



***“A COMPARATIVE ANALYSIS OF NEW ZEALAND
AND AUSTRALIAN OFFSHORE INVESTMENT
RULES”***

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A dissertation submitted to Auckland University of Technology in
partial fulfillment of the requirements for the degree of Master of

Business (MBus)

2008

School of Business

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II. ATTESTATION OF AUTHORSHIP

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma or a university or other institution of higher learning.

III. ACKNOWLEDGEMENT

Considerable support is required to bring a project of this scope to completion. Therefore, I would like to thank numerous people who have in one way or another helped me to write this dissertation.

I would like to express my gratitude to my mentor, Mr Nigel Smith who provided ongoing support and valuable feedback during the progress of the paper. I was inspired to choose this area of tax as the topic of my paper, after completing the International Tax courses led by Mr Smith.

I would like to express my appreciation to Dr Chris Ohms who taught the course on Tax Avoidance which provided me with good insight into the tax avoidance aspects of this paper.

I would also like to express my appreciation to the following staff at the Inland Revenue Department for sharing their knowledge and resource materials during the course of my research:

Geraldine Ryan (CFC and FIF)

Robyn Laurie (FIF)

Lastly, I would like to thank Denis Moodley, Ranjit Singh, Aradhna Lal and Jeni Vaughan for providing peer support and accompany during the course of my study.

IV. ABSTRACT

The deregulation of major world economies led to increased globalisation of enterprises which provided opportunities for New Zealand and Australian taxpayers to expand or move their businesses offshore. The globalisation brought niche opportunities for businesses to develop profitable offshore operations. The growth in offshore investments triggered the problems associated with the erosion of the New Zealand and Australian tax base. The risk in New Zealand was identified by the Labour led Government in the early 1980's; when New Zealand entities began investing in tax haven countries to take advantage of lower tax rates in these countries. As a result in late 1980's, New Zealand and Australia introduced offshore investment rules.

The reasons for the introductions of the offshore investment rules by the two countries were similar, but the rules differed in a number of ways. One of the main differences was that New Zealand did not differentiate between active and passive activities. On the other hand, the Australian tax rules exempt active business activities carried out offshore. Recently, the New Zealand Government announced that it is reviewing the Controlled Foreign Company (CFC) rules and like Australia, New Zealand CFC rules would exempt active income from tax; and only passive income would attract income tax.

This dissertation explores and compares the development of offshore investment rules in Australia and New Zealand. The exploration of the offshore investment rules involves a comparison of the history, economic theories, and tax avoidance possibilities. The main area of focus of this study is the CFC and Foreign Investment Fund (FIF) rules.

V. INTRODUCTION

The New Zealand CFC and FIF regimes and the Australian CFC, FIF and Transferor trust measures were originally introduced to prevent New Zealand and Australian taxpayers from using tax havens to defer their tax obligations.

Over the years, the policy intention behind these rules has changed from being anti tax haven or anti tax deferral measures to the promotion of growth in active business investments abroad. The main economic policies behind these measures are not to tax New Zealand and Australian residents on their true economic income. These rules apply accruals taxation to income that are earned overseas and which are not repatriated back to the respective home countries. There are certain exemptions to the rules which are discussed in the body of the report.

Historically, New Zealand and Australia have very similar economic and social environments and over the years these two countries have become very important trading partners to each other. Therefore it is not surprising that both countries introduced anti tax haven measures during similar time periods (late 1980's to early 1990's) with the policy statements behind the introduction of the rules being very similar.

Over the years, both countries have reformed their respective offshore investment rules to better fit the changing economic environment. Globalisation also had huge impact on the evolution of the offshore investment rules in recent times. As a result, both Australian and New Zealand governments have been carrying out major overhauls of their offshore investment rules¹. The changes have been as a means to ensuring the competitiveness of their countries in the international capital markets. In May 2006, the New Zealand Government tabled the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill in Parliament. In the same month, the Australian treasury announced reforms to its international tax regime, which included simplification of the Australian CFC rules. In the 2007 budget, the New Zealand government announced that further changes will be made to the New Zealand international tax rules.

¹ Policy Advise Division of Inland Revenue, 23 Feb 2007;
www.taxboard.gov.au.content/rita_report/index.asp

The main purpose of this report is to consider the historical development of the offshore investment rules of the two countries, critically assess the current rules and draw conclusion as to the similarities and differences of the rules. The research encompasses the following major areas in relation to the rules:

- Historical development of the regime
- The purpose and effect of the regime from Australian and New Zealand context
- Recent Developments in both countries
- The effects of International tax avoidance.
- A comparison of the rules between Australia and New Zealand

VI. HISTORY AND PRINCIPLES

A. New Zealand

1. The deregulation years

In 1962, the United States was the first country to introduce CFC rules. The globalization of the world economy in the mid 1980's led to other countries, including New Zealand, adopting a comprehensive offshore investment rules.

The events that led to the introduction of the offshore investment rules in New Zealand commenced in 1982. Until then, tight foreign exchange controls were in place and very limited amount of funds were able to leave New Zealand, making it very difficult for New Zealand residents to invest offshore. Very strict exchange controls meant that consent had to be obtained in normal circumstances in order for any offshore investment to be made. The regulatory requirements for a consent for offshore investment had a practical effect of limiting the amount of investment by New Zealanders outside New Zealand and, as a result, had the effect of limiting the extent to which New Zealanders might seek to invest offshore as a means of reducing their income tax liability.

The deregulation of the New Zealand economy began in 1982 and in December 1984 the Labour led government eased exchange control regulations allowing New Zealand residents to invest overseas. This resulted in increased overseas investment. However the easing of the exchange control regulations were not the only reason for the increased overseas investment. There were other factors that fueled the overseas investment by New Zealand tax residents. These were:

- In 1983, Australia and New Zealand signed the Australia - New Zealand Closer Economic Relations Trade Agreement (CER).

- There was an increase in immigration from Asia/Pacific region which opened up new trade markets in these regions. This increased the flow of financial capital and human capital between these regions.
- In 1985, The New Zealand currency was allowed to float freely against foreign currencies.
- In 1986, the company tax rate rose from 45% to 48%. Then in late 1988, the company tax rate was reduced to 33%.

By 1990, foreign direct investment by New Zealand tax residents reached \$4 billion. During 1990-1991, the proportion of investments in tax havens (Cook Islands, the Netherlands, and Cayman Islands) rose to 55% and then 73% in the following two years. Investments in these tax haven countries were driven by tax consideration. The New Zealand taxpayers were increasingly using the deregulation of the economy as an opportunity to invest offshore in a way which minimised New Zealand taxes. In cases of equity investment, although dividends were subject to New Zealand income tax, it was relatively easy for New Zealand investors to invest in shares in a company (or unit trust) which did not distribute any income. The investors benefited through growth in value of the shares, which could potentially be realized as a tax free capital gain. In addition, in the case of companies, dividends derived were exempt from income tax.

Regardless of the ability to avoid income tax in respect of gains derived through investment in foreign shares, or similar types of investment, it was possible to achieve substantial benefits simply through deferring the time at which income tax was paid by investing in companies (or trusts) which only made distributions after a significant number of years of deferral. During the 1980s high inflation meant that there was a considerable advantage to be obtained through deferring the payment of income tax.

2. The anti haven measures

It was recognized during late 1980's that the New Zealand tax base was being significantly eroded by tax efficient investment structures and accordingly the Government appointed a consultative committee to consider the position and recommend changes. On 18 June 1987, the Labour led Government announced that they would be introducing anti-tax haven measures.² The reasons provided by the Minister of Finance, Roger Douglas in his preface were as follows:³

"New Zealand residents are subject to tax on their worldwide income. However, some residents, notably larger companies and wealthy individuals, are avoiding tax on their foreign income, some of which is income that is diverted from New Zealand. This places an unfair tax burden on others and undermines the integrity of the tax system"

...

"...the anti-tax haven measures would be the first step towards a comprehensive tax regime designed to combat international tax avoidance"

In his preface, the Minister of Finance outlined the main elements of the regime. These were:

- The basis of taxation would be "branch equivalent" basis and "comparative value" basis;
- There were no detailed rules in relation to control;
- Distinction between tainted and non-tainted income were eliminated;
- Foreign income earned through any non-resident entity would be taxable (there is no grey or black list countries);
- De-minimis rules were to be introduced for small shareholding in non-resident companies;
- Foreign income from non-resident trusts would be consistent to the income earned through non-resident companies.

Consequently, during the periods 1988 to 1993, New Zealand saw the formulation of complex offshore investment rules namely Controlled Foreign Companies (CFC) and

² Douglas R, Consultative Document On International Tax Reform, December 1987.

³ Ibid

Foreign Investment Funds (FIF) rules to prevent diversion of income to tax havens. At the same time the foreign dividend withholding payment (FDWP) and foreign unit trust rules were introduced.

The CFC and FIF rules were introduced with effect from 1 April 1988⁴. Prior to the implementation of the FIF and CFC rules, income from non-resident companies was exempt from tax on repatriation to New Zealand by virtue of the inter-corporate dividend exemption provided by section 63 of the Income Tax Act 1976. However, the rules relating to FIF investments were substantially changed and the commencement date applied from 1 April 1993.

B. Australia

1. The early years

In the early 1970's, Australia taxed income such as dividends, interests and royalties on a territorial basis. Foreign sources of income earned by Australian residents were not subject to Australian tax as long as it was subject to foreign tax.⁵ Therefore dividends received by Australian companies from offshore were effectively exempt from Australian tax. In 1963 the Downing Inquiry reported on the reform of the Australian tax system⁶ and in 1974 and 1975 the Asprey Committee recommended elimination of the exemption of foreign source income and introduction of a full tax credit system.⁷ In 1985 the Australian government announced the introduction of a foreign tax credit system effective from 1 July 1987.⁸

Like New Zealand, in 1983, Australia abolished exchange controls. The policy was designed to facilitate foreign investment in Australian companies. The aim of the policy was to encourage investment of capital in areas where it was most productive. From 1 July

⁴ Controlled Foreign Companies – Tax information Bulletin Appendix, Tax Information Bulletin, Volume 2 No 3 October 1990.

