistent with a number of other important tax policy objectives. The business community was strenuously opposed to what would have been the introduction of a capital gains tax on unrealised gains.

The CV method is not defended in the CD as a capital gains tax. There is no discussion of the fundamental design issues associated with such a tax, such as whether it should tax only real or nominal gains and whether it should apply on an accrual or realisation basis. Given the novelty of the CV proposal, its lack of any international precedent, its valuation problems, its cash flow consequences and the absence of a convincing justification for it in the CD, it is not surprising that the proposal found no support amongst those who made submission.⁴³

The Committee concluded that the CV method outlined in the CD failed to place sufficient regard on the conventional criteria for evaluating taxation proposals, namely equity, efficiency and certainty.

⁴² International Tax Reform, Part 1 – Report of the Consultative Committee March 1988, paras’s 1.5.5 and 1.5.11.

⁴³ See n42 p8 para 1.5.7.

In the case of foreign entities, which were not subject to the CFC/BE regime, the Committee outlined a proposal which would balance the objectives of preventing tax avoidance and deferral plus achieving economic neutrality in a manner which retained taxpayer goodwill (voluntary compliance). To achieve this balance of objectives the report concluded that a CV regime could only be:

*justified where there is a serious avoidance problem that exists or can reasonably be expected to develop. Outside that area and CFCs, the taxation of gains, other than dividends, that residents derive from offshore investments should await the introduction of a general capital gains tax. In the Committee's view, minor or non-controlling shareholdings in companies resident outside tax havens clearly fall in the category of investments that are best taxed under a capital gains tax. ... Offshore funds, especially those located in tax havens are clearly the biggest avoidance problem. The Committee therefore favours the introduction of a foreign investment fund regime targeted at investment vehicles, which confer significant tax benefits, such as unit trusts based in tax havens.*⁴⁴

4.7.7 The original legislation

The Income Tax Amendment Act 1988 (No 5) introduced Part IV A into the Income Tax Act 1976. The principles, which were enacted in 1988, are generally speaking still applicable in 2003.⁴⁵ Briefly, the CFC regime applies to any foreign company in which five or fewer New Zealand resident taxpayers control 50% of the share capital. The main exception was for entities, which are resident in the six grey list countries. In the case of any CFC which was not resident in a grey list country, the resident New Zealand individuals were assessable on their pro rata share of the annual income of the CFC where they own an income interest of 10% or greater. The CFC's income was calculated on the same basis as if it was a foreign branch of a New Zealand resident company.

Any foreign tax paid by the CFC is creditable up to the amount of the New Zealand income tax payable on that income. However, foreign tax credits did not flow through as imputation credits.

The 50% control test was subject to a series of complex "look through" rules, which defined control as the aggregate of a person's direct, and indirect control interest in addition to the interests of associated persons and nominees. The "look through" rules were designed to prevent a New Zealand resident from dispersing their interest in a controlled foreign company thereby circumventing the negative impact of the regime.⁴⁶

⁴⁴ See n42 pp31-32 paras 3.1.2-3.1.5.

⁴⁵ Sections 245A-245Q of the Act

⁴⁶ Now in Section 245A-245C(9) of the Act.

The original FIF regime reflected the principles contained in the recommendations of the Consultative Committee.⁴⁷ The regime should be targeted at non-resident entities, which fall outside the CFC/BE regime because they provide taxation benefits, which do not depend on the concept of a control or income interest, which are pivotal to the CFC regime. However, the Committee stressed that the FIF regime should be targeted only at non-resident entities, which provide significant tax advantages that are not available from comparable New Zealand, based entities. Accordingly, they were primarily concerned with, for example, a unit trust based in a tax haven, which invested in debt securities (including New Zealand securities), which would offer a significant advantage, compared to any New Zealand investor who subscribed for units in a comparable New Zealand unit trust. Their recommendations were based on an examination of the Canadian regime, which was primarily targeted at tax haven funds, which were previously marketed in Canada. The Committee's recommendations were based on two key criteria.

- that the income or change in value of the entity was primarily derived from holding or trading portfolio investments in shares, investments in debt instruments, real property, commodities, royalty agreements, etc and
- the effect of the residence of the entity and its distribution policy is to reduce the tax payable on the income below what it would have been had the income been taxed in New Zealand as if it were derived by a New Zealand resident investor.

The original legislation provided that all interests of a New Zealand resident in a foreign entity that is not a CFC is an FIF and subject to the regime unless they qualify under one of four exceptions.⁴⁸ The exceptions were:

- the foreign entity is resident in one of the six grey list countries
- the foreign entity paid foreign tax of at least 20% of their income
- the foreign entity distributed at least 60% or more of their total income⁴⁹
- at the end of the accounting year, the foreign entity assets consisted of no more than 40% of the following:
 - an income interest in a CFC of greater than 25%
 - rights as a beneficiary under a trust
 - rights as a partner in a partnership
 - FIF interests
 - financial arrangements
 - annuities
 - rent producing land
 - royalty producing assets
 - rights or options to acquire or dispose of any of the above categories of assets.

⁴⁷ See n42, pp.35-38, paras's 3.3.1 and 3.3.8.

⁴⁸ Now Section 245R(2) of the Act.

⁴⁹ Total income included capital profits and gains measured according to generally accepted accounting principles.

Any New Zealand resident taxpayer who had the misfortune to hold an interest in an FIF was taxed upon any increase in the value of their interest in the FIF taking into account both revenue and capital gains both realised and unrealised.

4.7.8 Deferral of the FIF regime

The brief summary of the original regime highlighted its inherent complexity and the difficulty a non-portfolio investor would face in trying to obtain relevant information to determine whether they satisfied one of the four exemptions. The original legislation attempted to introduce the distinction between active/passive income with the regime applying only to passive income, which was not distributed to New Zealand resident investors in a taxable form. A second deficiency with the original regime was that there was only one method of calculating income (comparative value) and that method assumed that all investors could obtain the market value of an FIF interest. That was clearly not the case. Accordingly, the previous regime never permanently came into effect and was ultimately repealed and replaced with the current regime, which applies to all interests held in an FIF on 1 April 1993.

5. The current CFC and FIF regimes – main criticisms

5.1 The current CFC Regime

5.1.1 Introduction

There is one major difference between New Zealand's CFC and the equivalent regimes enacted by the seven grey list countries. The New Zealand regime does not and never has contained an active income exemption. According to Arnold and Dibout,⁵⁰ as at 1 January 2001 twenty-three countries had adopted a CFC regime. Those countries include most of the major members of the OECD and a number of New Zealand's major trading partners. However, only three countries did not provide an active income exemption. They are:

- Hungary
- New Zealand
- Sweden.

Similar criticisms can be made about the current FIF regime. An individual taxpayer if considering a domestic equity investment and an identical investment in a non-grey list FIF would for tax reasons always choose the domestic investment. There can be no doubt that the FIF regime contains an inbuilt bias against offshore investment. Secondly, there is a significant range of tax outcomes associated with each of the four methods contained in the current FIF regime. The primary difference between a domestic investment and the identical FIF investment is the fact that the latter regime contains various forms of a capital gains tax. Generally speaking, there is no comparable tax impost associated with the domestic investment.

⁵⁰ Brian J Arnold and Patrick Dibout (Franc) Cahiers – de droit fiscal International. International Fiscal Association 2001 San Francisco Congress vol LXXXVII pp25-88, at pp28 and 59 (referred to as Arnold).

5.1.2 Active income exemptions

According to Arnold,⁵¹ most countries, which have adopted the transactional approach, provide an active income exemption because only tainted income is attributed to the resident shareholders. Generally speaking tainted income encompasses base company income and passive income. Countries, which have adopted the jurisdictional approach, provide a defacto active income exemption, because of an exemption for a CFC located in a high tax country. Finally, countries, which have adopted the entity approach, provide an exemption for any CFC that is engaged primarily in industrial and commercial activities or that its income is primarily derived from active business income.

To paraphrase the words of the McLeod Committee, according to Arnold,⁵² New Zealand certainly stands out from the rest of the crowd.

*Only three countries – Hungary, New Zealand and Sweden – do not make any distinction between tainted and other income for the purposes of their CFC rules. This aspect of the Hungarian, New Zealand and Swedish rules is remarkable. For them, the only relevant factor in determining whether a CFC's income is attributed to its resident shareholders is the rate of foreign tax in the country in which the CFC is resident. Thus, for New Zealand, all of the income of a CFC that is resident in a country other than one of the seven grey list countries will be attributed to its New Zealand shareholders **even if the CFC is engaged exclusively in an active business such as manufacturing or mining.** (emphasis added).*

5.1.3 The active/passive boundary

Given that 20 out of 23 countries have adopted a passive income exemption it is interesting to speculate on why New Zealand has consistently resisted calls for the implementation of a similar exemption. A brief examination of the country summaries contained in Arnold indicates that the 20 countries define passive income differently. However, it usually includes dividends, interest, rent, royalties, and often capital gains. A number of CFC regimes contain an exemption for interest and rent where it is clearly part of an active business. An obvious example is interest earned by a financial institution and rent derived by a property investment company.

Similar issues arise in relation to interest and dividend income derived by a CFC from transactions with other related parties. Dividends are generally considered to be prima facie passive income. However dividends received by a CFC from another CFC could become subject to double taxation. Accordingly, many regimes contain a mechanism to avoid double taxation. Similar issues arise in respect of interest income derived by a CFC from related parties.

⁵¹ Arnold p38, 51, 58-64.

⁵² Arnold p51.

5.1.4 Base company income

Arnold⁵³ uses this term to describe income derived by a CFC from transactions, which occur outside the country in which the CFC is resident, but are from transactions with related parties. Base company income is targeted because there is a prima facie inference that the reason for the transactions is to avoid domestic tax rather than to ensure international competitiveness. Treating base company income as tainted for CFC purposes overcomes the practical difficulties of attempting to apply transfer-pricing rules to those transactions. The most common forms of base company income are insurance and reinsurance premiums, and income from shipping and air transport activities.

5.1.5 The capital revenue boundary

Arnold⁵⁴ contains a useful summary of the range of mechanisms used by different countries to limit the scope of the active income exemption to ensure that it is not used as a device to convert what would ordinarily be considered passive income into active income. The various tests are comparable to the range of judicial techniques adopted by the New Zealand courts to define the capital/revenue boundary. Recent examples include:

- Lease inducements.⁵⁵
- Restrictive covenants. The approach taken by the Court of Appeal in *CIR v Henwood*⁵⁶ and *CIR v Fraser*⁵⁷ clearly demonstrate that the courts have had little difficulty in distinguishing between cases which have held that an inducement and/or a restrictive covenant related to income from employment from situations where the transaction was on capital account
- The business of investing/dealing in shares. Recent decisions of the Court of Appeal include *CIR v Rangatira*⁵⁸ and *National Insurance Co Ltd v CIR*.⁵⁹ Those decisions are consistent with the seminal decision of the Court in *National Distributors*.⁶⁰ The distinction between investing and dealing has been recognized IRD in a series of well-known public binding rulings that distinguish between actively managed and passive investment funds.
- Pre-1973 Land sale cases. There is a long line of cases in which the New Zealand courts have successfully dealt with the capital revenue boundary in

⁵³ Arnold, p54.

⁵⁴ Arnold, p59-61.

⁵⁵ See *CIR v Wattie* (1998) 18 NZTC 13,991 (Wattie).

