# Submission

By

BusinessNZ

To The

# Inland Revenue Department

On The

# New Zealand's International Tax Review: A Direction for Change Discussion Document

**9 March 2007**

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**NEW ZEALAND'S INTERNATIONAL TAX REVIEW: A DIRECTION FOR CHANGE**
**SUBMISSION BY BUSINESS NEW ZEALAND[1]**
**9 MARCH 2007**

## 1. INTRODUCTION

1.1 Business New Zealand welcomes the opportunity to comment on New Zealand's International Tax Review (ITR) Discussion Document (referred to as 'the document'), released by the Inland Revenue Department (IRD). There are some key changes outlined in the document that we believe will represent a positive and practical step forward in aligning New Zealand's position with other countries, including some changes that are long overdue. We hope the end decisions made by the Government are done so to primarily increase New Zealand's competitiveness, and reduce compliance costs for businesses.

## 2. SUMMARY OF RECOMMENDATIONS

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

*(a)* ***The second option of allowing a permanent exemption for offshore active income, with no taxation of subsequent dividends, proceeds (p.5);***

*(b)* ***The Government positively define passive income, with active income defined by default as the remainder (p.5);***

*(c)* ***The Government take a confined view of what should be included under the definition of passive income (p.5);***

*(d)* ***The Government adopt the entity approach to attributing income of a CFC to its resident shareholders (p.6);***

*(e)* ***Administrative and compliance costs are given high priority when assessing changes to New Zealand's international taxation regime (p. 8);***

*(f)* ***The grey list remains (p.9);***

*(g)* ***The same tax treatment of the active/passive distinction be extended to foreign branches (p.9);***

*(h)* ***A proposed reduction in the non-resident withholding tax for non-portfolio dividends proceeds, while reductions in non-resident withholding tax for interest and royalties also be further considered by the Government (p.10); and***

*(i)* ***The Foreign Investment Tax Credit mechanism remains (p.10).***

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

## 3. BACKGROUND

3.1 The document represents the potential for a considerable change regarding New Zealand's international taxation position. As the discussion document outlines, the ITR complements other business taxation initiatives currently taking place, such as the Business Taxation Review. Both reviews have the ability to create both a significant taxation change within New Zealand, as well as providing offshore businesses with viewing New Zealand as a more attractive country in which to set up business. If implemented correctly, the outcome would surely lead to growth in the New Zealand economy.

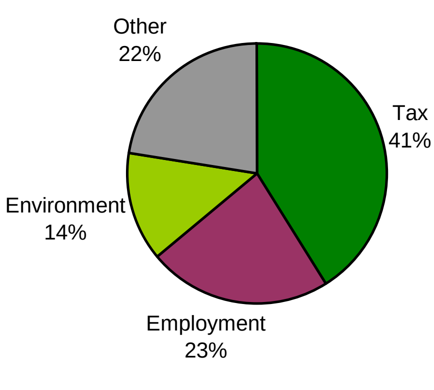
3.2 Business New Zealand does not intend to provide comments on all chapters in the document, as there are particular issues that involve considerable specialist knowledge. Instead, we wish to concentrate on two of the broader but significant issues; namely the introduction of an active/passive distinction for controlled foreign companies (CFC's), and the non-resident withholding tax (NRWT) rates applicable under New Zealand's Double Tax Agreements (DTAs).

## 4. COMPLIANCE COSTS AND RESULTS OF THE 2006 BUSINESS NEW ZEALAND/KPMG COMPLIANCE COST SURVEY

4.1 Many of the matters the document seeks submissions on come back to the issue of compliance costs on businesses. The Government's adherence to this issue is well justified, given the role tax compliance costs play when assessing the overall picture of compliance costs on businesses in New Zealand.

4.2 Business New Zealand conducts the annual Business NZ/KPMG Compliance Cost Survey[2] that has now been running for four years. Over that time, the survey consistently shows tax to be the leading compliance cost issue for all business, regardless of size. Figure 1 shows that in 2006, tax made up 41% of the total compliance costs for all business.