⁵ Income Tax Assessment Act 1936, section 23(q)

⁶ Arnold Brian J, *Future Directions of International Tax Reform*, Australian Tax Forum, Vol 5, No4, 1988 p 455; R,I Downing et al., *Taxation of Australia; Agenda for Reform* (Parkville: Melbourne University Press, 1964).

⁷ Arnold Brian J, *Future Directions of International Tax Reform*, Australian Tax Forum, Vol 5, No4, 1988 p 455

⁸ Ibid, p 456

1990, Australia introduced the *Cash Transactions Report Act 1988* under which import or export of \$5,000 or more cash had to be reported to the Cash Transactions Report Agency. While this may have adequately dealt with direct transfers of funds to tax havens, it could not deal with indirect transfers.⁹

Historically three principle methods were available in Australia for taxing foreign source income, each of which had the objective of reducing the double taxation of such income. These were:¹⁰

- The exemption method whereby no tax was imposed in the home country of the investor. This was essentially the method followed by Australia until 1987;
- The credit method in which the home country taxed the foreign income of the resident investor, gross of any foreign tax, at the rate applicable in the home country, but provided credit for foreign taxes paid;
- The deduction method whereby the home country taxed the net (of foreign taxes) foreign income at the rate applicable in the home country. This is equivalent to providing a deduction for foreign taxes paid.

With both the credit and deduction methods, tax liability to the home country occurred when the income was remitted to the home country. This resulted in two aspects of deferral advantage to the taxpayer. If the foreign country had a tax rate less than the Australian corporate tax rate, a deferral advantage was available under the foreign tax credit system. The second deferral opportunity was between the resident company and the individual taxpayer. The longer the deferral of income to Australia and the ultimate shareholder, the lower the effective tax rates (taking into account use of money interest).

Transfer pricing measures were already in place and could have been used to limit tax haven abuse. However transfer pricing adjustments could only be made in relation to non-arms length transactions and could not cover all types of tax haven abuses – especially arms length transfer of equity or indirect transfer of investments to a tax haven.

⁹ Burns L, *Controlled Foreign Companies: Taxation of Foreign Source Income*, Longman Professional, 1992, p 8

¹⁰ Anderson P, *Economic Policy Considerations in the Taxation of Foreign Source Income*, Australian Tax Forum journal of taxation policy, law reform, Vol 5 No 4 1988

2. Australian anti haven measures

The treasurer, Mr. Keating as part of the Economic statement ('the May Economic Statement') on 25 May 1988 announced proposals to counter use of tax havens by Australian residents. The proposal envisaged taxation of certain foreign sourced income on an accrual basis.¹¹ The proposed changes were described in *The Taxation of Foreign Source Income: A Consultative Document*, released by the Treasury on 25 May 1988.¹² The proposals consisted of two essential elements:¹³

- Taxation on an accrual basis of the income of non-resident entities (companies and trusts) in which Australian residents had interests, where the income had been derived in a low tax country or had benefited from a designated tax concession in another country, and
- An exemption from the foreign tax credit system for dividends received by companies from direct investments (that is, those involving 10 percent or greater voting interest) in non-resident companies or from other investments which have been subject to accruals taxation.

The Australian CFC rules were introduced with effect from 1 July 1990. At that time Australia was the eighth country to introduce such rules. Other countries that had introduced CFC rules prior to Australia were: Canada, France, Germany, Japan, New Zealand, the UK and the US.¹⁴ From this it seems that Australia would have been influenced by these major trading partners to introduce the anti-avoidance measures.

The new rules in relation to FIFs were proposed in the Information Paper dated 2 April 1992. The new FIF rules were to come into force on 2 April 1992.¹⁵ However on 9 October

¹¹ Fraser P, *Australian Tax Haven Measures*, Australian Tax Forum, Vol 6, No 1, 1989

¹² *Taxation of Foreign Source Income: A Consultative Document (forming part of the Economic Statement, May 1988)* (Canberra: AGPS, 1988)

¹³ See 10 above, p 410

¹⁴ Burns L, *Reform of Australia's CFC rules*, Australian Tax Forum, Vol 21, No 1, 2006

¹⁵ Gotterson A, *Interaction of the CFC and FIF Rules*, The CCH Journal of Australian Taxation, Vol 4 Issue 3, Jun/Jul 1992, p 73

1992 the Australian Government announced that the Income Tax Assessment Amendment (Foreign Investment) Bill 1992 was withdrawn and a new Foreign Investment Fund Bill was to be introduced in Parliament during November 1992.¹⁶ The amended Bill was passed by the Australian Parliament and it received Royal Assent on 15 December 1992.¹⁷

¹⁶ Gotterson A, *Interaction of the CFC and FIF Rules – A further development*, The CCH Journal of Australian Taxation, Vol 4 Issue 5 Oct/Nov 1992, p 75

¹⁷ Gotterson A, *Interaction of the CFC and FIF Rules*, The CCH Journal of Australian Taxation, Vol 5, Issue 1, Feb/Mar 199, p 75

VII. THE ECONOMIC POLICIES POINT OF VIEW

A. New Zealand's Economic Perspective

1. Tax Neutrality

The New Zealand international tax regime reforms were implemented to reduce the domestic cost of capital, reduce opportunities for tax avoidance and deferral of taxes, and improve neutrality for residents between investing home and offshore. The key guiding principles for the tax reforms were to tax foreign and domestically sourced income as equitably as possible in order to promote efficient allocation of investments.

A neutral tax system is important for an efficient and effective economy because it maximises the taxpayer's freedom of choice. Freedom is an ultimate value, and a tax system in which the taxpayer enjoys more freedom for decision making on this ground alone is considered preferable to the one on which the freedom is less.¹⁸ A neutral tax system has the additional advantage of minimising the economic loss due to any given level of taxation because it minimises the misallocation of resources caused by the interference of the fisc in the market process. A neutral tax system is arguably fairer as between taxpayers than a discriminatory system which favours one taxpayer relative to another.¹⁹

A tax system should be neutral between domestic and offshore investment. In order to achieve the best return on investment, a taxpayer should have a freedom to invest anywhere in the world without being influenced by tax consequences. David Dunbar in one of his articles described tax neutrality as follows:²⁰

“...tax system should be neutral between domestic and offshore investment. This is commonly known as the *capital export neutrality* (CEN) principle. Secondly there should be neutrality between

¹⁸ Bracewell-Milnes, *A Liberal Tax Policy: Tax Neutrality and Freedom of Choice*, at www.thedegree.org/econ014.pdf

¹⁹ Ibid

²⁰ Sawyer A, *Taxation Issues in the Twenty-First Century*, N.Z. : Centre for Commercial and Corporate Law, University of Canterbury, 2006, Article by Dunbar D, *Offshore Investment By New Zealand Residents: Can A More Neutral Tax Regime Be Developed?*, p 147.

domestic and foreign investors. This principle is known as *capital import neutrality* (CIN). Thirdly, the international tax system should allocate the total revenue from foreign investment between the countries concerned in a manner that is appropriate. This is known as *inter-national equity* (INE). Finally, there is the concept of *national welfare maximization* (NWM) which provides that foreign taxes are treated as a cost of doing business and therefore foreign taxes are treated as a deduction from gross income. There are no credits for the foreign tax.”

2. *Welfare maximisation argument and capital Import*

If a neutral tax system is important for a healthy functioning of New Zealand economy, then why does the government discriminate against New Zealand investors investing offshore compared to offshore investors investing in New Zealand? The reasons are explained in the Treasury discussion documents.²¹

The main points from the discussion documents are:

- The Government’s objectives are to shift New Zealand economy from slow growth to a high growth track and this requires investments from overseas.
- The New Zealand resident’s offshore investments should be designed to ensure highest returns on investments to all New Zealanders.
- Taxes on non-residents should be designed to raise revenue without raising interest rates or barriers to the foreign funding for investment that New Zealand needs to grow and without risking serious erosion of the New Zealand skills base. New Zealand needs to be an attractive destination for quality investment: investment that will improve New Zealand skill base, raise productivity and encourage an outward looking business focus.

Therefore, from the above statements made by the Minister of Finance, it is noted that economic policies override the neutrality of the tax system by having lower taxes (in

²¹ Richardson R & Creech W, *Taxing Income Across International Borders – A Policy Framework*, The Treasury, 30 July 1991, p 4

the form of NRWT) on non-resident investors. A statement from the Treasury document in relation to taxation of non residents read:²²

“Tax treaties often involve a system of foreign tax credits. That is, in return for both parties agreeing to impose lower rates of NRWT, they agree to give a credit for each other’s NRWT against the taxes they impose on their own residents’ foreign-source income. Such credits allow New Zealand to raise revenue from NRWT (albeit at a lower rate) without increasing the cost of capital.”