⁵⁶ *CIR v Henwood* (1995) 17 NZTC 12,271.

⁵⁷ *CIR v Fraser* (1996) 17 NZTC 12,607. It should be noted that six years later Parliament repealed these two decisions in 2001 as part of a legislative package which included increasing the top marginal rate of personal income tax from 33% to 39%, and taxing trust income distributed to 'minor beneficiaries'.

⁵⁸ *Rangatira Ltd v CIR* (1996) 17 NZTC 12,727 (Rangatira).

⁵⁹ *National Insurance Ltd v CIR* (1999) 19 NZTC 15,359 (National Insurance)

⁶⁰ *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346 (National Distributors). The Minister of Finance announced on 5 March at the 2004 IFA conference his officials were examining this distinction.

the context of transactions involving land. See for example *CIR v Walker*⁶¹ and *CIR v Eunson*.⁶²

The approach taken by the New Zealand courts in these cases strongly suggests that our judicial system is capable of taking a realistic and robust approach to any legislation, which defines the outer limits of an active income exemption. The robust approach taken by the Court of Appeal in *Dandelion Investments* strongly suggests that a comparable structure would be classified as producing passive income. Both of the *Europa Oil* cases would most likely be classified as involving passive income.

If Parliament was concerned about the fiscal risks of leaving the courts an unfettered discretion, then there are a number of approaches adopted by the 20 countries that have successfully implemented an active income exemption, which could form a useful legislative template for a New Zealand exemption. They include the following:⁶³

- A number of countries have adopted a quantitative requirement, which forms part of their active income exemption. For example Australia provides that active income must be at least 95% of the CFC's total income. Countries, which include France, Japan and the United Kingdom, have adopted a 50% threshold.
- Other jurisdictions have adopted a qualitative test, which focuses on the source of the active business income. The income must be derived from transactions in which the country is resident (known as a local market activity test) and/or from transactions with unrelated parties (whether inside or outside the CFC jurisdiction).
- A third approach is to specifically exclude certain types of income or activities. For example, the United Kingdom exemption is not applicable to a CFC whose main business is in investment or the delivery of goods to and from the United Kingdom.
- A fourth legislative solution is to require the CFC to have a substantial presence in the foreign country. For example, the United Kingdom requires the CFC to manage its own business, which means it must have sufficient property and employees to carry on the business. That exemption would not exclude the type of shelf company operations disclosed in *New Zealand Forest Products NV v Commissioner of Inland Revenue*.⁶⁴
- Finally, a number of countries have prohibited certain activities. For example the Japanese active income exemption is not available to a CFC whose main business is investment, licensing, or leasing ships or aircraft.

⁶¹ *CIR v Walker* CIR v. Walker [1963] NZLR 339.

⁶² *Eunson v CIR* [1963] NZLR 278.

⁶³ Arnold, p59-61.

⁶⁴ *New Zealand Forest Products Finance NV v Commissioner of Inland Revenue* [1995] 2 NZLR 357.

5.2 The current FIF regime

5.2.1 An inbuilt bias

A common criticism of the current FIF regime is that it contains an inbuilt bias in favour of New Zealand investment.⁶⁵ The following Table summarises the extent to which non-grey list investments are over-taxed compared with a comparable New Zealand domestic investment or an investment in a grey list country.

An inevitable consequence has been the development of tax efficient investment structures, which take advantage of the fact that there are no look-through provisions in the grey list/non-grey list distinction. For example, a number of UK based investment funds have used their grey list exemption to effectively invest New Zealand funds into an extensive range of non-grey list countries. This type of behavioural response to the inherent bias contained in Table B is discussed in further detail in section 6.

Table B: Comparative Taxation of Investments

Taxpayer	Type Investment		
Capital account	NZ Co shares Not taxed	Grey list Co shares Not taxed	Non-grey list Co shares Taxed
Passive index fund	NZ passive fund Taxed	Grey list passive fund Taxed	Non-grey list passive fund Taxed
Active fund	NZ active fund Not taxed	Grey list active fund Not taxed	Non-grey list active fund Taxed
Share trader	NZ Co shares Taxed	Grey list Co shares Taxed	Non-grey list Co shares Taxed

5.2.2 An illogical range of investment outcomes

A second common criticism of the current FIF regime is the range of potential outcomes arising from the same investment. This is highlighted in the case of an individual who has invested in a non-grey list country with a shareholding of less than 10%. Table C contains a hypothetical set of financial results associated with the investment. Each of the figures is used to calculate the underlying income under the four current methods.

⁶⁵ See section 8 for further details.

Table C: Comparative Calculations

	Year ended 31 March 2002	Year ended March 2003
Income interest	8%	8%
Net after-tax accounting profit	\$200,000	-\$100,000
Branch equivalent income	\$150,000	-\$150,000
Opening market value	\$70,000	\$80,000
Closing market value	\$80,000	\$60,000
Opening book value	\$50,000	\$55,000
Closing book value	\$55,000	\$51,000
Dividends	\$5,000	\$5,000
Interest expense	\$4,000	\$4,000

Table D highlights the range of outcomes that are possible associated with a two-year investment, which declines in value.

Table D: Comparative Calculations

	Year ended 31 March 2002	Year ended March 2003
Branch equivalent	\$12,000	-\$12,000
Accounting profit	\$16,000	-\$8,000
Comparative Value	\$11,000	-\$19,000
Deemed rate of return ⁶⁶	\$5,230	\$5,753

5.2.3 Practical considerations

Finally there are a number of well-known difficulties surrounding the selection of one of the four options. Only if the taxpayer has access to certain types of information are the branch equivalent and accounting profit method realistic options. Furthermore some of the methods have monetary limits. There are significant differences in the treatment of tax losses and the availability of foreign tax credits. The following Table summarises these concerns.

⁶⁶ The deemed rate of return for the 2003 year is 9.90%. The 2002 rate of 10.46% was chosen to simplify the calculations.

Table E

	Comparative value	Deemed rate of return	Accounting profits	Branch equivalent
Section of Income Tax Act 1994	CG 18	CG 19	CG 20	CG 21
When is the method used	Calculation is only of the New Zealand investor's share in the value of the entity as a whole.	Used when the CV or AP methods cannot reasonably or practically be used and the taxpayer is an individual with FIF interests of no more than \$100,000 (market value)	This method can only be used for small shareholdings in publicly listed companies or unit trusts.	Requires access to detailed financial accounting information and for most FIF interests the information available will not be sufficient for this method to be used.
How is income determined?	Income attributed by comparing: (a) market value at year end plus any gains derived during the year (e.g. dividends); less (b) market value at end previous year plus any expenditure incurred in the year (e.g. purchase of further shares)	Method takes the book value of the taxpayer's investment multiplied by a deemed rate of return.	The after-tax accounting profit including extraordinary gains (below the line) of the FIF multiplied by the percentage income interest which the New Zealand investor has in the FIF.	Income and expenditure of the foreign entity is calculated as if it were a New Zealand taxpayer. Income is attribute to New Zealand investors based on their shareholding.
Advantage	The method is available for any taxpayer and any FIF.	Simplicity	Simplicity	Only creates tax liability on profits, which would also have been taxable in New Zealand.
Disadvantage	Lack of information as to the market value of the investment. Taxes capital and unrealised gains.	Assumes taxpayer's investment is earning at least the deemed rate of return. If the investment is performing poorly or making losses, this method still requires tax to be paid on attributed income.	Taxes capital gains, which form part of accounting income, which would not normally be taxable in New Zealand.	Complexity.
Treatment of foreign tax	Gives a tax credit for foreign withholding taxes deducted from dividends received, but gives no credit for underlying foreign taxes paid.	No credit is given for underlying foreign tax	In effect, a credit is given for the foreign tax liability as the calculation is based on after-tax profits.	Credit is given for foreign tax paid.

6. Behavioural responses to the FIF and CFC regime

6.1 Introduction

Despite the enactment of a CFC/FIF, trust and FDWT regime is it still possible for a company to circumvent those legislative barriers and receive the tax outcomes illustrated in *Dandelion Investments*? According to one source, the answer is yes. Please refer to paragraph 6.5.1 below.

What about individual taxpayers looking for a safe offshore passive investment? Can they avoid the negative impact of the above regimes? Once again the answer is yes.

The following brief analysis of the range of tax planning opportunities should be taken into account before any decisions are made about the future direction of any reform of the current CFC and FIF regimes.

6.2 OEIC's

6.2.1 Background

This acronym stands for Open Ended Investment Company. According to Smith & Turner⁶⁷ "*OEICs are unit trusts in corporate form and the UK counterpart to the [European] investment fund that is well known in Luxembourg, France and other countries [A]uthorised unit trusts, OEICs and investment trusts which are "approved" by the UK, Inland Revenue are tax favoured investment vehicles ... the taxation framework for OEICs is broadly similar to that applying to authorised unit trusts.*"

These have operated out of the United Kingdom since 1997 and were promoted to New Zealand investors in early 2000. OEICs are a tax efficient investment vehicle, which enables individual New Zealand investors to pool their funds into a grey list entity, which in turn invests in non-grey list countries. One of the major tax advantages of an OEIC is that they are exempt from UK capital gains tax (CGT). In view of the penal nature of the comparative value method, it is hardly surprising that New Zealand investors would seek to invest in structures, which overcome the tax disadvantages of investing outside the narrow grey list of seven countries.

OEICs are similar to a unit trust in that the investor's funds are pooled and invested in a wide range of cash, bonds and shares. OEICs are limited liability companies and therefore the investors hold shares rather than units. Accordingly, an OEIC can issue and cancel shares depending on the level of application and redemptions. Given that the shares are fully backed by the net value of the assets, the current market price of the share will reflect the true appreciation and depreciation (if any) of the underlying assets. A second significant advantage of an OEIC is that they fall under the New Zealand Securities Commission exemption which means they do not need to have an investment statement or prospectus provided other conditions are met which include the presentation of a "key features" document to individuals.

6.2.2 Taxation of OEICs

A number of the United Kingdom based OEICs that have been promoted recently in New Zealand were emphasising the capital growth and that there would be few dividends to reduce the tax paid on the investment. Dividends derived by the OEIC are taxed at the United Kingdom company rate of 20% and are often automatically reinvested. The emphasis on capital growth is a significant advantage because capital gains are, generally speaking, free of tax in the hands of a New Zealand resident individual, which is a favourable outcome, compared with the comparative value

⁶⁷ "Investment Funds" International Bureau of Fiscal Documentation, Supplement No 7 June 2002 pp1-115, p6.

method, which also taxes unrealised capital gains. Secondly, the OEICs realised capital gains are not subject to UK CGT.

6.2.3 OEIC versus a New Zealand unit Trust

The following Tables demonstrate the tax advantage of an OEIC compared with a New Zealand unit trust. The underlying assumptions are that the funds have been invested equally in New Zealand and overseas equities and that both funds offer similar returns. They both expect to generate \$800 per annum of which 50% will be in the form of capital growth and the remaining 50% will be dividend income that will be derived equally from New Zealand and non-New Zealand equities. The Tables include four additional assumptions listed after Table F.