**Figure 1: Proportion of Total Compliance Costs (2006)**

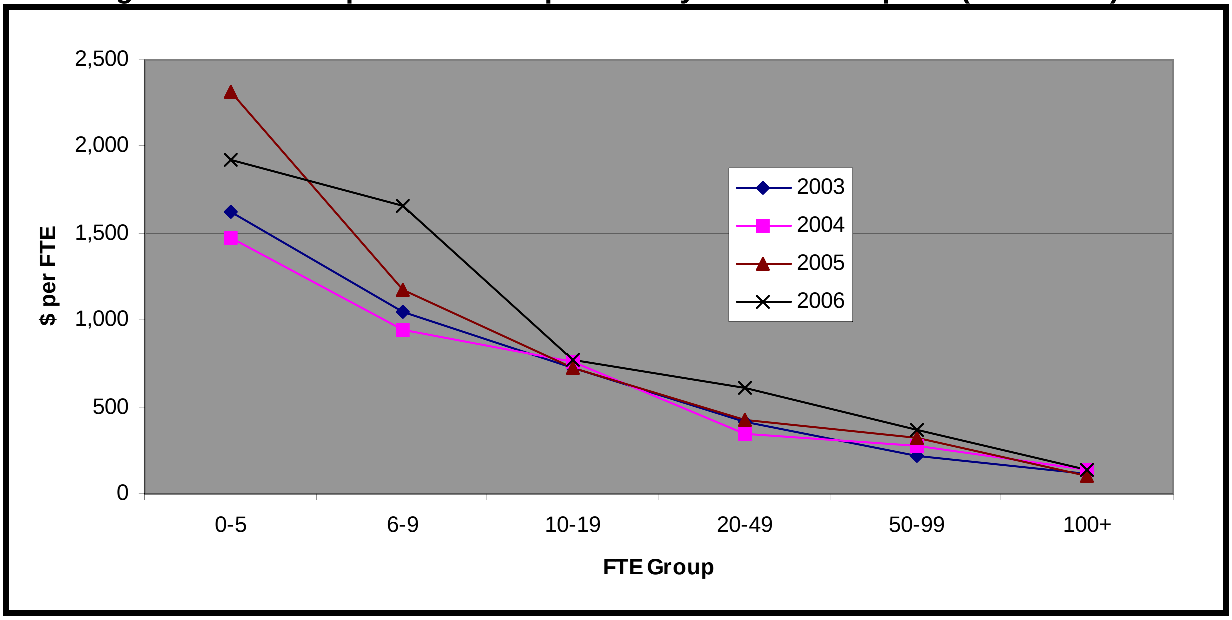



[2] For more information, visit http://www.businessnz.org.nz/surveys/504

4.3 Figure 2 shows that the cost of compliance falls disproportionately on smaller businesses, compared to larger businesses. With the inclusion of a higher number and proportion of smaller businesses in the survey for 2006, previous estimates of the cost of tax compliance for small businesses may have been under-estimated in previous years. Therefore, proposals by the Government to reduce the compliance load on business has a much greater effect on small businesses, which currently make up the bulk of firms in New Zealand.

4.4 The results clearly show that the day-to-day dealings of businesses with IRD and the taxation issues that are involved make a significant contribution to overall compliance costs, and improvement would be welcomed on many fronts. Business New Zealand would never argue that compliance in taxation, or indeed any other area, should be zero. There is always a natural level of compliance that businesses should adhere and comply with for the good of their business. However, the document deals with issues that have the potential to cause a significant 'compliance headache' for many businesses. Therefore, we believe compliance costs, as an issue, should be high on the list as a key-determining factor when assessing what changes should occur as part of the ITR.

**Figure 2: Tax Compliance Costs per FTE by Size of Enterprise (2003-2006)**




4.5 The following issues as outlined in the document have the potential to decrease or increase compliance costs on businesses, depending on the final decisions made by the Government.

## 5. INTRODUCTION OF AN ACTIVE/PASSIVE DISTINCTION

5.1 The document discusses the fact that New Zealand's rules for taxing offshore investment through CFC's have taken a different path compared to other countries over the last 20 years. While we have taxed offshore income as it accrues, with credits given for foreign taxes that have been paid, all other countries in the OECD have taken a different approach. Other countries have decided to either defer taxing offshore active income or exempt it all together.

The situation that has developed out of this is that New Zealand has followed a path that no one else now walks along, which has the potential to significantly impact New Zealand's competitiveness.

5.2 The last comprehensive review of New Zealand's tax system – The McLeod Tax Review of 2001 – summed the situation up well by noting that while the current system was conceptually attractive, its lack of conformity with international taxing norms has put pressure on the New Zealand tax system. Such divergence from international norms that is costing the country both in terms of competitiveness and economic gains, calls for a practical, rather than an ideological solution.

5.3 Figure 1 of the document that shows outbound FDI stock perhaps best highlights the telling gap New Zealand has developed in terms of poor outbound FDI compared with both Australia and the OECD average. Also, New Zealand was the only country in the OECD between 1990 and 2004 that experienced a drop in intensity of outbound FDI. This means that changes are certainly required to reverse the trend.