It is also noted from the Treasury documents that New Zealand residents foreign sourced income is taxed on the principle of National Welfare Maximization (NWM). However, to meet the NWM principle, the other principles which are Capital Export Neutrality (CEN), Capital Import Neutrality (CIN) and Inter-national Equity (INE) are breached. This has been explained as a “See Saw Principle”²³ where the principle has been explained as:²⁴

“... welfare losses from a tax can, in some circumstances, be offset by the imposition of another tax. In this case, part of the welfare losses accruing from a suboptimal tax on capital imports can be offset by imposing a “suboptimal” tax on capital exports, and vice versa”

Economists have described the NWM by taxing on a seesaw basis for a small open economy like New Zealand as follows:²⁵

“...when the total wealth is fixed, an extra dollar of capital exports reduced the domestic capital stock by one dollar, so that the opportunity cost of capital exports is simply the marginal product of capital. In this situation, the optimal capital export tax for a small economy occurs when the social return from capital exports equals the marginal product of capital (i.e. zero deadweight losses). This is achieved when residents are taxed on their offshore income, net of foreign taxes, at the same rate as they are taxed on their domestic income. Similarly, zero deadweight losses on capital imports occur when capital imports are taxed at a zero rate (assuming no foreign tax credits).”

²² Ibid, p 7.

²³ Slemrod J, Hansen C, Procter R, “*The Seesaw Principle in International Tax Policy*”, (1994) NBER Working Paper No 4867, at <http://ideas.repec.org/p/nbr/nberwo/4867.html>

²⁴ Ibid, p 2

²⁵ Ibid, p 4

Due to the Government policy of attracting offshore investments, since the late 1980's taxes on inwards investment has reduced significantly. The main driver behind the reduction of taxing inwards direct investment has been that foreign investors require a rate of return higher than what they could get in their home country or alternative country, after paying all outgoings which includes taxes.

In order to attract foreign investment into New Zealand, the foreign investor is taxed at a lower rate than a New Zealand taxpayer. This shifted the burden of the tax to New Zealand residents.

The offshore investment policies of New Zealand favors capital import by imposing minimal tax on foreigners New Zealand sourced income. On the other hand it discourages capital export by taxing offshore investments on an accrual basis and placing limitations on overseas tax credits.

Therefore during the late 1980's and early 1990's, New Zealand implemented a rift of anti-avoidance and anti-deferral measures which included transfer pricing, thin capitalisation, CFC and FIF rules. In relation to the CFC and FIF New Zealand applied somewhat stricter rules than the other OECD countries. The New Zealand CFC rules are broader than that of other countries in the sense that they include all kinds of economic activity and did not differentiate between "passive" or "active" income (until recently²⁶). By contrast, most other countries apply CFC rules only to "passive" investment income and a limited class of "active" business investments.

Furthermore New Zealand applies the CFC and FIF regimes to many more jurisdictions than most other countries, whereas most other OECD countries restrict the rules to classified tax havens.²⁷

It is interesting to note that recently the Labour led New Zealand government is changing its long standing economic stance in relation to offshore investments. A media

²⁶ Hon De Michael Cullen and Hon Peter Dunn, *New Zealand's International Tax Review: An Update – Developing an active income exemption*, Inland Revenue Policy Advice Division and New Zealand Treasury, October 2007.

²⁷ New Zealand imposes offshore investment rules to all countries except the listed "Grey List" countries.

release by Hon Trevor Mallard (Minister of Economic Development) dated 30 August 2007²⁸ noted as follows:

“The Labour-led government is committed to working with business to transform this economy into one that is both innovative and sustainable, and one that generates higher incomes for New Zealanders. To do this we need to develop globally competitive firms as the small New Zealand market is just not enough. Our inward investment rates are okay but our outward investment rates need a boost. Other countries are also starting to develop explicit outward investment programmes in recognition of the benefits they can generate back home.”

Currently the government is intending further reforms to the international accruals rules by introducing active income exemptions for offshore investments which promotes the above intentions of Mr Mallard and the Government.

B. Australian Economic Policies (Point of View)

1. The economic policies (purpose)

During late 1980's two strongly different views were held in relation to the appropriate tax treatment of foreign sourced income. One group stressed the need to tax all income at the same rate for reasons both of equity and of efficient resource allocation – the capital export neutrality argument. The other group stressed the need to create a competitive environment for Australian firms investing abroad and argued that foreign source income should be taxed at the rate facing other investors in that source, arguably the rate of the capital importing country – capital import neutrality.²⁹ The introduction of an imputation system of corporate taxation ('Imputation') and the foreign tax credit system ('FTCS'), both with effect from 1 July 1987, were attempts to achieve 'equity' and 'neutrality'. Very broadly, the word 'equity' is generally used by economists to refer to the concept that taxpayers in similar circumstances should pay the same amount of tax and that liability to tax should be based on an ability to pay. 'Neutrality' is used to refer to situations

²⁸ http://www.med.govt.nz/templates/MultipageDocumentTOC_29947.aspx (last retrieved 07 Nov 2007)

²⁹ Anderson P, *Economic Policy Considerations in the Taxation of Foreign Source Income*, Australian Tax Forum journal of taxation policy, Law Reform, Vol 5 No 4 1988, p403

where the taxation system does not effect investment decisions.³⁰ This reflects the reality that as long as income is re-invested offshore, the only tax that applies is that of the local jurisdiction and hence the competitiveness of the company is not put at risk. This is not always true when the offshore investment is in a tax haven.

From an economic point of view, imposition of taxes on profits is itself a distortion which reduces the after tax rate of return on investments and hence decreases the level of investment in the domestic economy. In a society which depends on public services, such distortions are unavoidable. Hence in an open economy like Australia, the potential for tax leakages is more prevalent since a lower tax rate in another country will provide an incentive to invest abroad. Australia derives greater return from domestic investment than from investment abroad because, in the latter case, taxation revenue is lost to the host country. A private investor will continue investing offshore as long as the return (after tax) is higher than in Australia. With the introduction of policies to eliminate the deferral advantage for certain foreign investment, Australia has attempted to ensure that foreign investment is motivated by genuine economic factors and not by taxation considerations. Other considerations from an economic point of view are that where capital export is excessive, it has a negative impact on the domestic labour market (jobs created offshore rather than locally) and thus reduces domestic welfare. On the other hand there are arguments in favour of global benefits of international investment rather than in terms of the separate benefit of either the capital exporting or capital importing.³¹

In 1987 the OECD published a series of four related studies on International Tax Avoidance and Evasion.³² The most common concern expressed by tax administrators of member countries were:

- The use of tax havens affects the neutrality of taxation in economic decisions; and
- Competition between taxpayers is seriously distorted by the fact that some taxpayers can use tax havens to avoid or reduce tax, while others do not or cannot.

³⁰ Fraser P, *Australian Tax Haven Measures*, Australian Tax Forum, Vol 6 No 1 1989, pg100

³¹ See n 29, p 406 where reference was made to – T.Horst, 'A Note on the Optimal Taxation of International Investment Income', (1980) 44 *Quarterly Journal of Economics* 793.

³² See n 30, p 101 – makes reference to "OECD, 'Tax Havens: Measures to Prevent Abuse by Taxpayers', in OECD, *International Tax Avoidance and Evasion: Four Related Studies* (Issues in International Taxation, No 1) (Paris: OECD, 1987)

The above issues were considered by the Australian government when considering the reforms.

The deregulation of the Australian economy also led to a desire for profit shifting through tax avoidance methods. Although Australia had tax provisions to deal with International profit shifting, these provisions were not easy to enforce. From an Australian resident's perspective, these provisions were not necessary if all foreign sourced income was taxed on an accrual basis.

The introduction of accrual taxation to foreign investments and the changes of the Foreign Tax Credit System (FTCS) implemented tax provisions that deal with the deferral of taxation that FTCS could not resolve.

VIII. THE NEW ZEALAND CONTEXT

A. The Pre-CFC Rules

Before the CFC rules were implemented, overseas income was taxed on the basis that a person resident in New Zealand was liable to income tax on all income derived from New Zealand and elsewhere, whether or not it was remitted to New Zealand.³³ In relation to the overseas income, it included dividends, royalties, interest, personal service income, and pension income from overseas.

Where the overseas income was subject to tax in New Zealand, a credit for income tax paid overseas was allowed against the New Zealand income tax that was applicable to the overseas sourced income. The credit limit was the lesser of the actual overseas tax paid on the overseas income, or the New Zealand tax applicable in relation to the overseas income.³⁴

As noted previously, taxpayers did not have to pay tax on an accrual basis for investments in offshore entities where income was not repatriated to New Zealand. However income from other sources - employment or personal services was taxable regardless of whether it was remitted to New Zealand.

B. The Original CFC Rules

The original CFC rules were applicable from 1 April 1988. On implementation the CFC rules generally applied to foreign company's where:³⁵

- five or fewer New Zealand residents held an aggregate control interest in foreign company of greater than 50 percent; or

³³ CCH New Zealand Master Tax Guide 1989, para 1680

³⁴ Ibid

³⁵ The 1995 Tax Conference "*Outbound Investment*" New Zealand Society of Accountants and Price Waterhouse, 29&30 Sept 1995.

- a single New Zealand resident held a control interest of 40 percent or greater in a foreign company, unless a non- New Zealand resident, who is not associated that New Zealand resident, held a control interest of the same category in that foreign company, equal to or greater than, the New Zealand resident's interest; or
- a group of five or fewer New Zealand residents, had the power to control the exercise of the shareholder decision-making rights of a foreign company, which thereby ensured, that the affairs of the company were conducted according to the groups wishes.