Table F: Investment in an OEIC

Income		
Capital Growth	400	
NZ dividend income	200	
Non-NZ dividend income	200	
Total income	\$800	
Taxation within an OEIC		
<i>Capital growth</i>		
Non-taxable		0
<i>NZ dividend income</i>		
Dividend	200	
FITC	35	
UK tax @ 20%	47	
Less WHT	(35)	
Incremental UK tax	12	12
<i>Non- NZ dividend income</i>		
Dividend	200	
UK tax @ 20%	40	<u>40</u>
		52
<i>Taxation of distribution from OEIC</i>		
Total dividend income	400	
Less UK tax	(52)	
Net dividend	348	
NZ taxation @ 39%	136	136
<i>Taxation on exiting fund</i>		
Capital gain		<u>0</u>
TOTAL TAX PAYABLE		188

The four assumptions:

- No withholding tax is imposed on non-New Zealand dividends.
- The annual capital growth is realised each year.
- New Zealand dividends are fully imputed.
- Foreign investor tax credits (FITC) are utilized.

Table G: Investment in a New Zealand Unit Trust

NZ Fund		
<i>Capital growth</i>		
Gains	400	
NZ tax @ 33%	132	132
<i>NZ dividend income</i>		
No tax as dividend is fully imputed		0
<i>Taxation of distribution from unit trust</i>		
Total distribution	400	
Less NZ tax	(66)	66
	334	
Imputation Credits	<u>165</u>	
(66 + 99)	499	
Tax @ 39%	195	
Less Imputation Credits	<u>(165)</u>	
<i>Taxation on exiting unit trust</i>		
Capital gain	30	30
TOTAL TAX PAYABLE		228
	Extra tax (ie 5%)	(40)

Capital gains are not taxable in the United Kingdom. To the extent they are not taxed when exiting the OEIC, this represents a significant tax shield compared with New Zealand unit trusts. In the above example the OEIC receives dividend income, and in turn pays a taxable dividend to the New Zealand resident investor. This is an important assumption because an OEIC, which merely returns all of its gains in the form of an enhanced exit price, could be creating a New Zealand tax liability for the New Zealand resident investor. The question arises whether the units were acquired with the purpose of resale at a profit, in particular if there is no prospect of deriving a taxable dividend. This issue also arises with Australian unit trust structures that are designed to avoid New Zealand income tax on NZGS.

6.3. Australian unit trusts and New Zealand government stock

6.3.1 Introduction

The Minister of Finance's announcement on 6 August 2003 did not describe how the current interface between New Zealand and Australian domestic law enabled an individual New Zealand resident to avoid the New Zealand income tax which would otherwise have been payable on a direct investment in NZGS. One possible structure would seek to take advantage of the differences in the way in which unit trusts are taxed on each side of the Tasman, plus an income conversion mechanism.

6.3.2 Trans-Tasman taxation of unit trusts

For New Zealand tax purposes a unit trust is deemed to be a company and is taxed in accordance with the general principles applicable to non-Qualifying Companies (QCs)/Loss Attributing Qualifying Companies (LAQCs).

The position in Australia is similar to the New Zealand trust regime.⁶⁸ The underlying law governing the creation and administration of an Australian trust is similar to the equivalent New Zealand provisions. In both cases a trust is not a separate legal entity or a person but is a set of obligations and rights created by the trust deed. An Australian trust may be established as either a discretionary or as a fixed trust. Collective investment funds operating as trusts are established as unit trusts, which are a subset of a fixed trust because each beneficiary's interest is measured in units. A collective investment unit trust is either closed, i.e. there is a fixed number of units, or is open ended where there is no restriction on the size and units maybe redeemed from the trust manager or traded on a recognised Australian exchange.

For the purposes of this article, there are no relevant special tax rules that apply to unit trusts, which are collective investment funds. An Australian unit trust is subject to the ordinary trust regime. The equivalent Australian rules are similar to the current New Zealand regime in that trustee income is calculated in accordance with the core provisions of the Australian Act, and the net income of the trust is either allocated and taxed in the hands of the beneficiaries, or in the hands of the trustee. In the case of income allocated to the beneficiaries, there are specific rules, which enable the beneficiaries to qualify for any applicable foreign tax credit or franking credit, which is attached to the distribution. Both trans-Tasman regimes deal with the question of losses in a similar manner. The income allocation rules in Australia do not apply to a net loss. There is no Australian mechanism for allocating losses to beneficiaries, which is similar to the New Zealand trust regime in which losses are locked in at the trustee level but can be carried, forward and offset against future net income.

6.3.3 Australian unit trusts and New Zealand resident taxpayers

A crucial feature of the current Australian regime, which enables New Zealand resident taxpayers to take advantage of an Australian unit trust, is the principle that a

⁶⁸ The following summary is based on the discussion in chapter 6 (pp172-214) Australian Master Tax Guide (2003 edition), CCH Australia Limited.

non-resident beneficiary is only subject to Australian tax on income, which is attributable to sources in Australia. This principle is contained in section 97(1)⁶⁹ which provides that a beneficiary is required to include in their assessable income

- a share of the net income that is attributable to any period when the beneficiary was a resident of Australia irrespective of the source of the income, and
- the share of the net income that is attributable to a period when the beneficiary was not a resident of Australia and is also attributable to sources in Australia.

In the context of an Australian unit trust, which has acquired NZGS, a distribution to a New Zealand resident taxpayer would only be subject to Australian tax if an Australian source could be attributable to the interest and/or discount income. However, the Australian source rules provide that in the case of interest income the source is generally speaking a place where the obligation to pay the interest arose. In other words, the country where the loan contract was made or the credit was first made available is the source of the income. This principle was established in recent cases such as *Spotless Services Ltd v FCT*⁷⁰ and is consistent with the leading New Zealand case *Philips (NV) Gloeilampenfabrieken v CIR*⁷¹

6.3.4 New Zealand tax consequences

From a New Zealand tax perspective there are two issues associated with the New Zealand resident's investment in the Australian unit trust. The first is New Zealand withholding tax. Generally speaking there is no relationship between the individual New Zealand shareholders and the Australian unit trust, which are dealing at arm's length. Accordingly, the investment in NZGS would qualify for the 2% approved issuer levy regime. No New Zealand NRWT is payable.

The second issue is the conversion mechanism whereby the distribution from the Australian unit trust is treated as a tax-free receipt in the hands of the New Zealand resident shareholder. One simple mechanism would be for the Australian unit trust to distribute the net income in the form of non-taxable bonus shares. For New Zealand tax purposes the Act makes a clear distinction between a taxable bonus issue and a non-taxable bonus issue. The latter distribution is specifically excluded from the definition of a dividend under section CF 2(3) of the Act.

The only provision, which the IRD could rely on, is section CD 4 of the Act. That provision includes in gross income inter alia any gain derived from the sale of personal property, which was acquired for the purpose of resale. If the Australian unit trust does not distribute any of its net income as taxable dividends then the resident taxpayer may have considerable difficulty in arguing that any subsequent resale of the non-taxable bonus shares fall outside section CD 4. The application of that provision

⁶⁹ Income Tax Assessment Act 1936 (Cth).

⁷⁰ *Spotless Services Ltd v FCT* 96 ACT 5201(*Spotless*).

⁷¹ *Philips (NV) Gloeilampenfabrieken v CIR*. [1955] NZLR 868 (CA).

would depend on the applicability of cases such as *National Distributors*⁷² and *Macmine Pty v FCT*⁷³

Accordingly, from a purely tax planning perspective, a resident New Zealand individual investor would be advised to wherever possible invest in an Australian unit trust which includes as part of its distribution taxable dividends.

6.4 United Kingdom unit trusts and non-grey list investments

6.4.1 Background

The Minister of Finance did not, in his August 2003 announcement, discuss the tax planning opportunities associated with United Kingdom domiciled unit trusts such as Schroder or Foreign & Colonial.

An individual New Zealand resident taxpayer who wishes to invest in a large multinational such as Nestlé (based in Switzerland) or a company such as Swire Pacific (a major shareholder in Cathay Pacific Airways) is from a New Zealand income tax perspective faced with two strategies. The individual can invest directly and in both cases the investment would be subject to the CFC regime on the grounds that both the companies are based in two non-grey list countries. Alternatively, the investor could invest in a unit trust that is based in a grey list country, which in turn invests in the non-grey list multinational company. From a purely tax perspective, the popularity of grey list based unit trusts can be explained in terms of the narrow scope of the grey list, and the adverse tax consequences which follow from a small portfolio investment in a multinational company such as Nestlé or Swire Pacific.

6.4.2 Two common examples

The 2001 Annual Report and accounts of Foreign & Colonial disclose that the twenty largest equity holdings constituted 58% (the 2000 year comparable figure was 60%) of total assets. Eighteen of those investments were in non-grey list countries. Two of the investments Deutsche Bank (2.5%) and BASF (1.7%) relate to major German multinational companies. The 2001 Annual Report discloses a list of investments by country. Approximately 88% of the investments were in European countries, which are not on the grey list. In other words, only 12% of the investments were in German and United Kingdom companies.

The interim report as at 31 March 2003 for Schroder reveals a similar pattern. The twenty largest investments constituted 58% of shareholders funds. Given that the Schroder fund primarily invests in the Asia Pacific region and that only one country (Japan) is on the grey list, it is not surprising that none of the twenty largest investments fall within the grey list.

Both of these UK based unit trusts clearly demonstrate the viability of a New Zealand individual portfolio investor circumventing the narrow restriction of the grey list (and the negative tax consequences) by investing in a grey list domiciled unit trust which in

⁷² *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346.

⁷³ *Macmine Pty v FCT* 1979 ATC 4,133 (*MacMine*)

turn invests in an appropriate portfolio of non-grey list equities. It is not entirely clear from the Minister's announcement why this popular investment strategy was not discussed. It would appear that the Minister's primary concern is limited to investment strategies which reduce or eliminate the New Zealand income tax which would have been payable if the New Zealand investor had made a direct investment in a New Zealand asset such as NZGS.

6.4.3 UK taxation of a UK unit trust

The information for shareholders contained in Foreign & Colonial's 2001 Annual Report and accounts states that:

An approved investment trust does not pay tax on capital gains.

Furthermore, note 7 and note 11 indicate that the amount of UK tax payable at the corporate rate of 30% was effectively zero because of the relief for foreign taxation.

It would appear from the accounts that a resident New Zealand investor would suffer no United Kingdom corporate tax on this investment. It is also consistent with the list of investments based on the country disclosed in the annual report. Approximately 1.5% of the investments were held in United Kingdom companies.

The current taxation of a United Kingdom unit trust is also consistent with the disclosure contained in Foreign & Colonial's Annual Report.

Foreign & Colonial and Schroeder's are both authorised unit trusts and are therefore exempt from tax on their capital gains. They are also exempt from tax under Schedule D, Case I (of the UK tax legislation) on certain trading income derived from futures and option contracts. Furthermore, capital gains derived from debt securities are also exempt from taxation.

Finally, an approved unit trust:

may in certain circumstances distribute their income as if it were a payment of yearly interest and, by obtaining a tax deduction for the deemed interest payment, effectively pay no UK tax. ... The broad intentions of the interest distribution regime are to enable non-UK resident investors to receive certain interest and other underlying income without imposition of UK tax either within the authorised unit trust or by way of withholding by the fund. Such UK withholding tax as may be applied by the authorised unit trust in relation to the distribution of other income may be reduced or eliminated under the interest article of a relevant double taxation agreement with the UK.⁷⁴

⁷⁴ "Investment Funds" International Bureau of Fiscal Documentation, Supplement No 7, June 2002 pp1-116 at p48.

