

Submission

By



To The

Inland Revenue Department

On The

**New Zealand's International Tax Review:
Developing an active income exemption
for controlled foreign companies**

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**NEW ZEALAND'S INTERNATIONAL TAX REVIEW
SUBMISSION BY BUSINESS NEW ZEALAND¹
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1. INTRODUCTION

- 1.1 Business New Zealand welcomes the opportunity to comment on New Zealand's International Tax Review: Developing an Active Income Exemption for Controlled Foreign Companies issues paper (referred to as 'the paper'), released by the Inland Revenue Department (IRD). Overall, while we believe that the changes in this area are a step in the right direction, there is also room for improvement to enhance New Zealand's ability to be a leader, rather than a follower when it comes to our exemption regime.

2. SUMMARY OF RECOMMENDATIONS

- 2.1 Business New Zealand makes the following **recommendations** with regard to New Zealand's International Tax Review paper, namely that:

- (a) ***Any revised recommendations for the active income exemption seek to ensure New Zealand's position is more competitive when compared with other jurisdictions (p.2);***
- (b) ***The guiding principle of maintaining a level of protection for the domestic tax base is given the lowest priority of the three principles outlined in the paper (p.3);***
- (c) ***The passive income threshold test value of less than 5% of their total gross income is increased to less than 10% (p.3);***
- (d) ***There is greater acknowledgement of alternative reporting standards other than IFRS and NZ IFRS when applying the active business test. (p.4);***
- (e) ***The threshold for total interest deductions of less than \$250,000 for a company is supported. (p.4);***
- (f) ***New Zealand group's debt-to-asset ratio is increased to 90% (p.5);***
- (g) ***An exemption is introduced on a transitional basis for two years, whereby companies defined as exempt under the financial reporting standards are also exempt from the proposed criteria outlined for the interest allocation rules (p.6);***
- (h) ***The grey list is retained (p.6);***

Notwithstanding that Business New Zealand wishes the grey list to be retained for compliance cost purposes, if the grey list is to be abolished then:

¹ Background information on Business New Zealand is attached in the appendix.

- (i) ***A transition period of two years is introduced for the grey list whereby businesses have an exact date in which the list will be formally abolished. (p.6).***

3. CONTEXT AND OVERVIEW

- 3.1 Business New Zealand has previously submitted on this issue, with our submission in March for *New Zealand's International Tax Review: A Direction for Change Discussion Document*. Our submission stated that we supported the direction of Government to allow a permanent exemption for offshore passive income. This involved the Government positively defining passive income, with active income defined by default as the remainder. We also submitted that administrative and compliance costs should be given high priority when assessing changes to New Zealand's international taxation regime. Lastly, the grey list should be retained. The current paper has taken some of our views into account, while others could be improved.
- 3.2 The paper states that much of what is discussed is largely of a very technical nature. Indeed, the mechanisms to ensure the successful introduction of an active income exemption for New Zealand are often complex, with changes in one area having various flow-on effects. Business New Zealand does not intend to submit on various technical aspects of the paper, as we wish to concentrate on a few areas that we believe will have the greatest effect on our wide membership base. However, we would expect the views of those with a substantial technical knowledge of these areas within the major chartered accounting firms, as well as the New Zealand Institute of Chartered Accountants (NZICA) are fully taken on board.
- 3.3 The paper states that the new international tax rules will...*"bring New Zealand into line with international norms and remove tax disincentives for businesses to locate in New Zealand and expand into other countries from a New Zealand base"*. While it is certainly worthwhile improving New Zealand's tax competitiveness so as to improve our position with other countries, improvement should be taken to the extent of making New Zealand more competitive than other countries to promote economic growth. In particular, the paper states that *"the government's commitment to economic transformation is at the heart of this package. In order to drive economic transformation, New Zealand must clearly distinguish itself in the global economy as a dynamic and competitive place in which to do business, improving incentives for businesses to invest and grow"*. We could not agree more with this statement, but believe the proposals only bring us to the level of regimes in countries we typically compare ourselves with, such as Australia and the USA. Many of the recommendations do not take New Zealand beyond this.