Originally a separate definition of “associated persons” was introduced for the international tax regime and only applied for the purpose if international tax part of the Act.³⁶ Interests held in foreign companies by persons who were associated with a New Zealand resident were included in determining the resident's control in connection with that foreign country.³⁷ Where a nominee (e.g. Bare Trustee) held the interest on behalf of the New Zealand taxpayer, it was deemed that the New Zealand taxpayer held the interest in a CFC.³⁸

The grey list exemptions applied to seven countries. These were United Kingdom, USA, West Germany, France, Canada, Japan and Australia.³⁹

Control interest was calculated in the last day of each calendar quarter and was measured based on the highest percentage a person held of paid up capital, nominal capital, voting rights, entitlement to profits, or entitlement to net assets on distribution. The indirect control interest in a foreign company is held through interposed controlled company.⁴⁰

The CFC legislation effectively required the foreign company to be treated in the same manner as a foreign branch of a New Zealand company. Accordingly income from

³⁶ CCH New Zealand Master Tax Guide 1990, p 541, para 21020; ITA 1976 section 245B

³⁷ CCH New Zealand Master Tax Guide 1990, p 541, para 21020

³⁸ Ibid, p 542, para 21025; ITA 1976 section 245A

³⁹ Ibid, p 543, para 21040; ITA 1976 section 245P, schedule 15

⁴⁰ Ibid, p 544, para 21050; ITA 1976 section 245C – 245E

the CFC attributed to the New Zealand taxpayer was based on interest income.⁴¹ The taxpayer's proportion of the foreign tax credits can be used by the taxpayer against the New Zealand tax.⁴²

The attributions of foreign losses calculated under the branch equivalent regime were ring fenced to the jurisdiction from which the losses were derived.⁴³

C. The 1993 FIF Rules

Taxation of income in New Zealand is based on two basis rules. These are the "source principle" and "residency principle". The source principle taxes all income derived by non-residents from New Zealand and the residency principle taxes worldwide income of a New Zealand tax resident.

The FIF regime was first enacted by the Income Tax Amendments Act (No. 5) 1988. Under this regime, the definition of FIF interest was too complicated and therefore the regime never permanently came into force and was repealed. The main difficulty with the previous FIF regime was the distinction between active and passive income and it allowed only one method of calculation, which was comparative value method.⁴⁴

During 1993, the FIF regime was amended and the rules applied to all FIF interests held by New Zealand residents on or after 1 April 1993. The new regime extended the definition of an interest in FIF and gave the taxpayer four different methods to calculate FIF income. Taxpayers with FIF interest were required to disclose their interests. The disclosure requirements were brought in by the introduction of Income Tax Amendment Act (No. 2) 1993. Currently section 61 of the Tax Administration Act 1994 (TAA) imposes a requirement on the taxpayers to disclose their FIF interests.

The current definition of FIF interest has not changed since its implementation. FIF is investment in any of the following:

⁴¹ Ibid, p 547, para 21070; ITA 1976 section 245G – 245I, 245K

⁴² Ibid, p 549, para 21085; ITA 1976 section 188, 245K

⁴³ Ibid, p 548, para 21075; ITA 1976 section 188, 191, 245M, 245T

⁴⁴ TIB Vol 4 No.9 (May 1993), pg 23

- A foreign company (eg shares in a foreign company);
- A foreign superannuation scheme;
- A natural person not resident in New Zealand to the extent that person issues life insurance policies outside New Zealand;
- An entity specifically listed in Part A of Schedule 4 of Income Tax Act 2004 (ITA) – currently no entities are listed for this purpose.

An attributing interest attributes income from the investment to the investor, even though the investor may not have received the income at that point in time. There are three categories of rights that are treated as attributing interests in FIF.⁴⁵ They are:

1. rights of a person which would be treated as a “direct income interest” in the entity under the CFC rules (assuming the foreign entity were a CFC). Generally includes shareholding in foreign companies or unit trusts;
2. rights to benefit as a beneficiary or member under a foreign superannuation scheme;
3. rights to benefit from life insurance policy issued by a FIF insurer.

Taxpayers were allowed certain exemptions from FIF under the original rules. The exemptions were as follows:

1. A 10% or greater income interest in a CFC.
2. Grey List Exemptions⁴⁶ - An interest is excluded from FIF treatment if the FIF is:
 - resident in one of the “grey list” countries listed in Part A of Schedule 3;
 - liable to income tax in that country; and
 - not an entity listed in Part B of schedule 4 (none at this stage).

However the grey list exemptions only applied to interests in foreign companies, not foreign superannuation schemes or foreign life insurance policies.

⁴⁵ Income Tax Act 2004 (ITA) sections EX 30 and EX 31

⁴⁶ Ibid, section EX 33

3. Immigrants Exemption⁴⁷ - New immigrants who are natural persons were exempt from FIF rules for 4 years if they acquired interest in foreign superannuation scheme or life insurance policies when they were not resident. In other words, new immigrants had have 48 months to change their interest in these types of investments.
4. Employment Related Super exemption⁴⁸ - An interest is not an attributing interest in a FIF if it is a right in a foreign superannuation scheme which relates to employment. For this exemption to apply, the right must:
 - have accrued before the person first became a New Zealand resident;
 - accrue within the four income years (plus the part year of residence) after the person becomes a resident;
 - be acquired only through employment (or self employment);
 - be contributed to by the person, the person's employer or another superannuation scheme;
 - have limited ability to withdraw until retirement age.
5. *De minimis* exemption⁴⁹ - An interest is excluded from FIF treatment if the person is a natural person (not acting as trustee) and the total cost incurred by or on behalf of the person in acquiring interests which would otherwise be attributing interests in FIFs does not exceed \$50,000 (\$20,000 originally).

A person is treated as deriving FIF income or incurring FIF loss if none of the above exemptions applied to the particular category of FIF.

In relation to the FIF investments, the New Zealand resident had a choice of calculating deemed income or losses from FIFs using one of the four methods. These methods were:⁵⁰

⁴⁷ Ibid, section EX 35

⁴⁸ Ibid, section EX 36

⁴⁹ Ibid, sections CQ 5(1)(d), DN 6(1)(d) and EX 56

⁵⁰ The 1995 Tax Conference "Outbound Investment" New Zealand Society of Accountants and Price Waterhouse, 29&30 Sept 1995.

- Comparative value method – the taxpayer calculates income from foreign entity based on the increase in the market value of the interest held in the FIF.
- Deemed rate of return method – this allows the taxpayer to calculate their income by multiplying the value of the FIF, by an annually published rate of return.
- Accounting profits method – this allows the taxpayers to work out their share of the overseas entities profit, or loss, based on its published accounts
- Branch equivalent method - this allows the taxpayers to use New Zealand tax legislation to calculate their share of the overseas entities profits or losses.

D. Taxation (Savings Investment and Miscellaneous Provisions) Act 2006

In May 2006, The Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill was introduced with the main focus of reform to the tax rules on income from share investment made through managed funds by individuals. The Act was ratified on 18 December 2006.

The new rules apply to investments by New Zealand residents in foreign companies where the investor owns less than 10% of the company. The key features of the new rules are as follows:⁵¹

- The previous exemption in the foreign investment fund rules for investments of less than 10 percent in companies resident in "grey list" countries have been abolished. (The "grey list" countries are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.)
- Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange, such as the All Ordinaries index (the 500 largest listed companies), are exempt from the foreign investment fund rules. The general income tax rules will continue to apply to these Australian investments:

⁵¹ Inland Revenue Tax Information Bulletin: Vol 19, No 3 (April 2007)

that is, taxable only on dividends if the shares are held on capital account and on dividends and realised share gains if the shares are held on revenue account.⁵²

However, investments in Australian-resident listed companies held by portfolio investment entities are generally taxable only on dividends.

- A NZ\$50,000 minimum threshold applies to an individual's investments in foreign companies other than Australian-resident listed companies. If the original cost of these shares totals NZ\$50,000 or less, the foreign investment fund rules do not apply to the individual. This threshold does not generally apply to trusts.
- Investments in certain Australian unit trusts that meet minimum investment turnover requirements and use the RWT proxy rules are exempt from the foreign investment fund rules.
- There are two temporary exemptions for investments in certain grey list companies for five years and two years respectively. Investments in Guinness Peat Group plc qualify for the five-year exemption (that is, for the 2007-08 to 2011-12 income years) and investments in the New Zealand Investment Trust plc qualify for the two-year exemption (that is, the 2007-08 and 2008-09 income years). Investors who hold shares in these companies on revenue account may elect for the exemption not to apply to them.
- There is an exemption for venture capital investments in grey list companies that were previously resident in New Zealand and maintain a significant New Zealand presence.
- There is a limited exemption for offshore shares acquired through employee share purchase schemes if there are restrictions on the disposal of the shares. The exemption applies only for the duration of the restrictions.
- The "grey list" exemption will continue to apply for non-portfolio investments of 10 percent or more in foreign companies. However, because of their widely held nature, the following entities do not qualify for this grey list exemption: portfolio investment entities, superannuation schemes, unit trusts, life insurers and group investment funds.

⁵² Income Tax Act 2007, section EX 31

- Two new income calculation methods under the foreign investment fund rules - the fair dividend rate and cost methods - have been introduced to apply generally to less than 10 percent interests in foreign companies (including unit trusts).⁵³
- Under the fair dividend rate method:⁵⁴
 - Tax is paid on 5 percent of the share portfolio's opening market value each year.
 - If the investor is an individual or family trust and the total return (dividends and capital gains) on the portfolio is less than 5 percent then tax can be paid on the lower amount with no tax payable when the total return is nil or negative.⁵⁵ Refer to the next bullet point on how this is achieved.
 - Paying tax on an amount lower than 5 percent is achieved by allowing individuals and family trusts to use the comparative value method. Individuals and family trusts have the ability to switch freely between the fair dividend rate and comparative value methods between income years.
 - Within the same income year an individual or family trust must apply either the fair dividend rate method or the comparative value method. It is therefore not possible to use the fair dividend rate method for shares which produce a total return of over 5 percent (thereby getting the benefit of the 5 percent cap under that method) and use the comparative value method for shares which produce a total return of less than 5 percent in the same year.
 - Generally, only shares held at the start of an income year are taken into account and therefore purchases and sales of shares during a year are ignored.
 - However, shares that are both purchased after the start of an income year and sold before the end of the same income year are taxed on the lower of 5 percent of their cost or the actual gains made on these "quick sales". Under the FDR method there is no capital and revenue or share trader distinctions.
 - Dividends are not taxed separately; however, foreign withholding tax deducted from dividends is still available as a foreign tax credit.