6.5 How to avoid the CFC regime

6.5.1 A recent example.

According to a senior IRD official at least one taxpayer has devised a relatively simple scheme to circumvent the control and income test. In September 2000 Robin Oliver described the following scheme he could have obtained from an IRD client.⁷⁵

As previously mentioned, New Zealand levies tax on the worldwide income of residents. This includes income generated through offshore subsidiaries. One attempt to get round this is for a New Zealand company to pay an unrelated non-resident bank a sum of money in return for the option to purchase, for a minimal amount, shares in a New Zealand cash-box subsidiary of the non-resident bank. The bank then invests the sum tax-free in a haven and returns the capital plus tax-free interest in the form of share capital in the New Zealand subsidiary. The New Zealand company gains the value of the return of capital plus interest when it exercises its option to purchase the subsidiary.

This is a remarkable statement because it demonstrates the virtual impossibility of protecting the tax base from "trojan horses", such as the scheme described by Oliver, which works because it exploits a number of gaps in the New Zealand domestic tax base.

6.5.2 A share option

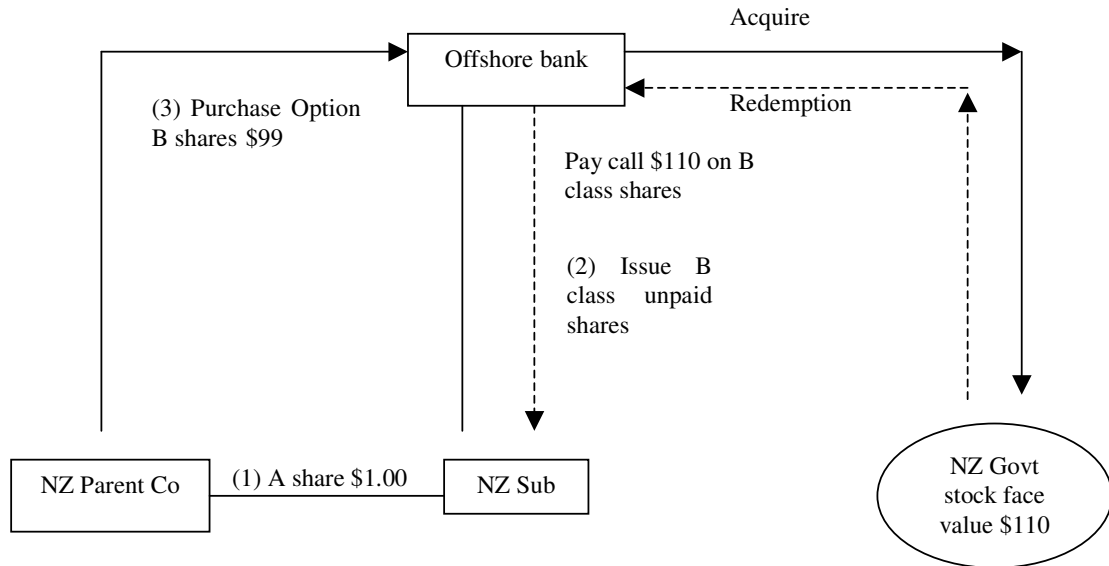
One possible way of implementing the ideal described above would be for a New Zealand resident company to enter into the relationship summarised in the following Diagram with an offshore bank.

Briefly, the structure in Diagram 10 would involve the incorporation of a New Zealand subsidiary with two classes of shares. The control or "A" class shares would be held by the New Zealand parent company (I). The voting rights associated with the "A" class shares would enable the parent company to effectively control the subsidiary.

The New Zealand subsidiary would also issue "B" class shares to the offshore bank (2). Those shares would remain unpaid and would not confer any voting rights until they become fully paid shares.

⁷⁵ "Capital gains tax – the New Zealand case", a paper prepared for the Fraser Institute 2000 symposium on capital gains taxation, September 15-17 2000, Vancouver, BC, Canada by Robin Oliver General Manager (Policy) Inland Revenue Department New Zealand, email: robin.oliver@ird.govt.nz. The author stated at p2 that the views expressed in this paper were his own and were not necessarily those of the NZ IRD or the NZ Government. The scheme is summarised in this quotation that appears on p10 final paragraph. It must be noted that Oliver expressed NO view on for example whether the structure could be attacked under section BG 1. He was merely using this as an example of the tax planning opportunities, which are created by the absence of a CGT in NZ.

Diagram 10: The scheme mentioned by Oliver.



The CFC/FIF regimes contain sufficient legislative barriers to tax any offshore investment made by the New Zealand subsidiary. However, those regimes do not apply to a non-resident taxpayer such as the offshore bank, who derives non New Zealand source income. One method of “cashing up” the offshore bank would be for the New Zealand parent company to purchase an option from the offshore bank to acquire the “B” class shares (3). In the hypothetical example, the option price would be \$99 and the offshore bank would use the proceeds from the option to purchase an offshore asset or alternatively NZGS. The tax consequences associated with the NZGS is that it would qualify for approved issuer levy and the New Zealand tax on the implicit interest income of \$10 would be 2%. From the offshore bank’s perspective no New Zealand tax would be payable.

After the NZGS has matured, the offshore bank would use the proceeds to pay up the “B” class shares. Accordingly, the share capital of the New Zealand subsidiary would be \$110. The parent company would then pay the excise price of \$1 to obtain the “B” class shares from the offshore bank.

One method of returning the original investment to the New Zealand parent company, would be for the New Zealand subsidiary to repurchase the “B” class shares from the parent company for \$110.

6.5.3 Income tax consequences of the above arrangement

The IRD would probably try to tax the implicit interest of \$10 by invoking the following tax principles and provisions of the Act:

- The concept of a sham
- Business income: section CD 3

- Personal property: section CD 4
- Financial arrangements : sub part EH
- Anti-avoidance : section BG 1

6.5.3.1 The legal nature of an option

The economic effect of the arrangement summarised above is that the parent company invests \$100 with the offshore bank, which is used to acquire NZGS, which matures for \$110, thereby producing a prima facie taxable gain of \$10. This result is achieved via the purchase of an option for \$99. Can the IRD attack the transaction on the grounds that the option is a sham?

The granting of an option is capable of a simple jurisprudential analysis. The grantor (Offshore bank) is in contract law the offeror and the grantee (NZ Parent Co) is the offeree. The grantor irrevocably offers for a specified period of time to hold open for acceptance by the grantee the offer to sell the subject matter of the option agreement. The offeree during the specified time has the right to accept the offer and thereby bring a contract into existence by the exercise of the option according to its terms and conditions. During the period of the option, the grantor/offeror has a contractual obligation to the grantee/offeree not to put it out of their power to do what they have irrevocably offered to do for the option period. It is clear law that an option agreement retains to the grantor the beneficial ownership of the property, which is the subject of the grant unless and until the option is exercised according to its term. The grantor retains the equitable ownership and beneficial enjoyment of the property subject to the grant. These principles are summarised in *J Sainsbury Plc v O'Connor*.⁷⁶

6.5.3.2 Is the option a sham?

In this example it is clear that there is a high option fee and a minimal payment for its exercise. The overwhelming economic inference is that the grantee will exercise the option. The question becomes whether it is really an option or something else (eg. a sham).

It is settled law that for New Zealand income tax purposes the courts have consistently required a strict juristic analysis of the contractual arrangements according to their actual terms and conditions. The courts will require the CIR to respect the legal form of the transaction according to its terms unless it can be shown that the parties had in fact no intention of honouring those terms and that they used the documentation as a label to disguise their true purpose, i.e. a tax sham.

It is clear from Diagram 10 that the economic substance is that the grantee will exercise the option and that the option price is disproportionately large relative to the exercise price but that does not lead to the conclusion that the arrangement is a sham. As long as the documentation will enable the grantee of the option to refuse to pay the option price of \$1 and not to conclude a binding contract the transaction is an option. That has a clear and intended contractual consequence and the court would respect the party's intentions.

⁷⁶ (HMIT) [1990] BTC 363 at p380.

This approach originated in *Re Securitibank (No 2) Ltd v CIR*⁷⁷ that has been consistently adopted for tax purposes. There is no longer any ability for the CIR to adopt an economic equivalent approach. The New Zealand Court of Appeal and Privy Council have rejected an economic equivalent approach in the following cases:

- *CIR v Europa Oil (NZ) Ltd (No 1)* [1971] NZLR 641
- *Marac Life Assurance Ltd v Commissioner of Inland Revenue* (1986) 8 NZTC 5,086
- *CIR v Henwood* (1995) 17 NZTC 12,271
- *Fraser v Robertson* [1991] 3 NZLR 257
- *A Taxpayer v CIR* (1997) 18 NZTC 13,350 (CA)
- *CIR v Wattie* [1999] 1 NZLR 529

In the present context, Marac Life Assurance is relevant.

6.5.3.3 Marac Life Assurance Ltd v CIR

During the relevant income year proceeds from the disposal of policies of life insurance were tax free in the hands of the policyholder. The top marginal rate of personal tax was 66%, whereas life companies were taxed under section 204 of the 1976 Act at 33%. Accordingly, from a tax perspective, there was a tax advantage in an individual taxpayer investing in NZGS via a life insurance company because there was only one layer of tax at half of the top marginal rate.

The 'trick' was to structure the form of the transaction as a policy of life insurance whereas the economic substance was a loan from the taxpayer to a financial institution, which invested the proceeds in NZGS. The legal mechanism to achieve this favourable outcome was a product known as a "Marac Life Bond" (MLB). A MLB contained all of the essential attributes of a policy of life insurance within the meaning of section 204 of the 1976 Act. A crucial feature of a MLB was that if the policyholder died before the maturity date, the amount payable under the MLB was the single premium plus accumulated bonuses, calculated according to inter alia the prevailing rate of interest payable on the NZGS acquired by Marac from the net single premium. The mortality cost of the Life cover was only 0.5% of the premium, and this was calculated on the assumption that the average age of the policyholder was sixty years.

A strong Court of Appeal⁷⁸ held that MLB contained all of the essential features contained in a contract of endowment assurance. A MLB could not be classified as a sham simply because there was a favourable tax outcome. Nor could they be reclassified for tax purposes based on CIR perception of the so-called substance of the relationship between the parties, and the existence of other less tax efficient products in the market. Richardson J said:

⁷⁷ [1978] 2 NZLR 136.

⁷⁸ Cooke, Richardson, McMullin, Somers and Casey JJ.

There is no basis for severing off life insurance and leaving a separate lending contract between the investor and Marac. Each sum payable by Marac is a single undivided sum as is the premium payable by the investor and there is no warrant for attributing to the parties alternative contractual arrangements for the investment of the premiums paid. That being so, and there being no basis for arguing that the life insurance benefits were considered by the parties to be so totally insignificant as to be brushed aside as a colourable mask (and accordingly it is unnecessary to express any legal view as to that), I am satisfied that Ongley J was correct in characterising each type of Marac life bond as a policy of life insurance for the purposes of the Life Insurance Act 1908, and the Income Tax Act 1976 and the Securities Act 1978.⁷⁹

The same type of analysis and reasoning applies ipso facto to the pricing of an option.

6.5.3.4 Business income

Prima facie, the payment of an option fee by the grantee to the grantor in respect of shares in a wholly owned subsidiary is prima facie on capital account. The transaction is not part of the ordinary income earning process of the parent company under section CD 3. The situation could be otherwise if the parent company was a financial institution and potentially subject to the principles, which deal with the taxation of banks and insurance companies and gains, derived from their investment portfolios. Even if it could be said that the acquisition of the “B” class shares pursuant to the option was part of the revenue account activities of the parent company, that is unlikely to create a taxable event.