Recommendation: The any revised recommendations for the active income exemption seek to ensure New Zealand's position is more competitive when compared with other jurisdictions.

- 3.4 The May update discussion document took three guiding principles informing the proposed reforms, namely:

- The new rules should, as much as possible, allow firms to get on with their legitimate business activity;
- The new rules should, as much as possible, minimise compliance costs; and
- The new rules should maintain a level of protection for the domestic tax base.

Business New Zealand want a revised set of rules to permit firms to grow their business. Also, associated compliance costs should be minimised to ensure any deadweight loss to a firm remains low. However, we are unconvinced by the third principle of protection to the domestic tax base. If correctly administered and shown to be a competitive regime compared with other countries, an active income exemption has the potential to greatly boost the overall tax base in the medium-long term, thereby wiping out concerns about lowering the overall tax revenue base.

- 3.5 In our previous submission, we submitted that principles relating to protection of the tax base be given the lowest priority. We continue to take this view, as the long-term benefits of the exemption far out way a potential short-term revenue loss.

Recommendation: That the guiding principle of maintaining a level of protection for the domestic tax base is given the lowest priority of the three principles outlined in the paper.

4. ACTIVE BUSINESS TEST

- 4.1 The paper outlines various suggested frameworks for an active business test. While Business New Zealand approves of the general framework, there are a few areas that we would recommend amendments to.
- 4.2 Firstly, the paper states that “a CFC will be treated as primarily active, if, in simple terms, its passive income (including base company services income) is less than 5% of its total gross income”. The document also states that the 5% value is consistent with that used in Australia and the USA.
- 4.3 The government has stated that as the test is applied on a gross rather than a net basis, the 5% threshold should mean that a primarily active business should pass the test. However, given our views above regarding a competitive regime, rather than one that sets itself at the level of other countries, we recommend that the threshold value be increased to less than 10% so as to allow a higher proportion of businesses to be able to pass the test to ensure compliance costs are minimised.

Recommendation: That the passive income threshold test value of less than 5% of their total gross income is increased to less than 10%.

- 4.4 Chapter 3 of the paper also outlines the general approaches under the active business test. As part of the design of the test, the government believes the information to which the test is applied should have a level of consistency

across different entities to ensure the overall integrity and fairness of the new rules. Therefore, the paper states that taxpayers have an option to perform the test on the basis of:

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

4.5 Business NZ is pleased to see that the government has actively sought a choice in which taxpayers can perform the test that acknowledges not all businesses run the same type of financial standards. However, we believe the inference to IFRS is top heavy, as it may not be applicable to other smaller businesses that could be using existing business standards.

4.6 While there are no clear numbers around the extent with which businesses that wish to apply the active business test may or may not already use IFRS in some capacity, we would want to ensure the proposed regime is flexible enough to cover various standards that apply.

Recommendation: That there is greater acknowledgement of alternative reporting standards other than IFRS and NZ IFRS when applying the active business test.

5. INTEREST ALLOCATION RULES

5.1 The paper states that interest allocation rules will apply to a New Zealand company with CFCs unless it has:

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

In addition, companies required to comply with interest allocation rules will apportion their interest deductions if the New Zealand groups' debt percentage ratio is greater than 75%. While these rules are not unreasonable, we believe there is an opportunity for an enhancement of the rules to improve our competitiveness, especially for businesses looking to expand offshore.

5.2 Firstly, while we typically want thresholds and limits to be as advantageous as possible, we believe the amount of interest deductions at \$250,000 is a substantive amount, and we would certainly not want to see this threshold being lowered in any way.

Recommendation: That the threshold for total interest deductions of less than \$250,000 for a company is supported.