⁵³ Ibid, section EX 48

⁵⁴ Ibid, section EX 52

⁵⁵ Ibid, sections EX 46(6), 46(7) and 46(8), TIB Vol. 19 No 3 April 2007, p 30

- There are no foreign investment fund losses under the FDR method.
- The fair dividend rate method cannot be used for "guaranteed return"-type investments. The comparative value method must be used for these investments.
- The cost method⁵⁶ taxes 5 percent of the cost of a person's investments, with the cost base increased by 5 percent each year to proxy for an increase in the value of the investment. This method is available for investments for which it is not possible to obtain market values (except by independent valuation) and therefore it is not practical to apply the fair dividend rate method. The cost base can be reset by independent valuation every five years.
- Investors can use the other methods for calculating foreign investment fund income or loss - branch equivalent, accounting profits, comparative value and deemed rate of return - if they satisfy the conditions for using these methods.
- The previous ring-fencing rules for foreign investment fund losses (other than those calculated under the branch equivalent method) have been repealed. A person is allowed a deduction for FIF losses against taxable income except for losses calculated under the BE method which is subject to jurisdictional ring fencing⁵⁷. FIF losses from the years 2006-07 or earlier years that have not been used are deductible during the 2007-08 tax years.⁵⁸ The losses under the old FIF rules are deductible against taxable income and any unused FIF losses are carried forward to future years. However these losses which are allowed to be claimed against New Zealand income can only arise in relation to Comparative Value method, Deemed Rate of Return method and Accounting Profits method. Losses cannot be produced under the Fair Dividend Rate method and the Cost method and Comparative Value Method (only where there is a FIF interest of 10% or less in portfolio interests⁵⁹). FIF losses under the Comparative Value method where the FIF interest for shares is over 10%, do not attract restriction on claiming FIF losses⁶⁰.

⁵⁶ Ibid , section EX 56

⁵⁷ Ibid, section EX 50 (8)

⁵⁸ TIB Vol. 19 No 3 April 2007, p 40

⁵⁹ Income Tax Act 2007. section EX 57 (7)

⁶⁰ Staples Tax Guide 2007, para 850.345

- The rules for converting amounts from foreign currency into New Zealand currency have been made consistent. In particular, the changes require taxpayers to be consistent in their use of currency conversion methods.
- The rules dealing with when a person enters into or exits from the foreign investment fund rules, such as when a person becomes a resident of New Zealand or the \$50,000 minimum threshold is exceeded so a person enters into the rules, have been amended to cater for the new fair dividend rate and cost methods.
- Offshore investments which become subject for the first time to the new foreign investment fund rules enter the new rules at their market value on the start date of the new rules (which for most individuals will be 1 April 2007). Special rules apply to persons who own shares acquired prior to 1 January 2000 and who may not have records for the cost of their shares. Under this rule the market value of the shares as at 1 April 2000 is halved and used to calculate the amount to be added to the cost of the investment acquired on or after 1 January 2000 to determine whether the minimum threshold is exceeded.⁶¹

It is noted that the above changes are only in relation to FIF interests. No changes were made to the CFC rules.

However the discussion document released on 13 December 2006 outlined the government's intention to bring out further changes which would include the exemption of active income from the CFC rules. The tax exemption of the active income aligns New Zealand with other developed countries that exempt active income from being taxed on accrual basis.

The justification provided for the changes in the rules have been that the changes would improve New Zealand's international competitiveness through promoting and enabling environment for globally connected firms to locate in New Zealand and expand

⁶¹ Income Tax Act 2007, section EX 67 (10) and (11)

into other countries from the New Zealand base.⁶² The rules were developed in line with three guiding principles:⁶³

1. The new rules should as much as possible allow firms to continue with their legitimate business activities
2. The rules should as much as possible reduce compliance costs; and
3. The rules should maintain a level of protection for the domestic tax base.

The active business test would reduce barriers to New Zealand taxpayers from investing outside the grey list countries. Investment decisions can be made based on business needs rather than tax benefits.

Keeping with the above principles, the government took the following policy decisions:⁶⁴

- A tax exemption for the active income of a controlled foreign company will be introduced. The exemption of active income will consist of the introduction of an active income exemption for CFC.
- Ordinary dividend from CFCs to the New Zealand parent will be exempt from domestic tax. For simplicity and compliance cost reasons, this exemption would apply to dividends from CFC's regardless of whether the CFC passes the active business test. Dividends that would not qualify the underlying foreign test credit under the current rules would not be eligible for the exemption.
- A simple "active business" test will be developed to exempt all CFCs with less than five percent passive income, no matter where they do business. The test will be designed to replace the current eight-country "grey list" exemption. The discussion document outlined two principal approaches to implement the active-passive system. These are the entity approach (which categorises based on characteristics of a company) and transactional approach

⁶² See n 26, p 3

⁶³ Ibid

⁶⁴ Ibid, p 4

(which considers the transactions entered into by the company to determine whether it is active or passive). A hybrid approach is favored by the New Zealand Government which is similar to the Australian method.

- Even if a CFC does not meet the active business test, only passive income will be taxed in New Zealand.
- A relatively limited definition of passive income that would include dividends, interest, royalties and certain rents will be developed. The narrow definition of passive income is as a result of concerns that a broad definition of passive income would increase compliance costs.
- A limited set of “base company” rules for services will be developed. Base company rules treat certain nominally active income of a CFC as passive in cases where there is a risk that either the income relates to activities conducted on the home jurisdiction or that the CFC has been created to relocate profits into a low-tax jurisdiction.⁶⁵
- Once the exemption is in place, interest allocation rules will limit the extent to which New Zealand businesses can deduct interest costs relating to offshore investments. The thin capitalization rules in relation to safe harbour of 75% will be maintained - these rules are similar to the Australian rules. The worldwide comparison test will also be maintained.
- The conduit rules will be repealed because it will become unnecessary in relation to active income - because the active income of CFC s will generally become exempt.

The discussion document⁶⁶ in number of instances makes reference to the Australian CFC rules⁶⁷ and the changes appear to align the New Zealand rules closer to the Australian rules. The above changes are still in discussion and it is more likely that the changes in CFC rules will be legislated.

⁶⁵ Ibid, p 13

⁶⁶ Ibid

⁶⁷ Ibid Pg 13 – “A number of countries, including the United States and Australia, have broad base company rules”... Pg 17 “Second, the Australian experience suggests that limiting the components of passive income is much more important than increasing the threshold in achieving compliance savings” ... Pg 21 – Australia has comprehensive interest allocation rules, and Canada has just announced that it will be denying interest deductions for loans incurred to fund outbound investments earning exempt income”.

E. The Current CFC Rules (Sept 2007)

The current CFC rules assume that the foreign entity is a branch of the New Zealand shareholder and requires tax in the foreign entity to be re-calculated under the New Zealand tax rules. Limited amount of foreign tax credits are allowed.

The resident rules are important for determining whether the CFC rules apply. The CFC rules generally apply to New Zealand residents except for persons who are transitional residents. The transitional resident rules were added to remove tax barriers for international recruitment to New Zealand. The rules give new residents 48 months for being treated like non-residents in relation to foreign sourced income. Therefore a person only attributes CFC income or loss to the extent that the person is a New Zealand resident.

For the CFC rules to apply, the relevant company must be a foreign company. The foreign company is treated as a CFC if any of the following three tests are satisfied during the accounting period:

- A group of five or fewer New Zealand residents hold an aggregate control interest of greater than 50% at any time during an accounting period;
- A single person resident in New Zealand holds control interest of 40% or greater in a company at any time during the accounting period, unless another non-associated person holds an equal or greater control interest of the same category;
- A group of five or fewer New Zealand residents have the power to control the shareholding decision-making rights in respect of the foreign company and so ensures that the affairs of the company are conducted in accordance with the wishes of the group.

Although the definition of a CFC is based on the control interest, the actual attribution of income or losses is based on income interest (direct and indirect) in a CFC. The attributed income or losses of a person is calculated based on branch equivalent income or losses. The branch equivalent method assumes that the offshore company is a branch of a New Zealand resident and therefore is taxed accordingly. Generally the net income and

losses of the offshore company is calculated as if the offshore company were a New Zealand resident. However, currently the CFC rules do not have a look through taxation. Therefore the CFC that is being treated as New Zealand branch does not have to include income or losses from other foreign companies where it may have interests.⁶⁸ If the CFC was actually a New Zealand resident it would have to take these amounts into account.

Currently New Zealand exempts CFCs from grey list countries⁶⁹ to be attributed to the New Zealand taxpayers. The current grey list exemptions allow CFCs to defer taxation irrespective of whether they are engaged in active or passive income earning activities. However the New Zealand taxation arises only when a dividend is paid to the New Zealand shareholder may not just be to a company from the grey list company. The dividends paid to New Zealand companies from these grey list countries may be effectively free from New Zealand tax due to the Foreign Dividend Withholding Payments (FDWP) and Underlying Foreign Tax Credit (UFTC) regimes. The current grey list exemptions exclude all of New Zealand South East trading partners except Australia and Japan.

A person subject to the CFC rules may elect to keep a branch equivalent tax account (BETA) which is a memorandum account used to prevent double taxation of attributed CFC income. Credits arise to the BETA accounts when CFC income is returned. The credit balance in the BETA accounts can be used to offset and pay the dividend withholding payments liabilities or income tax liabilities when dividends are received from the offshore company. This reduces the New Zealand shareholders, Foreign Dividend Withholding Tax (FDWT) or income tax liability as the case may be. Where the New Zealand Company distributes the dividends received from the offshore entity to an individual New Zealand shareholder, there is double taxation because the income will not contain any imputation credits paid under the CFC or the FDWT regime.