Case law has consistently held that section CD 4 only applies to gains, which are of an income nature, which arise from the ordinary income earning operations of the taxpayer. Secondly, the arrangement summarised above does not produce any taxable gain. The parent company has merely paid \$99 for an option to acquire shares with a paid up value of \$110. In other words, the parent company has not realised any gain from that transaction. A gain would only arise if the parent company were to dispose of the “B” shares, which is unlikely to occur. If the parent company needed to realize its original investment this could be achieved by the subsidiary repurchasing the “B” class shares thereby avoiding a sale.

The approach taken by the majority of the Court of Appeal and the Privy Council in *Wattie* would effectively prevent the CIR from successfully arguing that the anticipated difference between the acquisition cost of the shares upon the exercise of the option (\$99) and their anticipated worth at the exercise date (\$110) could constitute gross income. Case law has consistently held that unless the taxpayer realises the gain, there is no liability under section CD 4. Cases such as *Myer Emporium*⁸⁰ are distinguishable on their facts because the implicit gain of \$10 is not derived for New Zealand income tax purposes.

⁷⁹ Note 77 at p5,098.

⁸⁰ *Commissioner of Taxation of the Commonwealth of Australia v The Myer Emporium Ltd* (1987) 163 CLR 199.

6.5.3.5 A profit making undertaking or scheme

Could the CIR argue that the anticipated difference of \$10 between the cost of the shares and their anticipated worth at the exercise date of the option constitutes gross income on the grounds that the gain arose from a profit making undertaking or scheme within the meaning of the third limb of section CD 4?

There is a clear distinction in terms of the legal nature of the property obtained by the grant of an option and what might be called the underlying property acquired when that option is exercised. The CIR may try and argue that where one type of property is “swapped” or “exchanged” for another type of property there is a “realisation” for income tax purposes if the property is on revenue account. This is known as the *California Copper Syndicate* principle and is part of New Zealand tax law by virtue of the Court of Appeal decision in cases such as *Auckland Savings Bank*⁸¹ and *Wattie*. However, it is highly unlikely that the “B” class shares would be on revenue account and therefore this principle is unlikely to apply.

Secondly, the correct analysis of the relationship created by an option is that the taxpayer engages in an acquisition, which is the antithesis of either “exchange” or “realisation” which gives rise to a taxable event with a third party. Clear proof of this distinction is the case of a taxpayer who purposes trading stock at a bargain price. Until the taxpayer either sells or disposes of that trading stock via a transaction with a third party, there is no taxable event. It is inherent in the concept of an acquisition that there is no disposition or realisation at that point in time.

This approach is confirmed by the decision of the House of Lords in *British South Africa Co v Varty*.⁸² That case concerned an acquirer of options in the course of their trade. The facts involved an option which, when it was exercised, was worth more than its acquisition cost and the UK Commissioners sought to tax the difference notwithstanding that the shares obtained had not been sold. The House of Lords held that the exercise of an option was not a realisation and did not give rise to a taxable event. Further support for this general approach can be found in two well-known Australian cases *Macmine*⁸³ and *Leibler*.⁸⁴ Both those cases can be distinguished on their facts, but their conceptual approach is consistent with the decision in *Varty*.

The closest New Zealand decision is the judgment of Wilson J in *A G Healing*.⁸⁵ Briefly, the taxpayer was granted via a will an option to acquire property at a fixed price, which was at the date of death significantly below the current market value of that property. The taxpayer immediately exercised the option, acquired the property and contemporaneously sold it at a profit. The CIR was unsuccessful in his attempt to invoke the third limb of section CD 4. Wilson J held that the events did not disclose a profit making undertaking or scheme on the grounds that the taxpayer had merely converted a gift obtained under a will (the option) into money.

⁸¹ *Auckland Savings Bank v CIR* [1971] NZLR 569.

⁸² *British South Africa Co v Varty (HMIT)* [1965] 2 All ER 395 (Varty).

⁸³ *Macmine Pty Ltd v FCT* 1979 ATC 4,133.

⁸⁴ *Leibler & Others v FCT* 1982 ATC 4,005.

⁸⁵ *A G Healing & Co Ltd v CIR* [1964] NZLR 222

6.5.3.6 Myer Emporium and Wattie

There are a number of passages in the judgement of the High Court of Australia in *Myer Emporium*, which could encourage the CIR to attempt to apply that approach in New Zealand. However, the judgment of the majority of the Court of Appeal and the Privy Council in *Wattie* has effectively reduced the scope of that argument in this hypothetical situation. Both Blanchard J and Lord Nolan posed the rhetorical question of whether the taxpayer in *Wattie* actually derived a gain from the interrelated transactions. All that can be said in the hypothetical scenario is that the parent company has acquired shares, which may be capable of producing a gain, but until the parent company sells the shares the gain is not realised and accordingly nothing is derived for tax purposes.

Furthermore, *Myer Emporium* can be distinguished on its facts. The taxpayer in that case undertook a transaction, which was part of its ordinary business of providing finance to the Myer group of companies. While the particular transaction was novel and unusual in the general context of the taxpayer's business, it was nonetheless entered into as a business transaction in the course of the taxpayer's ordinary business and accordingly the gain was taxable as business income. Secondly, the taxpayer in *Myer Emporium* realised a gain from the disposal of the right to future income. The Federal Commissioner of Taxation was able to point to a taxable event that involved a discrete disposal. In the hypothetical example, the parent company simply acquires a parcel of shares, which at the time of the exercise of the option are worth more than the price paid for the option.

6.5.3.7 Financial arrangements – non-residential bank

It is difficult to see how the CIR could successfully invoke Division 2 of Part EH of the Act. There are a series of significant statutory barriers contained in sections EH 21 to EH 24, which individually and collectively appear to be insurmountable.

The position of the offshore bank is straightforward. Section EH 21(3) provides that the accrual rules contained in Division 2 do not apply to a non-resident who is a party to a financial arrangement unless the exception in section EH 21(2) applies. That provision provides that the accrual rules only apply to a non-resident to the extent that a financial arrangement relates to a business carried on by a non-resident through a fixed establishment in New Zealand. It would be a relatively simple exercise for the offshore bank to arrange the transactions in such a way that they are not attributable to the fixed establishment (if any) maintained by the offshore bank in New Zealand.

Assuming that Division 2 does not apply to the offshore bank, it follows that the offshore bank is not required to disclose to the CIR how and what the offshore bank used the money received from granting the option (\$99) for.

Diagram 10 above suggests that the offshore bank will use the \$99 to purchase NZGS, which will mature at a future date and provide the offshore bank with a ready source of funds to pay the call of \$110 on the "B" class shares. The purchase of the NZGS is the only aspect of the overall arrangement, which contains any features of a financial arrangement. However, for New Zealand income tax purposes the CIR has no

statutory authority to ascertain whether in fact that occurred. Accordingly the CIR is not able to apply the accrual rules to the offshore bank that is not subject to New Zealand income tax on the gain derived from the purchase and disposal of the NZGS.

6.5.3.8 The definition of a financial arrangement

Any attempt by the CIR to tax the New Zealand parent company or the New Zealand subsidiary under the accrual rules faces the following hurdles. The first is whether the transactions summarised in Diagram 10 above, satisfy the definition of a financial arrangement. Section EH 22(1) defines a financial arrangement as:

- a debt or debt instrument, and
- any arrangement under which a person receives money in consideration for a person providing money to any person at a future time or when an event occurs in the future.

For the purposes of section EH 22(1), the general definition of “arrangement” contained in section OB 1 of the Act applies which as noted above includes any contract, agreement, plan, or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect. There is no doubt that the definition of arrangement and financial arrangement are intended to have the widest possible application to any combination of linked or integrated transactions. However, there is a crucial threshold issue, which arises in this case, namely whether the integrated arrangement is a financial arrangement within the meaning of section EH 22(1) of the Act. Put at its broadest, can the CIR successfully argue that the arrangement is that the offshore bank obtains money (being the payment of the option to obtain the “B” class shares) in consideration for a promise to provide money being the payment of calls on the “B” class shares (to the New Zealand company) at a future date?

6.5.3.9 Is the option agreement a financial arrangement?

It is difficult to see how the purchase of an option falls within either section EH 22(1)(a) or (b). The amount paid by the New Zealand parent to the offshore bank is paid in consideration for the offshore bank granting to the New Zealand parent company an option to purchase the “B” class shares. The amount is determined wholly and solely by reference to the expected future value of the shares. The value attributable to the shares arises by virtue of the offshore bank’s obligation to pay future calls on the shares to the value of \$110.

Prior to the offshore bank granting the option to the New Zealand parent company, the New Zealand subsidiary will issue to the offshore bank the unpaid “B” class shares, which carry a future obligation to make calls equal to their par value of \$110. Those transactions will occur **prior to** the option agreement being entered into between the offshore bank and the New Zealand parent company. Until those transactions have occurred, the offshore bank is not in a position to grant an option in respect of those shares. Accordingly, it cannot be said that the New Zealand parent company paid the offshore bank \$99 in consideration for a future promise by the offshore bank to pay future calls of \$110. The obligation of the offshore bank to pay

future calls arose **prior to** the option agreement. It therefore follows that the option agreement is not a transaction, which falls within the scope of section EH 22(1)(b).

The purchase of the option is not a debt or debt instrument within the meaning of section 22(1)(a). The phrase “debt or debt instrument” is not defined in the Act. Accordingly that expression would have its ordinary commercial meaning. Applying the ordinary natural meaning of a debt, the statutory expression embraces sums of money which are now payable, or which will become payable in the future, by reason of a present obligation. The payment of the option is not a future obligation because it is made contemporaneously with the granting of the option. In other words, the concept of a financial arrangement does not include the simultaneous passing of consideration by two parties, which will occur under the option arrangement.

Could the Commissioner attempt to apply section EH 22(2) to the payment of the future calls of \$110? Similar hurdles appear to face the CIR. Paragraph (b) of the definition applies to an arrangement whereby a person obtains money in consideration for a promise to provide money in the future. Therefore the payment of future calls could not be regarded as a financial arrangement unless the offshore bank obtained money in consideration for the promise to make the future calls. However, it is clear from the sequence of transactions summarised in Diagram 9 above, that the offshore bank did not obtain any money under the agreement with the New Zealand subsidiary to pay future calls of \$110. The money obtained by the offshore bank arose under a subsequent transaction, namely the granting of an option to the New Zealand parent company.

Secondly, the payment of future calls is unlikely to satisfy the ordinary meaning of the phrase “debt or debt instrument” discussed above. It would be a relatively simple matter for the offshore bank and the New Zealand subsidiary to ensure that the offshore bank’s obligation to pay future calls is not a present obligation. The “B” class shares could provide for example that the shareholder is not required to pay a call unless and until they receive a notice from the company advising of the payment date and the amount of the payment required on that date. That would ensure that the obligation to make a future payment is conditional upon the receipt of the relevant notice issued by the subsidiary. The creation of this type of condition precedent would ensure that the future calls are contingent on the production of a notice and a contingent amount is not regarded as a debt. This principle was established in cases such as *Bennett & Kells*.⁸⁶

6.5.3.10 Is an option an excepted financial arrangement?

Assuming for the purposes of argument only that the transactions summarised in Diagram 9 above do create a financial arrangement within the meaning of section EH 22, the next hurdle faced by the CIR is the definition of an excepted financial arrangement contained in section EH 24 of the Act. In the context of a proposal, section EH 24(1)(o) provides that shares or an option to acquire or sell shares are excepted financial arrangements. Generally speaking, an excepted financial arrangement is not a financial arrangement and accordingly there is no accrual

⁸⁶ *Bennett & Kells (Trustee of the Estate of Nolan) v CIR* (1984) 6 NZTC 61,996.

implications associated with those categories of transaction. Ever since the accrual rules were first enacted in 1986, shares have been treated as excepted financial arrangements. Options to sell or acquire shares have also been treated as excepted financial arrangements. In the present context, there can be no doubt that a properly drafted option would satisfy the ordinary commercial meaning of an option. In relation to the “B” class shares, they would satisfy the definition of a share contained in section OB(1) of the Act, which is any interest in the capital of a company.