5.4 Therefore, Business New Zealand is pleased to see that the document proposes the introduction of an exemption for offshore active income of CFC's to steer New Zealand towards the international taxation path that other countries now follow.

5.5 The call for change has not been a recent phenomenon. Major accounting firms, institutes and organisations such as the New Zealand Institute of Chartered Accountants have historically called for an active/passive distinction. General reaction from tax experts to the document has generally been positive in that respect.

5.6 The document provides two possibilities for implementing the exemption:

1. Deferring taxation of active income earned offshore until the profits are repatriated, with a credit for foreign taxes paid; or

2. Allowing a permanent exemption for offshore active income, with no taxation of subsequent dividends.

5.7 Although the Tax Review in 2001 recommended a deferral, the Government has advocated an exemption system for what they deem to be offshore active income, which they believe would be simpler, and would go further towards improving incentives for New Zealand-based firms to take advantage of international opportunities. The exemption also has the advantage of removing any tax constraint of repatriating foreign profits back to New Zealand, whereas taxing dividends from foreign CFCs may deter companies repatriating those profits back to New Zealand.

5.8 In terms of the arguments put forward by the Government in favour of an exemption system, and looking at the way in which international trends have directed themselves, Business New Zealand agrees that the second option of a permanent exemption for offshore active income is the preferable way forward.

***Recommendation: That the second option of allowing a permanent exemption for offshore active income, with no taxation of subsequent dividends, proceeds.***

5.9 In terms of establishing exactly what is and is not included, the document provides the options of either positively defining passive income, or positively defining active income. Given many countries choose to define passive income positively, and that the overall benefits of doing so are stronger than positively defining active income as outlined in the document, Business New Zealand agrees that Government should positively define passive income, with active income defined by default as the remainder.

***Recommendation: That the Government positively define passive income, with active income defined by default as the remainder.***

5.10 If a positively defined passive income option is set as the way forward, then determining what will actually be classified as comprising passive income will be vital for definitional purposes. The document states that interest; rents, royalties and dividends are typically classified as passive income. Also, base company income[3] is often included within this group. Collectively, these components are typically regarded as 'tainted income'.

5.11 There are obvious precedents in terms of assessing what other countries have done in terms of defining what comprises tainted income as part of the passive income definition. These should help steer the Government towards a practical outcome. However, a wider net for inclusion of tainted income may lessen any possible increase in New Zealand's competitiveness. We may have effectively joined the club by making such changes, but any possible advantages could be curtailed.

5.12 While Business New Zealand has no firm view on what should or should not be included as passive income or alternatively tainted income, with the former it may be income that is from third party investment funds. For the later, there may be merit from only including income from avoidance type arrangements, as passive income taxed offshore and treated in a comparable way to New Zealand's system should not be included.

5.13 At the very least, we would want to see the Government take a more confined view of what they believe should be included under the definition of passive income.

***Recommendation: That the Government take a confined view of what should be included under the definition of passive income.***

5.14 In addition to the definition of passive income, there are other factors as outlined in the document that need consideration.

[3] Income derived by a CFC from selling property or providing services on behalf of the group of companies to shift domestic income offshore and avoid or defer domestic tax.

**The Transactional and Entity Approaches**

5.15 The Government has outlined two possibilities to attribute the income of a CFC to its resident shareholders:

1. *Transactional approac*h: examines each item of income derived by a CFC to determine whether it produces tainted income or non-tainted income. Accordingly, different income streams of the CFC attract different treatment depending upon the category; or

2. *Entity approach*: looks at whether the company is active or passive. Once categorised, then all of the income of the company is taxed in the corresponding manner, regardless of the nature of the income derived.

5.16 The document provides a thorough outline of the advantages and disadvantages of both approaches, which underlines the fact that if either approach is introduced, the design and details of how the approach will be implemented will be critical to whether it is successful or otherwise.

5.17 Overall, Business New Zealand is not in a position to provide detailed feedback in terms of the specific framework that would be best for the approach chosen. However, the detailed explanation in the document and feedback from members leads us to conclude that the entity approach would be the best way forward, especially when the approach is technically simpler than the transactional approach, which significantly helps lower compliance and administrative costs for business. Also, we believe the test for whether a business is deemed to be either 'passive' or 'active' should be simple, such as if the proportion of its passive income versus total income is less than say 10%.