Where a foreign (non resident) shareholder owns shares in a New Zealand company that derives attributed foreign income from a CFC or FIF, the non-resident shareholders are subject to tax on income not sourced from New Zealand. This breaches the resident and

⁶⁸ ITA 2004, section EX 21(13)(c)

⁶⁹ Schedule 3 of ITA 2004 - Australia, Canada, Germany, Japan, United Kingdom, United States of America, Norway, Spain.

source rules⁷⁰ on taxation of income. The conduit tax relief (CTR) rules were introduced to counter this problem by reducing the New Zealand resident company's tax liability on the foreign attributed income by reducing the FDWT liability to the extent that the company was owned by non-resident shareholders. The tax benefits are passed onto the non-resident shareholders in the form of CTR credits and additional dividends.

There are strict ring fencing rules in relation to CFC losses and foreign tax credits from a CFC. The losses and tax credits from CFC's can be claimed by a person or a company against their income tax liability only to the extent that the income tax liability or tax credits attributed from CFC residents in the same country as the primary CFC during the accounting period.⁷¹ Where the losses or tax credits are not utilized, they can be carried forward to following years and offset against the ring fenced CFC income of the primary CFC country.

F. Other International Tax Rules

1. Transfer pricing rules⁷²

The transfer pricing rules are specific anti avoidance provision that apply to the practice of shifting profits from one jurisdiction to another through manipulation of prices paid for goods and services between associated parties. The rules are based on the OECD guidelines to transfer pricing.⁷³ Inland Revenue has its own guidelines⁷⁴ that supplement the OECD guideline.

Transfer pricing rules supplement the CFC and FIF rules in relation to accumulation of profits in tax havens.

⁷⁰ New Zealand taxation of income is based on residence and source rules – A New Zealand tax resident is liable for tax on its world wide income, and a tax non-resident is liable for tax in New Zealand for income sourced in New Zealand.

⁷¹ ITA 2004 – sections LC5 and DN4.

⁷² Ibid, GD13

⁷³ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, at http://www.oecd.org/document/34/0,3343,en_2649_33753_1915490_1_1_1_1,00.html

⁷⁴ *Transfer Pricing Guidelines*, Tax Information Bulletin, Volume 12, No 10, October 2000, p 16.

2. Thin capitalisation rules⁷⁵

Thin Capitalisation rules apply to transfer of profits from New Zealand to offshore entities by debt gearing the New Zealand entity so that profits can be transferred by payment of interest to the offshore entity.

The rules apply to limit the deductions of interest in New Zealand where the taxpayer's New Zealand group percentage exceeds 75% and also exceeds 110% of the taxpayer's worldwide group debt percentage.⁷⁶

Like transfer pricing rules, the thin capitalisation rules supplement the CFC and FIF rules to prevent transfer of profits to low tax jurisdictions.

3. Conduit tax relief

The source rules state that non-residents are taxed in New Zealand for income sourced from New Zealand. This creates a problem where a foreign investor, effectively invests in a foreign entity through a New Zealand subsidiary. The income (dividend, CFC or FIF) is passed to the foreign investor through the New Zealand subsidiary.

The conduit tax relieve mechanism provides relief of tax to the New Zealand subsidiary when CFC, FIF and Dividend income is earned by the subsidiary on behalf of the non-resident investors. Discussion of how these rules apply is beyond the scope of this study and therefore is not discussed in detail.

⁷⁵ Income Tax Act 2004, FG1, FG2 and FG8B

⁷⁶ CCH New Zealand Master Tax Guide 2007, p 1016, para 26-126

IX. THE AUSTRALIAN CONTEXT

Under the accrual taxation system, the Australian residents' share of income derived from offshore entities is taxed in Australia. There are three main strands under which the income is taxed:⁷⁷

1. The CFC rules which applies to tainted income derived by CFCs which has not been comparably taxed offshore.⁷⁸
2. The transferor trust measures which applies the accrual rules to the income for non-resident trusts to which Australian entities have transferred property or provided services.⁷⁹
- 3 The FIF measures which complement the CFC and transferor trust measures by targeting income sheltered on offshore companies and trusts in which Australian resident taxpayers do not have controlling interest.⁸⁰

I will discuss the application of the rules when they were first implemented, as well as the current rules.

A. The Original Offshore Investment Rules

1. The CFC rules

The main purpose of the original CFC rules was to tax offshore income of Australian residents on an accrual basis. There are three strands of accrual taxation; the CFC rules, transferor trust measures and the FIF measures.

The Australian CFC rules were introduced effective from 1 July 1990. The rules amended the old Foreign Tax Credit System (FTCS) where the Australian resident was

⁷⁷ CCH Australian Master Tax Guide 2008, Para 21-105, pg 1,150

⁷⁸ Income Tax Assessment Act 1936, Part X, s316 to 468

⁷⁹ Income Tax Assessment Act 1936, Part III Div 6AAA, s 102AAA to 102AAZG

⁸⁰ Ibid, Part XI, s 469 to 624

taxed only when profits were repatriated to Australia. The principal changes to the FTCS were.⁸¹

- The exemption from Australian income tax of foreign branch profits of an Australian company derived by carrying on business at or through a permanent establishment in a country with a tax system comparable to Australia's;
- The exemption from income tax of amounts paid out of attributed income;
- The exemption of certain non-portfolio dividends from foreign countries;
- The substitution of passive income from interest income in relation to classes of income;
- The limitation on foreign tax able to be credited in the case of a dividend received by an Australian company from a related foreign company;
- The modification of the provisions relating to losses of previous years in relation to classes of income derived from foreign sources;
- The carry-forward and transfer of excess credits;
- The apparent non-exemption from Australian capital gains tax of capital gains arising from the disposal of assets used in carrying on business at or through a permanent establishment in a country with a tax system comparable to Australia's; and
- Tax sparring.

The application of the CFC rules was applied by answering the following questions.⁸²

1. Is the foreign company a CFC?
2. If the foreign company is a CFC, then is the taxpayer an attributable taxpayer in respect of the CFC?
3. If there is an attributable taxpayer in respect of a CFC, then does the CFC have attributable income?
4. If the CFC has derived attributable income, then what is the amount of that income?
5. What is the taxpayer's attributable percentage of the CFC's attributable income?

⁸¹ Gotteron A, *Foreign Tax Credit System: Changes Due to Accruals Proposals*, CCH Journal of Australian Taxation, Vol 2, Issue 2, April/May 1990

⁸² Burns L, *Controlled Foreign Companies: Taxation of Foreign Source Income*, Longman Professional, 1992, pg 14

6. If the CFC subsequently pays out a dividend to an attributable taxpayer, has that dividend been paid out of attributed profits?
7. If the Australian taxpayer is an attributable taxpayer in respect of a CFC, has that taxpayer complied with the record keeping obligations imposed on such a taxpayer?

The CFC rules from outset had active and passive income distinction where only passive income was caught by the CFC rules. Exemptions were given to dividend income from the CFC and exemptions were given to comparably taxed foreign branch profits. The transferor trust rules were also brought in but there was significant difference in that the transferor trust rules did not have an active income exemption that companies enjoyed. The comparable tax exemptions were available to the transferor trusts.⁸³

The CFC rules were based on the control test. Broadly the control test contained three tests which were based on facts in each individual circumstance. These were:⁸⁴

1. Actual control: Where a group of 5 or fewer Australian 1% entities, the aggregate of whose associate-inclusive control interest in company is not less than 50%.
2. Assumed Control: Where a single Australian entity whose associate inclusive control interest is not less than 40% and the Company is not controlled by another group of non-resident entities.
3. De facto control: Where the entity is controlled by a group of five or fewer Australian entities (including associates).

If the above control tests are applied to a taxpayer, the taxpayer would be an attributable taxpayer and accrual rules would apply to offshore investments. If the taxpayer did not fall within the attributable taxpayer definition, then there would be no accruals tax liability to offshore investments. Once the attributable taxpayer had been identified, CFC income would be attributed to the taxpayer based on the percentage equal to the total of the direct and indirect attribution interest in the CFC.

⁸³ Burns, L, *Harmonisation of Australian Anti-Defferal Regime*, at www.tax.law.unimelb.edu.au/download.cfm?DownloadFile=413D0407-1422-207C-BA1EB0806D06ED96

⁸⁴ Green, M R, Pizacalla M, *Taxation of Foreign Source Income: Emerging Issues*, The CCH Journal of Australian Taxation, Vol 5, Issue 3, June/July 1993.

Where the CFC is resident in an unlisted country the following rules apply:⁸⁵

- If the CFC passes the active income test, the only amounts to be included as notional assessable income will be the trust income attributed under section 102AAZD⁸⁶, and trust income assessable under Division 6 of Pt III (the ordinary trust provisions).
- If the company does not pass the active income test, its notional assessable income includes certain trust income (discussed above), adjusted tainted income and certain partnership income; calculated as if the CFC was a taxpayer and a resident of Australia.

Where the CFC is resident in a listed country, its notional assessable income is calculated as if the CFC was a taxpayer resident of Australia and the income includes.⁸⁷

- Adjusted tainted income that benefits from a specific eligible designated concession where the active income test is not passed;
- Adjusted tainted income that benefits from a general eligible designated concession where the active income test is not passed;
- Income that is not eligible designated concession (specific or general) in relation to any listed country, is not treated as derived from source in the listed country for the purpose of its tax law and is not taxed in any listed country;
- Trust income attributed under section 102AAZD;
- Ordinary trust income not taxed in the listed country or, where it is taxed in the listed country, designated concession income in relation to that listed country.