The final hurdle faced by the CIR is the application of section EH 22. This provision deals with the consequences of the broad definition of a financial arrangement. It covers transactions, which could fall within the definition, but include arrangements, which must be excluded because of the clear distinction between debt and equity. Section EH 22 contains a mechanism which bridges the potential conflict between section EH 22 and EH 24. It is possible that interrelated arrangements, which, if considered separately, are not financial arrangements, but because of their interdependency could be financial arrangements. Section EH 22 contains the general rule that if an excepted financial arrangement is part of a financial arrangement, then any income or expenditure which is solely attributable to the excepted financial arrangement is not subject to the principles contained in Division 2. Section EH 22(2) contains a list of exceptions but they do not include excepted financial arrangements in the nature of shares or options to acquire shares.

Assuming that the offshore bank is not subject to Division 2, it follows that the arrangements outlined in Diagram 10 above do not disclose how the offshore bank invested the proceeds from the sale of the option, i.e. in NZGS. Consequently, the only aspects of the arrangement, which the Commissioner can ascertain are the granting of the option and the exercise of that option culminating in the New Zealand parent acquiring fully, paid “B” class shares from the offshore bank. There are clearly no features of those transactions, which contain any element of a financial arrangement.

Finally, the statutory phrase appearing in section EH 22(1) “solely attributable to the excepted financial arrangement” creates a further hurdle for the CIR. Shortly after Division 2 was enacted the IRD issued a Tax Information Bulletin (TIB) outlining their interpretation of certain aspects of the 1999 amendments.⁸⁷ In the context of the scope of a composite financial arrangement and whether and how aspects are solely attributable to an excepted financial arrangement or a financial arrangement, the CIR gave a useful example, which shows the difficulty of attempting to link transactions entered into by unrelated parties. If A lends money to B in consideration for which B will subscribe for shares in C, the IRD stated that the only financial arrangement is the loan between A and B. The fact that B uses the loan funds to acquire shares in C does not mean that the acquisitions of shares are part of a financial arrangement. The shares are treated as an excepted financial arrangement because the subscription and dividends flowing from those shares are “solely attributable” to the acquisition of the shares. However, the CIR correctly noted that it is possible for a share buy back arrangement to form part of a financial arrangement. The discussion in the TIB is

⁸⁷ TIB vol 11 No 6 (July 1999) p10.150

useful insofar as it shows how difficult it is for the CIR to rely on this provision when there is no explicit reference to a financial arrangement.

6.5.3.11 Section BG 1 of the Act

There are two broad features of the arrangement disclosed in Diagram 9 above, which could lead to the CIR attempting to apply section BG 1 of the Act. The New Zealand parent company makes available (via the option) to the non-resident funds, which are used by the offshore bank to produce income, which is derived by the non-resident rather than the New Zealand parent. Secondly, the offshore bank enters into a transaction which produces a tax free benefit to the New Zealand parent which is calculated by reference to the time value of money without that benefit being taxed under the accrual rules. The analysis contained in Section 3 above is also applicable. Briefly, it is difficult to see how section BG 1 could be used to cut across the CFC and FIF regimes. There are a number of fundamental threshold requirements, which must be satisfied before either regime applies to a New Zealand resident. There is absolutely no prospect that the New Zealand parent company would obtain a control or income interest in the offshore bank. To put it bluntly, the New Zealand parent company can obtain the benefits from the arrangement without obtaining any interest in the offshore bank. To do otherwise so would be fatal and that would undermine the tax efficiency of the arrangements.

In relation to the accrual rules, a fundamental difficulty faced by the CIR is the clear boundary between debt and equity instruments. This is clear from section EH 24 which specifically excludes shares and options to acquire shares. The presence of those provisions strongly suggests that there is an explicit recognition within the accrual regime rules that if a taxpayer chooses to use an equity instrument to achieve their commercial investments, the accrual rules must be applied to the taxpayer according to the form of the actual arrangement entered into by the taxpayer. The general tenor of the recent judgment of the Privy Council in *Auckland Harbour Board* creates further difficulties for the CIR.

Finally, it does not follow that if the New Zealand parent had not entered into the actual arrangements disclosed in Diagram 10, the New Zealand parent company would have directly acquired a parcel of NZGS. There are a number of other well-known tax-free investments, which the New Zealand parent company could have invested the surplus funds in. Redeemable preference shares issued by a loss company, which used the proceeds to invest in NZGS, would have achieved a similar tax outcome.

7. Submissions : First Opportunity

7.1 Overview of current CFC/FIF regimes

Residents who invest in non-grey list countries are taxed on their income as it accrues. Under the CFC regime the income of the foreign entity is recalculated under New Zealand income tax principles and the relevant proportion of that income is attributed to the New Zealand shareholders.

When the BE income is repatriated to New Zealand as dividend, the previous tax can be offset against the FDWP payable in respect of that dividend. Taxpayers with investments that are subject to the provisions of the FIF regime are generally speaking taxed on the income as it accrues rather than when it is distributed to the New Zealand investor. The clearest example of this principle is the comparative value method.

By way of contrast, a taxpayer who invests in a grey list country is not subject to the provisions of either regime and the income from their investment is only taxed when it is distributed. The effective rate of tax is also affected by the provision of underlying foreign tax credits, and the ability to carry forward tax losses.

Finally, in respect of investments in non-grey list countries, there is no distinction between active and passive income.

7.2 Impact on non-resident investors

The recognition of income on an accrual basis, and the absence of an active income exemption, has caused potential difficulties for non-resident shareholders who invest in New Zealand resident companies that are subject to either the CFC and/or FIF regimes. The iniquitous results have caused successive governments to introduce regimes that are designed to alleviate some of the disadvantages caused to non-resident shareholders. For example, the conduit tax regime was introduced to alleviate the problems associated with companies that were owned by non-residents who invested off shore. One of the largest New Zealand companies adversely affected was Carter Holt Harvey's investment in Chilean forestry companies. That in turn created taxation difficulties for major foreign shareholders such as International Paper. The conduit tax regime has created a clear inequity between non-resident and resident shareholders.

7.3 The impact of subsequent changes to the international tax regime

One of the original policy objectives reflected in both the CFC & FIF regimes was a clear desire to ensure that the New Zealand tax system did not distort investment patterns. This would occur if a New Zealand resident faced the same rate of tax on all of their worldwide income regardless of its source. In other words, that objective was designed to improve New Zealand's welfare by reducing the extent to which New Zealand taxes distorted investment decisions. The New Zealand approach was significantly different from other comparable jurisdictions where the primary objective was to reduce the scope for tax deferral and/or avoidance via the trapping of passive investment income tax haven entities.

These objectives were to be achieved via the introduction of the CFC and FIF regimes along with an extension of the tax base to include a comprehensive capital gains tax. Placing a significant emphasis on the recognition of income on an accruals basis would ensure that New Zealand residents could not reduce or defer their New Zealand tax liability by diverting income into offshore companies or investment funds. If foreign sourced income were only taxed on a realisation basis, this would have enabled New Zealand resident taxpayers to invest offshore and permanently defer New Zealand tax on that income.

However, there have been a number of significant changes to the tax system since the introduction of the CFC and FIF regimes. They include the decision not to introduce a comprehensive capital gains tax, and grey list countries changing their domestic law to encourage non-resident passive investors to invest in tax preferred "conduct" structures.

Secondly, the introduction of the Underlying Foreign Tax Credit (UFTC) regime caused a fundamental change in the policy objectives of the CFC regime. Prior to the introduction of the UFTC regime, the primary objective was to ensure that foreign sourced income of New Zealand resident taxpayers was taxed at a similar rate to a domestic investment. The UFTC regime was designed to reduce international double taxation by ensuring that resident investors were exposed to the same total amount of foreign and domestic tax on their foreign investments. A third significant change is the recent increase in the top personal marginal rate of tax to 39%.

The impact of these three events is that the effective rate of tax, which applies to investments in non-grey list countries, is much higher than was originally envisaged. Conversely, the effective rate of tax, which applies to investments in grey list countries and most comparable domestic investments, is much lower. This occurs by virtue of the fact that New Zealand residents' investment income from non-grey list countries is taxed on an accrual basis, whereas income from most domestic investments and grey list countries is taxed (if at all) on a realisation basis. In addition, the FIF regime effectively imposes a capital gains tax on an unrealised basis.

It was against this background that a number of submitters took the opportunity to present submissions prior to the McLeod Committee issuing its interim report. The following recommendations were present in many of the leading submissions. They reflect the underlying theme that the current CFC and FIF regimes had sacrificed international competitiveness in the blind pursuit of economic purity.⁸⁸

7.4 The CFC regime

7.4.1 The active/passive distinction

All of the major submitters⁸⁹ noted that Australia, Canada, the United Kingdom and the United States restricted the application of their comparable international tax regimes to "passive" or "tainted" investment income from property and rental income, interest, dividends, and intellectual property. Active business income was generally exempt. Submitters noted that passive income is more likely to involve deferral or tax avoidance via the trapping of this type of income in tax haven entities. Given that New Zealand, Hungary, and Sweden are the only countries that tax active business income of their resident multinational corporations (MNC) the question arises as to the international competitiveness of New Zealand entities, which derive active (i.e. business income).

⁸⁸ See Institute of Chartered Accountants of New Zealand, "Submission to the Tax Review 2001", 15 March 2001 p13, paragraph 5.0 (ICANZ).

⁸⁹ See for example, "Buddle Findlay Submission to the Tax Review 2001", p6 submission 1 (BF), ICANZ p13, KPMG "McLeod Committee Submission" March 2001 (KPMG) p23, New Zealand Business Round Table "Submission on the Tax Review 2001" March 2001, PriceWaterhouseCoopers "Tax Review 2001: Submission to the Chair of the Tax Review 19 March 2001" (PWC).

One submitter went so far as to suggest that to the extent the comparable Australian regime contains an active exemption then all other things equal, New Zealand MNCs are likely to relocate to Australia.⁹⁰

Another submitter⁹¹ noted that the New Zealand Treasury had expressed the view that the active/passive distinction had been extensively examined and had been rejected for theoretical and practical reasons. That position is untenable in view of the summary noted above. Briefly, the 18 June 1987 Budget specifically referred to the distinction between active and passive income. Secondly the possibility of introducing an active/passive distinction was noted in submissions to the original Consultative Committee on full imputation and international tax reform. The March 1988 Report of that Committee recommended an exclusion from the proposal for non controlling interests in “active” tax haven entities. The government expressed a reservation and reinforced its concern in the Report on International Tax Reform, Part Two. The proposed active/passive distinction was omitted from the draft legislation and to the best of the author’s knowledge this distinction has never been raised in any official documents issued by the Treasury, Inland Revenue or successive governments since that date. It is difficult to accept the Treasury assertion that there has been previous consultation on the merits of an active/passive distinction.