***Recommendation: That the Government adopt the entity approach to attributing income of a CFC to its resident shareholder.***

**Base Maintenance Issues**

5.18 One of the main caveats of the passive income approach is that the Government has identified a number of base maintenance provisions to ensure that the active income exemption does not result in an inappropriate reduction of New Zealand's domestic taxation base. These include amendments to New Zealand's thin capitalisation and interest allocation rules, so that they apply to both foreign owned companies and locally owned companies with offshore investments. Also, lowering the thin capitalisation 'safe harbour' rates, and excluding investment in CFCs from the definition of assets for thin capitalisation purposes.

5.19 While we acknowledge to an extent the view stated in the document that decisions to relax rules in one area implies that other features would need to be correspondingly tighter, they should not be so much so that any net economic gains from change are wiped out or severely lessened. If other changes are not balanced, they may create significant tax disincentives in their own right. After all, the changes implemented would simply put New Zealand on an equal footing with countries it typically compares itself with. It does not propose changes that would make New Zealand more competitive in relation to other countries. Also, New Zealand's transfer pricing rules should be sufficient protection for the New Zealand tax base as they ensure that profits cannot be transferred from New Zealand companies to foreign CFCs.

5.20 For example, changes to the thin capitalisation rules would probably be required as an active/passive test for attribution of CFC income is introduced, but these should be a balanced set of changes, which are specifically targeted (i.e. an assets threshold exemption that is currently the case in Australia). This would provide a compliance cost saving to New Zealand owned companies that have only minimal offshore investment in relation to their total value.

5.21 One of the benefits from the active/passive distinction is that there is likely to be a reduction in compliance costs, as businesses with active investments would no longer have to comply with the CFC rules. This represents a tangible way in which Government can clearly lessen costs for business, while at the same time boosting our economic competitiveness.

5.22 Changes to New Zealand's international tax position will certainly bring about an adjustment to New Zealand's tax base. However, there is a consistent trend in the document of a significant erosion of the tax base with some measures taking place. However, this view seems to be very much placed on the static view of tax changes, rather than the dynamic view of changes leading to further business activity, and therefore increased revenue for the Government.

5.23 We note that page 18 of the document does examine lessons from international experience, but these are only from the perspective of design and implementation of tax rules that distinguish between active and passive income. It does not provide information on the consequences to the tax base. However, in some way the document does answer this question whereby in chapter 2 it examines implications for GDP growth and labour productivity. The document states, *"the government believes that there is no strong reason to expect that measures to liberalise the tax treatment of outbound CFC income would reduce capital and productivity in New Zealand. Indeed, to the extent that they provide incentives for firms to locate or stay in New Zealand and to expand to exploit opportunities offshore, they are likely to have the opposite effect".* We view this as an understanding by the Government that changes to New Zealand's taxation system that initially has the potential to initially decrease tax revenue can eventually increase the size of the tax revenue base, via increased economic activity.

5.24 If the chosen proposals for protection of the tax base by the Government are at the extreme end of those outlined in the document, there is the strong possibility for significant additional compliance costs being placed on businesses. While we would agree that it would be somewhat difficult to attempt to ascertain exactly what the effect to the tax base would be in terms of the changes outlined, New Zealand is in a unique position to examine what was the flow on effects in other countries that instigated similar changes, considering New Zealand is the last country in the OECD to consider such changes. As part of the review, we would expect the Government to investigate the flow on effects from changes to the international taxation base in terms of changes to the tax base over the short-medium term.

5.25 The document also states *"decisions will be a pragmatic compromise between the policy goals of the new approach, protecting the New Zealand revenue base and keeping the administrative and compliance burden to a minimum".* This is a laudable objective, and one in which Business New Zealand often seeks the Government to arrive at in terms of being both reasonable and pragmatic. However, it may be the case that there are too many competing objectives for any meaningful change. Therefore, it is practical that some objectives have to be favoured more over others. Obviously, the primary outcome should be the levelling of the playing field so that our tax regime for CFC treatment matches that of other countries, but as an outcome of that, we would want to see administrative and compliance costs minimised as much as possible.

5.26 Therefore, in addition to the findings of the annual Business NZ/KPMG Compliance Cost Survey discussed in Section 4 above, we submit that administrative and compliance cost matters are given high priority when assessing changes to New Zealand's international tax regime.

***Recommendation: That administrative and compliance costs are given high priority when assessing changes to New Zealand's international tax regime.***

## 6. IMPLICATIONS FOR THE TAXATION OF DIVIDENDS AND OTHER INTERNATIONAL TAX RULES

### Abolition of the Grey List

6.1 The last piece of the revenue base maintenance puzzle is reform of the grey list. This is a list of 8 countries considered to have a tax system similar to New Zealand. Already, income from grey list companies is exempt from accrual taxation. 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 the document points out, the rationale for the current grey list exemption to the CFC rules was to reduce the compliance costs associated with a comprehensive accrual system.