The exclusions from attributable income are:

- Income already taxed under another part of the Act (already taxed in Australia);
- Franked dividends; and

⁸⁵ Green, M R, *Taxation of Foreign Source Income*, The CCH Journal of Australian Taxation, Vol 4, Issue 4, Aug/Sept 1992, p 42

⁸⁶ Income Tax Assessment Act 1936

⁸⁷ Green, M R, *Taxation of Foreign Source Income*, The CCH Journal of Australian Taxation, Vol 4, Issue 4, Aug/Sept 1992, p 42

- Dividends received from listed country residents.

The *de minimis* test applies to attributable income; where the total income does not exceed \$50,000 or 5% of the gross turnover of the CFC.

Designated concession income is defined as follows:⁸⁸

- Domestic or foreign capital gains not subject to tax;
- Offshore interests, royalties, or shipping income not subject to full corporate tax; and
- Income or profits subject to a reduction of tax in a listed country as prescribed in Sch 9, Pt 2 of the Regulations.

The active income exemptions operate to relieve from accruals taxation all of the income earned by an unlisted country CFC or all designated concession income earned by a listed country CFC. If the active income test is not passed; only parts of the income will be subject to accruals tax, which are.⁸⁹

- Tainted income; and
- In the case of listed country CFC, income derived outside that country not taxed in a listed country.

To pass the active income test the CFC should meet the following preconditions:⁹⁰

- The company was in existence at the end of its statutory accounting period;
- The company must be resident at all times during the year in a particular listed country or a particular unlisted country;
- The company has kept appropriate account records (“recognised accounts”);
- The company must carry on a business through a permanent establishment in its country of residence at all times during the year;

^{88 88} Ibid, p 48

^{89 89} Ibid, p 48

⁹⁰ Ibid, p 48

- The tainted income ratio is less than 5%. The formula for calculating unlisted country ratio is [gross tainted turnover / gross turnover]. For listed country residents the formula is [tainted eligible designated concession income / eligible designated concession income].

2. *Transferor trust measures*

Division 6AAA deals with foreign trusts. The transfer trust measures were enacted due to the assertion that any Australian entity involved with a foreign trust, especially a foreign discretionary trust, must be doing so for tax avoidance reasons.⁹¹ There are separate rules for discretionary and non-discretionary trusts. An entity will be an attributable taxpayer for a discretionary trust if post 12 April 1989, the taxpayer transfers any property or services to the trust. For a non-discretionary trust, an entity will be an attributable taxpayer only where property or services is transferred on a non-arms length basis.

The attributed income from a transferor trust resident in an unlisted country includes all income except income already assessable in Australia, income which has been taxed in a listed country, franked dividend and amounts already taxed under the accruals system.

For the listed country trusts, the assessable income includes all income that is designated concession income. There is no active income exemption for transferor trusts. This was justified on the basis that the transferor trust rules apply only when there is no business purpose for the transfer to the trust.⁹² The income attributed to the transferor is based on branch-equivalent calculations. If a transferor cannot do branch-equivalent calculations, the income attributed is calculated by applying a notional interest rate to the value of the transferred property or services, compounded annually. The interest rate is based on the weighted average treasury note rate uplifted by five percentage points.⁹³

⁹¹ Green, M R, *Taxation of Foreign Source Income*, The CCH Journal of Australian Taxation, Vol 4, Issue 4, Aug/Sept 1992, pg 52

⁹² Burns L, Harmonisation of Australia's Anti-Deferral Regime,
www.tax.law.unimelb.edu.au/download.cfm?DownloadFile=413D0407-1422-207C

⁹³ Ibid

3. *The FIF measures*

The FIF measures were legislated effective from 1 January 1993. These rules were to apply to offshore investments by Australian residents where the Australian residents do not have control on the foreign entity. These rules apply to foreign companies and trusts.

The amount that is attributed to the Australian resident is calculated by the aggregate change in the market value of the taxpayer's interest in the foreign entity. There are certain exclusions. These are:⁹⁴

- Natural person with aggregate interest in foreign entities not greater than \$50,000;
- Shares held in a foreign company engaged principally in active business.

There are certain exemptions to the FIF rules; which are as follows.⁹⁵

- Exemption of foreign branch profits where the Australian companies carry's on business in a listed country through permanent establishment or branch income earned from an unlisted country but taxed in a listed country.
- Branch income derived by Australian companies through interposed partnerships and trusts.
- Exemptions for dividends that have already been subject to accrual taxation when it was earned.

FIF income is calculated using mark to value method where there is a recognised market for the taxpayer's interest in a FIF. If there is no recognised market, FIF income is calculated by applying a statutory interest rate to the taxpayer's interest in the FIF. The interest rate is based on market rates uplifted by 4 percentage points. In either case, a taxpayer can elect to apply the calculation method, which is a simplified branch-equivalent calculation that is a mix of tax calculation and financial accounting.⁹⁶

⁹⁴ See n 91, pg 53

⁹⁵ Ibid

⁹⁶ Burns L, *Harmonisation of Australia's Anti-Deferral Regime*, www.tax.law.unimelb.edu.au/download.cfm?DownloadFile=413D0407-1422-207C (last retrieved 9 Jan 2008)

4. The 2002/2003 review of International Tax Arrangements

In 2004, changes were introduced by the Australian government, which was made effective through the New International Tax Arrangements Act 2004. These changes were a result of the 2003 Federal Budget following extensive consultation and a report by the Board of Taxation, resulting in the Government announcing a package of reforms to international taxation. These were.⁹⁷

1. Largely eliminate attribution of most of the income of a controlled foreign company in a broad exemption listed country. Previously there were broad classes of income that were attributed to the Australian resident. This was replaced with specific types of concessional income or untaxed capital gain.
2. Increase the balance portfolio of FIF exemption for all taxpayers from 5% to 10%.
3. Exempt complying superannuation funds and similar entities from the FIF rules. Previously Complying superannuation entities, virtual PST assets and segregated exempt assets of life insurance companies were potentially subject to the FIF rules.
4. Remove 'management of funds' from the FIF rules. Previously managed funds were included in the 'blacklist' of non-eligible business activities in the FIF rules.
5. Exempt Australian public unit trusts from interest withholding tax on interest paid on publicly offered debentures issued to non-residents.

There were also changes to the participation dividend rules which extended the participation dividend exemption and applied the exemption to all such dividends and not just those paid out of comparably taxed profits. This had the effect of extending the active income exemption at the time of attribution to the time of repatriation. Consequently, any income that is not taxed under the CFC (or FIF) rules is now also exempt on repatriation if it is repatriated as a participation dividend. In other words, for this income, it is either CFC

⁹⁷<http://www.ato.gov.au/large/content.asp?doc=/content/46860.htm&pc=001/009/041/002/005&mnu=&mfp=&st=&cy=1> (last retrieved 9 Jan 2008)

(or FIF) taxation or no taxation. This puts pressure on the line between active and passive income under the CFC (and FIF) rules.⁹⁸

B. The Current Offshore Investment Rules

1. The CFC rules

The CFC rules generally apply accruals taxation to tainted income derived by the CFC resident from unlisted⁹⁹ countries and eligible designated concessional income¹⁰⁰ derived from CFCs resident in listed countries. The CFC rules will generally not apply to income derived by CFCs that pass the “active income test”.

In order to determine whether the taxpayer is an attributable taxpayer for CFC purpose, it is important one of the following criteria be met¹⁰¹:

1. The taxpayer should have 10% or more associate inclusive control¹⁰² in the CFC; or
2. The Taxpayer has minimum of 1% associate inclusive control interest of the CFC and is one of the five or fewer entities that controls the CFC.

A company will be treated as a CFC if any one of the following three control tests discussed previously applies.

The control test is applied at the end of the statutory accounting period.

The tax rules applicable to a CFC can differ depending on whether the CFC is resident in a listed or unlisted country. This affects the income attribution rules, active income exemption rules, and de-minimis exemption rules.

⁹⁸ See n 96, p12

⁹⁹ The current listed countries are Canada, France, Germany, Japan, New Zealand, UK and USA.

¹⁰⁰ Eligible designated concessional income is income from listed country which is taxed at concessional basis in that country (eg. Capital Gains Tax in NZ)

¹⁰¹ CCH Master Tax Guide 2008, para 21,140, Income Tax Assessment Act 1936, s 361

¹⁰² Associate inclusive control – aggregate of direct and indirect control interest held by the taxpayer and associated parties.

Income is attributed to the Australian taxpayer based on attribution percentage; which is the sum of taxpayers direct and indirect attribution interest in the CFC. The income is attributed at the end of the income year.

The active income test provides that where the taxpayer passes the test, some or all income from the CFC will not be attributable to the Australian taxpayer. This exemption provides an exemption to Australian enterprises engaging in genuine business activities in unlisted countries. In these cases the offshore income is taxable when it is repatriated back to the Australian taxpayer.

The active income test requires each of the following requirements to be satisfied in order to qualify for the exemption:¹⁰³

1. Be in existence at the end of its statutory accounting period and be a resident of a listed or unlisted country at all times during the accounting period when the company was in existence; and
2. Have at all times carried on business through a permanent establishment in its country of residence; and
3. Maintain accounts which are prepared in accordance with accounting standards and give a true and fair view of the financial position of the company; and
4. Have less than 5% of its gross turnover as stated in its recognised accounts in the form of tainted income.