7.4.2 Ring fencing of losses

The same group of submitters were equally forceful in their submissions on the current penal treatment of CFC losses. A CFC can only carry a loss forward and that loss is ring fenced in the jurisdiction in which the loss arose. Submitters noted that there is a degree of similarity with other countries’ rules on consolidation, but that in many cases loss quarantining only occurs in the context of a separate capital gains tax regime.

A common concern was that a regime which taxed successful investments but failed to give adequate relief for poor investments would invariably lead to under investment due to the arbitrary impact of the current ring fencing regime.

7.4.3 Reform of the grey list

Most submitters⁹² recommended an extension of the current grey list to include countries with which New Zealand has a double tax agreement, that have a proven record of protecting their tax base, and have comparable rates of tax. The international tax regime was introduced in 1988. Since then New Zealand’s capital and trade flows have changed significantly. Many of New Zealand’ major trading partners are located in South East Asia yet there is a disincentive to invest capital into those markets. A second significant change has been the enlargement of the European Union. However, only three EU countries are included on the grey list.

⁹⁰ Note 89, KPMG p23.

⁹¹ Note 89, PWC p14.

⁹² All submitters referred to a note 89 except KPMG.

7.5 The FIF regime

7.5.1 Threshold

Most of the submissions were extremely brief and to the point. A number of submitters recommended that the current threshold should be increased from \$50,000 to \$1 million. There was very little analysis (if any) to support their upper limits.

7.5.2 Public company exemption

One submitter⁹³ recommended a general exemption for all listed public companies. This would overcome the compliance issues created by the complicated nature of the calculations required under the FIF alternatives. Secondly, it would recognise the fact that portfolio investors are generally speaking not in a position to influence the distribution policy of a foreign company, which is listed on a recognised exchange.

7.5.3 Realisation basis

Most submitters noted that the emphasis under the current regime on the taxation of unrealised capital gains and unrealised foreign currency gains is inconsistent with the taxation of a comparable New Zealand sourced investment. Those two features created a strong disincentive for people considering migrating to New Zealand. Submitters acknowledged the important role a FIF regime could play in the protection of the New Zealand tax base but emphasised that these two features were not necessary and were likely to discourage migrants and New Zealand residents diversifying their portfolio investments.

8. Tax Review 2001: The June Issues Paper

8.1 Tentative conclusions

The McLeod Committee clearly understood the investment distortions caused by the current regimes. Under the heading “Business Interests and International Competitiveness” the McLeod Committee noted that⁹⁴

At this stage the Review has the preliminary view that the current compromise in the taxation of offshore income of New Zealanders is not sound and that change is necessary. ...

At this stage we would recommend repeal of the grey list. This recommendation would be made on the proviso that the repeal can be fitted within a revised and satisfactory regime for offshore investment.

⁹³ PriceWaterhouseCoopers “Tax Review 2001: Submission to the Chair of the Tax Review 19 March 2001” (PWC) at p18-19.

⁹⁴ Tax Review 2001: Issues Paper June 2001 at pp147-152, paragraphs 99-125.

We would not recommend this change if the effect was to bring all investment within the scope of the current CFC and FIF regimes. We contemplate recommending a repeal of the narrow seven country grey list in the context of a shift to an international tax regime for outbound investment along the lines of one of the options raised below.⁹⁵

8.2 The business communities ‘wish list’

A number of submitters had a clear view on a more appropriate framework for taxing New Zealand residents on their foreign sourced income. The McLeod Committee noted that New Zealand’s CFC and FIF regimes were the most far reaching in the world. The McLeod Committee acknowledged that⁹⁶ most of New Zealand’s major trading partners who had enacted comparable regimes, were primarily targeted at tax avoidance and that they inevitably contained measures which narrowed their scope, such as an active/passive distinction. Accordingly, the McLeod Committee noted that a number of submitters were strongly of the view that the current CFC and FIF regimes placed New Zealand foreign business operations at a comparative disadvantage. If the current CFC and FIF regimes were to be amended to better reflect the business community’s interpretation of “international tax norms”, then the following changes would be required.

- Repeal all provisions, which effectively tax New Zealand residents on their unrealised capital gains.
- Confine the ambit of both regimes to tax avoidance and tax deferral opportunities.
- The enactment of an active/passive distinction. CFC income would only be attributed to a New Zealand taxpayer if the CFC income fell into the “passive” category. Active income would only be taxed when repatriated to New Zealand.
- The primary emphasis under the FIF regime would be to prevent the deferral of New Zealand tax on offshore passive income.
- Foreign tax credits would continue to be permitted in accordance with New Zealand’s DTA obligations.

The McLeod Committee acknowledged that its recommendations involved a trade off between economic theory, real world considerations, and the three competing objectives of taxpayer compliance, dead weight costs, and New Zealand’s DTA obligations. There were two primary issues,(being foreign tax credits and the timing of the derivation of offshore income), which shaped their recommendations.

8.3 Treatment of foreign tax credits

In relation to foreign tax credits the McLeod Committee recognised there were two broad approaches. The first was to continue with the status quo. This would require New Zealand to recognise foreign tax credits in respect of income sourced from treaty countries. Furthermore, the McLeod Committee recognised a similar treatment for

⁹⁵ Paragraphs 117-120. The two options are summarised in paragraph 8.6.

⁹⁶ Note 94 at p147 paragraph 100.

non-treaty countries, because of the risk of introducing a significant distortion in favour of treaty countries. The second approach was the risk-free return method (RFRM). Under this approach, the actual income earned from the offshore investment is ignored. A taxpayer's gross income is the notional income earned from the investment on the assumption that the taxpayer had invested in a risk-free asset such as NZGS. The RFRM method taxes a presumptive return, which is adjusted for inflation, and no actual deductions such as interest would be permitted. It is the presumptive return as opposed to the actual return, which is taxed. Secondly, the RFRM method would not allow any deduction for foreign tax credits. However, in cases where the risk-free-return rate is below the actual return earned from the foreign investment, it will result in a lower level of taxation.

The primary advantages identified by the McLeod Committee from implementing the RFRM method would be the elimination of current distortions, which influence taxpayer's decisions about whether to invest in "income generating" or "capital growth" equities. The RFRM method is not without controversy. Any foreign asset, which experienced a sharp drop in value during a particular income year, would not receive a compensating reduction in the RFRM rate until the following year's valuation was undertaken. Secondly, the RFRM method would be calculated independently of the taxpayer's actual cash flows, which could cause taxpayers to realise liquid assets to pay the tax arising from the presumptive income. Finally, any alteration to a portfolio arising from the acquisition and disposal of equities could create difficulties for calculating the value of net assets at the start of the year. This difficulty could presumably be overcome by basing the value of net assets at the commencement of the year on the basis of the average of opening and closing values.

8.4 Recognition of income

In relation to the timing of the derivation of offshore income, the McLeod Committee were highly critical of the current CFC and FIF regimes, and appear to have endorsed most of the submissions summarised above. However, they went further than the submitters and specifically noted the distortionary effect created by certain unit trust structures.

*"[W]e are also concerned that vehicles such as low tax United Kingdom unit trusts are being used for investment into non-grey list countries, thereby undermining the rationale for the grey list. ... At this stage we would recommend repeal of the grey list. This recommendation would be made on the proviso that the repeal can be fitted with a revised and satisfactory regime for offshore investment."*⁹⁷

However, their recommendation was subject to the important qualification that the repeal of the grey list was not designed to bring all offshore investment within the scope of either the CFC or FIF regimes. Their recommendation was linked to one of the following options.

⁹⁷ Note 94 at p151, paragraphs 119-120.

8.5 Future reform options

The two policy options, which McLeod Committee evaluated in the context of the repeal of the grey list, were:

- A modified CFC regime, which would involve the introduction of an active/passive distinction for direct foreign investment outside of a designated list of low tax/tax haven countries. In the case of portfolio investments (i.e. holdings of less than 10%) and widely held unit trusts, the RFRM method would apply.
- The second option involved the application of the RFRM method to all offshore and domestic investments, or alternatively to offshore investments. The impact of this option would affect taxpayers as follows. Portfolio investors in grey list countries would experience an increase in the level of taxation under the RFRM method, whereas investors in non-grey list FIFs would expect a reduction in the current level of income tax.

9. The Submitters Response

9.1 Economic theory and active/passive income

The Corporate Taxpayers Group (CTG) joined the major March 2001 submitters.⁹⁸ In relation to the foreign tax credit and derivation of offshore income, the Issues Paper provoked a wide range of responses.

The CTG strongly attacked the formulation of tax policy based on economic theory, which reflects dubious assumptions. Some of their concerns were reflected in the Issues Paper.⁹⁹ For example:¹⁰⁰

“In a world where individuals and entities do not change residence and other countries apply similar principles, we accept the logic of the [see-saw] models implication that, if New Zealand does not levy any “net” tax on non residents investment into New Zealand it should allow only a deduction for foreign taxes.”

The CTG noted that New Zealand residents will and have changed their tax residence in response to the current international regime. The most recent summary of wealthy individuals who have migrated from New Zealand was provided by Deborah Hill Cone in a recent article in the *National Business Review* [9 May 2003] "The Tax Gypsies". The individuals include inter alia Sir Michael Fay, David Richwhite, Eric Watson and Alan Gibbs (who is the inventor of an amphibious motor car). Secondly, the CTG noted that:

“No country in the world has adopted our international regime. Quite the contrary, many of our trading partners adopt an avoidance

⁹⁸ Corporate Taxpayers Group Submission 31 August 2001. The reference to this submission is B236.

⁹⁹ Note 94 at p3-5 Annex I.

¹⁰⁰ Note 94 p149, paragraph 104.

perspective in designing their international tax regimes and therefore have regimes based on active/passive exemptions.”

Given that the economic theory noted by the McLeod Committee depends on other countries adopting a similar approach, and given that this has not occurred, the CTG and the McLeod Committee saw little benefit in New Zealand continuing to ignore the fact that the rest of the world has coped with the active/passive distinction.

9.3 Foreign tax credits

None of the submitters supported the recommendation that New Zealand should adopt the seesaw principle, which in its pure form would replace the current foreign tax credit regime with a deduction. The strongest criticism was made by the CTG:¹⁰¹

“The fundamental issue is whether New Zealand corporates are to be allowed to operate internationally. Currently they are already generally at a competitive disadvantage. Disallowing all foreign tax credits, even if possible given existing treaties, would be tantamount to imposing a toll on domestic corporates international activities, the penal nature of which would be fundamental.”

9.4 The risk free return method

The submitters did not adopt a uniform approach in their response to the RFRM proposal.¹⁰²

For example, PWC supported the application of the RFRM method to outbound investments. KPMG also supported the RFRM method but were concerned about the increased tax burden and cash flow difficulties imposed on taxpayers whose actual rate of return was less than the presumptive return. The ICANZ believed that the RFRM method should be confined to the FIF regime and in particular it would be a suitable replacement for the current deemed rate of return method.

At the other end of the spectrum, the CTG outlined a number of significant criticisms, which were not considered by the other submitters. They took issue with the Committee’s observation that the potential reaction of treaty partners to the disallowance of tax credits under the RFRM method would require further consideration. The members of that group strongly submitted that New Zealand’s treaty partners would not accept the denial of foreign tax credits and therefore the potential application of the RFRM method to treaty country investments was highly suspect. If their observation was correct, then it would follow that the adoption of the RFRM method would create a tax preference in favour of treaty countries.