- 5.3 Secondly, we believe the 75% New Zealand group's debt-to-asset ratio of 75% could be increased to say 90%. Many SME firms only have the ability to borrow domestically, and the proposed changes could be a deterrent for them to generally grow and expand their operations offshore. Under the proposed 75% level, there is a possibility that many high growth firms would not avoid interest denials because of the level that they need to borrow.
- 5.4 It is obviously difficult to assess what a differential of 15 percentage points in the debt-to-asset ratio would make in terms of the extent of those caught in interest denials. However, the rules would obviously have an effect on business, with the primary one being the level of expansion capable by the business. While the document states the *"safe harbour rule is consistent with the government's desire not to unduly restrict New Zealand businesses from exploring offshore investment opportunities"*, we would advocate New Zealand putting the 'best foot forward' for business growth (both here and offshore), and believe an increase from 75% to 90% is justified.

Recommendation: That the New Zealand group's debt-to-asset ratio is increased to 90%.

Entities with a Small Amount of Interest Deduction

- 5.5 The chapter also discusses entities with a small amount of interest deductions, and refers to submissions on the December discussion document where submitters requested that small New Zealand entities should be exempt from the interest allocation rules, with the exemption based on a qualified exempt company that does not exceed two of the following three criteria:

- Turnover limit of less than \$2 million;
- Assets limit of less than \$1 million; and
- Five or fewer full time equivalent (FTE) employees.

In addition, companies with 25% or more overseas ownership do not have to file audited financial statements provided they qualify for the exempt companies or differential reporting systems. This involves a two-out-of-three test for:

- Annual turnover of less than \$20 million;
- Assets of less than \$10 million; and
- 50 or fewer FTE employees.

The paper points out that the exemption would not offer sufficient protection for the New Zealand tax base, as entities that are 'small' under the criteria above could still allocate an excessive proportion of their global interest costs to New Zealand.

- 5.6 As a compromise, Business New Zealand believes it would be worthwhile if an exemption is introduced on a transitional basis for two years, whereby companies exempt from the financial reporting standards are also exempt from the proposed criteria outlined for the interest allocation rules. We

believe a period of two years would enable those companies that currently meet the exemption criteria but would get caught under the new arrangements would have enough time to make the necessary changes. Also, any loss to the tax revenue base would only be for a set time period, rather than an ongoing tax revenue leakage that the government is concerned about.

Recommendation: That an exemption is introduced on a transitional basis for two years, whereby companies defined as exempt under the financial reporting standards are also exempt from the proposed criteria outlined for the interest allocation rules.

Abolition of the Grey List

5.7 As we have stated in previous submissions, Business New Zealand believes the continued existence of the grey list is an important step in striking the right balance in terms of flow-on effects that are due to the CFC regime changes. Business New Zealand has never opposed the establishment and continued increased membership of the grey list, because it represents countries that have a comparable tax system to that of New Zealand. As has been previously mentioned by the government during the active income exemption issue, the rationale for the current grey list exemption to the CFC rules was to reduce the compliance costs associated with a comprehensive accrual system.

5.8 Business New Zealand does not see the need to withdraw New Zealand's grey list. We also doubt whether there would be any significant tax base maintenance issues with the retention of grey list countries that would in turn mean the active/passive distinction would not need to be applied. There is no direct loss because the tax from passive income was not collected to begin with due to the grey list provisions.

Recommendation: That the grey list remains.

5.9 Notwithstanding our primary view that the grey lists remains, if the government continues to take the view that it should be fully abolished, we would at least require some form of transition period along the lines discussed in 5.6 above. Again, if a transition period of two years was allowed whereby businesses were made fully aware that the grey list countries were to be abolished in two years from a particular date, they would then have enough time to re-structure business operations, while at the same time alleviate concerns the government again has about the tax revenue base being eroded over time.

Recommendation: That a transition period of two years is introduced for the grey list whereby businesses have an exact date in which the list will be formally abolished.

APPENDIX

6. About Business New Zealand

- 6.1 Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 67-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.
- 6.2 In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.
- 6.3 Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.