6.2 Business New Zealand does not see the need to withdraw New Zealand's grey list. As paragraph 7.15 of the document points out, there is already provision for relief of passive income depending on an existence of some similar grey list regime in other countries, such as Australia. In addition, the McLeod Tax Report in 2001 also strongly recommended the retention of the grey list for passive income, again due to the reduction in compliance and administrative burdens.

6.3 Overall, we 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, and the existing provisions in the grey list countries would most likely mean any passive income diverted in the grey list countries would be caught by the effective tax rates in those countries.

***Recommendation: That the grey list remains.***

**Foreign Branches**

6.4 As stated in the document, currently investments in CFCs and in foreign branches are both taxed on accrual, so a move towards an active/passive distinction for CFCs may also have implications for the way foreign branches are taxed.

6.5 While the way in which branches are taxed can differ between countries, we agree with the views expressed in the document that a key consideration should be whether to provide the same tax treatment to active branches so that New Zealand residents are not influenced by tax considerations in deciding whether to operate in a foreign jurisdiction through a subsidiary or a branch. Therefore, Business New Zealand believes as neutral stance should be taken, whereby the same tax treatment arising from the changes made as part of this review also extent to active branches.

***Recommendation: That the same tax treatment of the active/passive distinction be extended to foreign branches.***

## 7. NON-RESIDENT WITHHOLDING TAX (NRWT) RATES

7.1 The document discusses the possibility of lowering non-resident withholding tax (NRWT) rates applicable to dividends, interest and royalties under both domestic law and DTAs. However, while all three applications of NRWT are discussed, only those relating to dividends, and within that non-portfolio dividends appear to be serious considered for change by the Government.

7.2 The reason as outlined in the document for the Government appearing to only seriously consider a decrease in NRWT for non-portfolio dividends is that there is currently an international trend to reduce such rates, including Australia, the USA and the UK, which New Zealand needs to follow. However, the Government sees changes in relation to interest and royalties as having a too higher fiscal cost, along with possible avoidance implications with the former.

7.3 Business New Zealand agrees that changes regarding NRWT would increase New Zealand's attractiveness as a destination for foreign investment by reducing headline rates of tax and bringing New Zealand more closely into line with international norms. While we fully support the reduction in NRWT tax rates for DTAs, we consider a more full package of change regarding NWRT would provide better economic gains for New Zealand.

7.4 The document rightly points out that New Zealand is a net importer of capital and intellectual property. Reducing interest or royalties in terms of NRWT would bring about revenue loss, with the size of loss dependent on the decrease in the rates, and to some extent on the number of treaties affected. However, we again submit that the Government is not viewing the larger picture of what New Zealand's position should be on the international stage in terms of increasing the development in areas such as intellectual property. While effects to the taxation revenue base should be considered, they should not be the overriding factor in determining changes in policy, especially when only a static view of fiscal loss has been examined, rather than a wider view of the gains to the economy (as discussed in Section 5 above). As New Zealand companies generate intellectual property within the country and then sell it offshore, a lower NRWT rate for royalties under DTAs would have significant benefits, and no doubt spur further innovation to sell to the rest of the world.

7.5 Therefore, Business New Zealand submits that there is merit in extending the reduction in the NRWT rate applying to at least royalties, on top of that for non-portfolio dividends.

***Recommendation: That a proposed reduction in the non-resident withholding tax for non-portfolio dividends proceeds, while reductions in non-resident withholding tax for interest and royalties also be further considered by the Government.***

**Foreign Investor Tax Credit**

7.6 In relation to the issue of a reduction in NRWT, the document discusses whether the Foreign Investor Tax Credit (FITC) mechanism should remain within New Zealand's tax system. In short, the document defines FITC as a mechanism that reduces company tax on profits distributed as dividends to non-residents so that the total New Zealand tax impost (company tax and NRWT) does not exceed the normal company rate.

7.7 The document outlines potential advantages and disadvantages of removing the FITC mechanism. However, Business New Zealand takes the view that FITC adds a significant benefit, especially to non-resident portfolio investors. Therefore, removing FITC will reduce the returns many non-residents obtain from investing in New Zealand companies, which we believe would be an adverse outcome for future growth of the New Zealand economy.

7.8 Therefore, Business New Zealand does not support the removal of the FITC mechanism.

***Recommendation: That the Foreign Investment Tax Credit mechanism remains.***

# APPENDIX

## 8. About Business New Zealand

8.1 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 63-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.

8.2 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.

8.3 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.