¹⁰¹ Note 98 at p30.

¹⁰² Corporate Taxpayers Group p3-8 and 30-31, ICANZ p21, KPMG p14-17.

9.5 The active/passive distinction

All of the submissions spoke with a single united voice on the matter. If New Zealand hopes to achieve an internationally comparable regime, which permits New Zealand resident companies to successfully compete in international markets, then an active income exemption is imperative.

9.6 Repeal of the grey list and replacement with what?

Most submitters supported the McLeod Committee's recommendation to repeal the grey list and replace it with a satisfactory alternative. A number of submitters believed that the RFRM method was not a suitable or feasible replacement. Accordingly, they raised a number of additional possibilities. For example the CTG suggested that the grey list could be expanded to include all countries with a corporate tax rate of at least 20%. In relation to portfolio investments, they also supported an exemption for publicly listed companies that are actively traded on any recognised stock exchange.¹⁰³ Finally, they recommended an increase in the de minimis exemption from \$50,000 to \$100,000. The ICANZ supported each of these three recommendations.¹⁰⁴

One of the main concerns of all submitters was the underlying philosophy of the CFC and FIF regimes. Are they primarily designed to protect the New Zealand tax base from the type of avoidance/referral strategies discussed above, or is their role primarily to achieve tax neutrality?

10. The McLeod Committee's Final Report

10.1 A difficult balancing act

The McLeod Committee's final paper acknowledged the impact of the concerns raised by corporate taxpayers summarised above.¹⁰⁵ For example, the McLeod Committee was unable to recommend the application of the RFRM method to all offshore investments. However, the McLeod Committee was unable to accept a number of the crucial recommendations such as the adoption of the active/passive distinction. The McLeod Committee candidly acknowledged that they were unable to resolve some of the underlying tensions between economic theory and international practice identified in the Issues Paper.

*The key issue we have been unable to resolve is whether New Zealand should seek to tax offshore income as earned or more generally defer tax until repatriation. The current rules are an unhappy compromise and there remains considerable dissatisfaction with the present position. The tension is between the desires for the tax system not to produce tax incentives for residents to invest offshore. And the fact that **the international standard adopted by other countries (an***

¹⁰³ Note 98 at p28-31.

¹⁰⁴ Note 89 at p21.

¹⁰⁵ Tax Review 2001. Final Report, p152 paragraph 2.

*active/passive) regime is founded on such an incentive. The concern is that New Zealand's failure to follow the international standard produces significant losses for the country because it contributes significantly to the decisions by non-residents not to migrate to New Zealand and by residents to leave New Zealand. (Emphasis added)*¹⁰⁶

10.2 The current CFC regime

The McLeod Committee acknowledged that the current regime has been observed to contribute to decisions by New Zealand residents to leave New Zealand and by non-residents not to migrate to New Zealand. The Committee acknowledged that overseas jurisdictions generally adopted the active/passive distinction, which was supported by all of the primary submissions. The review Committee expressed concerns about the definition issues surrounding the distinction and the risk and that its adoption would create a distortion in favour of offshore investment. Accordingly, no firm recommendation was made. Their solution was for interested parties to discuss whether it was possible to reach an agreement on the active/passive approach.

We have considered the active/passive approach, which would defer New Zealand tax on active offshore earnings until repatriation, and for which business interests advocate. We do not embrace it with enthusiasm because of its distortionary effect towards offshore investment and the definitional issues it poses. But there are real issues of cost to New Zealand of not following this international standard. Our suggestion is that the government engage in further dialogue with interested parties to determine whether an agreement can be reached on the broad outline of an active/passive approach.

If the interested parties could not reach an agreement, then the Committee suggested that:

- the problem would be reduced by cutting the corporate rate of tax, and
- considering if the RFRM could be introduced as an alternative method, which taxpayers could elect instead of the current CFC/FIF regimes.

10.3 The current FIF regime

The McLeod Committee noted that the current taxation of domestic and offshore-managed funds is inconsistent and requires consistency of treatment. New Zealand managed funds are generally taxed on all investments whether in a grey list or non-grey list countries. However, a New Zealand based passive fund, which has obtained the appropriate IRD ruling is not subject to tax on its investment gains. Portfolio investors in grey list managed funds are not taxed on any realised capital gains even if there is little tax payable in the grey list country. The final report specifically referred to certain Australian and United Kingdom unit trusts.¹⁰⁷ For these reasons, the McLeod Committee had little hesitation in recommending the:

¹⁰⁶ Note 102 at pXI (Overview).

¹⁰⁷ Note 105 at p88 paragraph 8.73.

application of the RFRM method for all portfolio investments in offshore listed entities and offshore retail unit trusts. The RFRM method would apply whether such investments were in grey list or non-grey list organisations.

To this extent, the current FIF regime and its emphasis on grey list countries would become irrelevant.

11. Conclusion

11.1 What are the objectives of the CFC/FIF regime

Both regimes were designed to reduce the tax avoidance and tax deferral opportunities, which were associated with pre CFC/FIF offshore investments. To this extent the original proposals were consistent with the six other jurisdictions that had created similar regimes.

An equally important objective was to reduce the extent to which New Zealand tax distorted the onshore-offshore investment decisions of New Zealand residents. This would be achieved if the CFC/FIF regimes would ensure that foreign sourced income derived by New Zealand residents was taxed at the same time and at the same rate that would have been applicable to a domestic investment.

Whereas the comparable legislative regimes were aimed at passive investments located in tax havens this was not the sole emphasis of the December 1987 announcements. Comparable tax treatment could only be achieved with the introduction of the comprehensive tax CGT. If that had occurred then the emphasis under the CFC/FIF regimes on taxing income as it accrues rather than when it is distributed would have ensured a greater degree of consistency between onshore and offshore passive investments.

The international tax environment has changed dramatically since the December 1987 discussion document. New Zealand has not introduced a comprehensive CGT. In the case of domestic portfolio investments held by an individual New Zealand resident who is not a dealer or trader, only the dividend flows are subject to tax. A comparable grey list portfolio investment is taxed in a similar manner but a non-grey list investment is significantly over taxed.

The sensitivity of non-resident portfolio investment decisions to source country taxation was the rationale for the introduction of both FITC and AIL regimes. It would seem to follow that any disparity in effective tax rates distorts the domestic and foreign portfolio investment decisions of New Zealand residents. Tax considerations are a major factor and the clearest evidence of this is the Minister's concern in August 2003 over Australian unit trusts, which can be used as a conduit for investing in NZGS. Similar issues surround OEICs and grey list unit trusts such as Foreign & Colonial. But this seems to have escaped the Minister's attention. Portfolio investment decisions of New Zealand residents are no longer determined by the merits of the alternative investment but vagaries of the New Zealand international tax regime, which is a significant detriment, faced by investors. Furthermore this issue is

not confined to the FIF regime. Careful tax planning can also defeat the current CFC regime, which can be used to avoid New Zealand tax on New Zealand, sourced passive income.

The McLeod Committee identified a number of unresolved fundamental tensions, which are reflected in the current CFC/FIF regimes. Their analysis suggests that the time has come for a comprehensive solution, which starts, from a review of the original December 1987 policy objectives. A piecemeal ‘band aid’ approach will not resolve the tensions identified in paragraph 10.1.

The December 2003 Discussion Document may provide an opportunity for a reconsideration of how New Zealand currently taxes offshore income, and the alternative taxation models adopted by inter alia New Zealand’s major trading partners.

11.2 An active income exemption

The comparative study undertaken by Arnold and Dibout in 2001 indicated that New Zealand, Hungary, and Sweden were the only countries that had NOT adopted an active income exemption. This suggests that a priority of any reform would be to introduce an active income exemption into the current CFC regime. This would bring New Zealand into line with a fundamental international norm. As at 1 January 2001 20 of the 23 countries that had adopted a CFC regime have included this exemption. The primary explanation for this phenomenon is to preserve international competitiveness. For example if Air New Zealand were to own a tourist hotel in inter alia Hong Kong, the Cook Islands, or Tonga, could it be seriously argued that the investment should ipso facto become subject to the CFC regime simply because those three tourist destinations are also tax havens? The IRD and Treasury have had a longstanding concern about the difficulty of policing an active/passive boundary and whether it would produce any bias in favour of certain types of investment. However, the work undertaken by Sandler and Arnold in their country surveys strongly suggests that the collective experience of the 20 countries that have introduced this distinction does not create any significant difficulties in practice.¹⁰⁸

11.3 Reform of the Grey List

It would appear that there has been a significant conceptual shift in the rationale for the grey list. There were originally 61 countries, which formed the “black list”, and they included most of the well-known international tax havens. That suggested the role of the grey list was to prevent deferral and tax avoidance strategies, which was consistent with the approach of comparable regimes.

¹⁰⁸ The author has not undertaken a comprehensive review of the experience of NZ major trading partners such as the United States, which was the first country to enact a CFC regime. There could be difficulties in defining the boundary at the margin. For example how would the income arising from a captive insurance or shipping company, which is owned by an active exporter, be classified? The studies undertaken by for example Arnold & Dibout, and Sandler & Arnold suggest that type of income would fall outside an active income exemption on the grounds in was either base county income or tainted income. However the articles and reports referred to in footnote 39 contain no suggestion that defining the boundary is an insurmountable risk. The concepts discussed in para 5.1.5 can be used to assist in defining the boundary.

However, the current grey list consists of seven countries which suggest that there has been a shift away from an anti avoidance focus to notions of capital export neutrality. This principle reflects the assumption that there should be no tax preference for any type of foreign investment. The McLeod Committee correctly noted that the present grey list is inconsistent with this principle because it creates an inbuilt bias or incentive to invest into those seven countries because they are exempt from the CFC and FIF regimes.

11.4 The RFRM method

No other country has used this method to tax offshore direct investment and offshore portfolio investments. It would represent a significant variation from the international norms discussed by authors such as Arnold and Sandler.

In the case of an individual New Zealand resident investor who was faced with two identical investments, one onshore and offshore, the introduction of the RFRM method would create a bias in favour of the domestic investment because the latter would not be subject to the RFRM. In the case of the offshore investment the RFRM would however represent an improvement over the deemed rate of return method, which is, based on the average five-year nominal government stock rate plus a margin of 4%. The RFRM method has a lower presumptive rate of return and therefore would result in a lower effective tax rate than an identical investment that is subject to the deemed rate of return method. This conclusion is subject to the proviso that borrowing was not used to fund the comparable investment which is subject to the deemed rate of return method because the RFRM method ignores all interest costs.

11.5 Future reform

Part B of this article will consider these issues taking into account the proposals contained in the December 2003 Issues Paper on the “Taxation of non-controlled offshore investment in equity”. That document outlines two options for changing the way that equity investments that are currently subject to the FIF regime are taxed. The first option is a variation on the risk-free rate of return method recommended by the McLeod Committee. The second option is a more radical proposal, which that would apply to **all** offshore portfolio investments irrespective of the country of investment or the type of investor. In practice this option would effectively tax all investors on 70% of realised capital gains irrespective of the location of the investment or whether it was held on capital or revenue account.

In relation to the CFC regime part B will examine the recent Australian proposals and consider their appropriateness in light of the McLeod Committee recommendations.

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