Tainted income¹⁰⁴ covers passive income¹⁰⁵, tainted sales income¹⁰⁶ and tainted services income.¹⁰⁷ A CFC resident in an unlisted country which does not meet the active income test is taxed as if it were resident in Australia. In these instances, the attributed income will

¹⁰³ See n 101, para 21,180

¹⁰⁴ Ibid, para 21,180

¹⁰⁵ Passive Income includes dividends, tainted interests, rent and royalties, income derived from carrying on a business of trading in tainted assets and net gains from the disposal of tainted assets – CCH Australian Master Tax Guide 2008, para 21,180

¹⁰⁶ Tainted sales income is income from the sale of goods to an associated person or income from the sale of goods originally purchased from an associate who had a connection with Australia- CCH Australian Master Tax Guide 2008, para 21,180.

¹⁰⁷ Tainted services income is income from provision of services by the CFC to an Australian resident (not services provided to foreign permanent establishments) or non residents carrying on business through a permanent establishment in Australia-

include adjusted tainted income, trust income and income attributed under the FIF rules. If the CFC resident in an unlisted country passes the active income test, then attributable income will be trust income and income attributed under the FIF rules.

Where a CFC that is resident in a listed country fails the active income test, the attribution income includes the following:¹⁰⁸

1. adjusted tainted income that is eligible designated concession income; and
2. income that is not eligible designated concession income, is not derived from sources in the listed country and is adjusted tainted income not taxed in a listed country; and
3. income derived as a beneficiary of a trust that is not taxed in a listed country or Australia or, being subject to tax in a listed country, is eligible designated concession income in relation to a listed country; and
4. income attributed to the CFC under the transferor trust measures; and
5. income attributed to a CFC from a FIF.

There are a number of exemptions and exclusions applicable to CFCs. Income attributed from a CFC exclude “notional exempt income”. These are:¹⁰⁹

1. income assessed for Australian tax purposes independent of the operation of CFC measures (e.g. Income attributed under the FIF rules); and
2. dividends to the extent they have been franked; and
3. certain excluded insurance premiums.

There is also a de-minimis exemption for income attributable from listed countries. There is no such exemption for income attributable from non-listed countries. For a listed country CFC with a turnover of less than \$1million, the exemption applies where the attributable income does not exceed 5% of gross turnover. Where the listed country CFC's

¹⁰⁸ See n 101, para 21,200

¹⁰⁹ Ibid, para 21,200

have a turnover greater than \$1m the exemption applies if the attributable income is less than \$50,000.¹¹⁰

There are certain quarantine measures applicable to CFC Losses. The CFC losses from prior years can only be offset to CFC income in the current year. If, in the prior years, the CFC changed its residence from a listed country to an unlisted country and vice versa, the CFC losses are lost and therefore cannot be used. The losses from previous years are also reduced if during one of the previous years, the CFC attributed income was exempt due to one of the exemptions listed above (i.e. CFC passed active income test or *de minimis* exemption applied in one of the years)

There are certain rules in relation to calculation of capital gain tax when an entity enters the Australian CFC regime. These rules are outside the scope of this paper and therefore will not be discussed.

A taxpayer can keep Attribution accounts in relation to CFC and FIF. This ensures that the taxpayer is not double taxed when there is a subsequent distribution of CFC or FIF income. Where a CFC resident in an unlisted country makes a distribution payment from its accumulated profits, the payment will be treated as a deemed dividend by the CFC. However a non-portfolio dividend (10% or greater voting power held in the CFC) paid by the non-resident company to a resident company is not assessable for income tax. Dividends that are not non-portfolio dividends are subject to tax except where they are paid out of income that has already been attributed.

Most foreign income, including capital gains derived from an overseas branch of a New Zealand resident company, is exempt income if the branch passed the active income test (same as the test that applies to CFCs).

Australian taxpayers can also accumulate foreign income in non-resident trusts and take advantage of deferral in absence of accrual rules. Therefore accrual rules also apply to non-resident trusts. The main elements of the accrual taxation rules are:

¹¹⁰ Ibid, para 21,200

- The transferor Trust measures
- Interest charge on distribution of accumulated trust income

2. The Transferor Trust measures

An Australian resident taxpayer entity is liable for attribution of income from a non-resident trust if the taxpayer at any time transferred property or services to a

- non-resident discretionary trust (however transfers made on a arms length basis in the ordinary course of business are excluded from the attribution rules).
- non-resident non discretionary trust on a non-arms length basis.

There are special rules in relation to non-resident family trusts. If a natural person who is not a trustee, transfers property or services to the non-resident family trust, the attribution of income does not arise to the natural person taxpayer. The two types of family trusts that are recognised for this purpose are post marital family trusts¹¹¹ and family relief trusts.¹¹²

The attribution of income from the non-resident trust depends on whether the trust is resident in a listed or unlisted country. Broadly, the attributed income from the non-resident trust is reduced for both listed and unlisted country trusts by following amounts:

- an amount already assessable to the beneficiaries;¹¹³
- amount that is subject to tax in Australia on the trustee;¹¹⁴
- grossed up amount of franked dividend received by the non-resident trust from Australian companies;
- income received by the non-resident trust from another non-resident trust that has already been an attributed income to another transferor;
- income that has already been attributed under the CFC rules;
- income that has been subject to tax in a listed country;
- FIF income attributed to the trust where the CFC measures also apply.

¹¹¹ Post marital family trust – created on annulment of marriage or decree or order of judicial separation. The primary beneficiaries must be natural persons – spouse, child etc.

¹¹² Family relief trust – trust created for operated for relief of persons who are in necessitous circumstances. To meet the criteria, the assets of the trust must not be excessive.

¹¹³ Under section 97 of the ITAA 1936

¹¹⁴ Under section 98, 99 or 99A of ITAA 1936

The amount of attributed income that will be treated as assessable income of the taxpayer is dependent on the tax residence status of the taxpayer. The income is apportioned where the taxpayer has been tax resident of Australia only part of the year.

The *de-minimis* exemption applies where the total attributable income derived by all non-resident trusts (from listed and unlisted countries) does not exceed the lesser of \$20,000 or 10% of the aggregate of the net incomes of the trusts estates. The exemption applies only to the income from listed countries.

Income of the non-resident trust that is not caught by the transferor trust measures or has not been taxed on a current basis in the hands of Australian trustees or beneficiaries is subject to additional tax. An interest charge applies to the deferral of income which is intended to compensate for the deferral of revenue to Australia.

To avoid the interest charge, the taxpayer has to provide evidence that:

- in relation to listed country trusts, that income was not wholly attributed from the trusts designated concessional income; or
- in relation to unlisted country trusts, that the distribution was wholly from trust or estate that has been taxed in a listed country.

3. *Foreign Investment Funds (FIF)*

FIF measures apply to Australian residents who have FIF interest in a foreign company and/or foreign trust at the end of an income year, or foreign life insurance policy (FLP) at any time in an income year.

The interest in a foreign company is shares in the company and the interest in the foreign trust is interest in the corpus or income of the trust.

A FLP is life insurance policy issued by a non-resident (excluding an Australian policy), policies that cover life or life and permanent disability and policies issued prior to 1

July 1992 which cannot be surrendered and contracts between resident insurer and non resident re-insurer concerning life cover.¹¹⁵

There are three methods that a taxpayer can use to calculate FIF income. These are:

1. The market value method (MV)¹¹⁶ – [(market value of interest at the end of the year + distributions received during the year) – (market value of interest at the beginning of the year + cost of any FIF acquired during the year) + distribution received in relation to FIF disposed during the year]. FIF income and losses is ring fenced to losses or income from FIFs in the previous years.
2. The deemed rate of return method (DRR)¹¹⁷ – is used if it is not practical to use market value method. To use this method, the FIF will have to be grouped for similar types of FIFs. The formula is:

Opening value of FIF x deemed rate of return x No of days / 365

3. The calculation method (CM)¹¹⁸ – in order to use this method, the taxpayer is required to make an election which is irrevocable. This method requires the determination of the calculated profit or loss from a FIF for a notional accounting period. Where there is a calculated loss, the taxpayer's share of the loss may be carried forward to later notional accounting periods.

For FLPs the FIF income is calculated using one of the two methods. These are:

1. The deemed rate of return method (DRR)¹¹⁹ – refer to the method above
2. The cash surrender value method (CSV)¹²⁰ – the taxpayer will have to elect to use this method. The election will be irrevocable. The method used for the calculation

¹¹⁵ See n 91, para 21,380; ITAA1936, s482

¹¹⁶ Ibid, para 21,420; ITAA1936, s532, 535-542

¹¹⁷ Ibid, para 21,430; ITAA1936, s 543-557

¹¹⁸ Ibid, para 21,440; ITAA1936, s486, 558-560

¹¹⁹ Ibid, para 21,450; ITAA1936, s536, 585-590

of the FIF amount – [(cash surrender value at end of period+ distributions received + disposals) – (surrender value at start of period + cost of interest acquired during the period)]. Ring fencing of the FIF income and losses applies.

If during the notional accounting period, the FIF or FLP makes a distribution of income and the taxpayer returns this income for tax purpose, the FIF or FLP income is reduced by this amount.¹²¹

4. Other international tax rules

a) Temporary resident concessions

From 1 July 2006, certain concessions apply to temporary residents of Australia. Temporary residents are persons who hold a temporary visa under the Migration Act 1958. This visa entitles the person to remain in Australia during a specified period, or until specified events occurs, or while the holder has a special status. There is no time limit on how long a person can be temporary resident. A person may be a temporary resident irrespective if whether they are resident or non-resident under the tax rules¹²².

The following incomes of the temporary resident are exempt from Australian tax:¹²³

- A foreign source income exemption – exempts all foreign sourced income (e.g. Rent, dividends, interests, rental income etc) but does not include employment income or alienated personal service income, or net capital gains or employee share purchase discounts.
- Special types of foreign income – the temporary resident will be exempt from being an attributable taxpayer for CFC, FIF and Transferor tax purposes.
- Capital gains or losses will be treated in the same manner as that made by a non-residents.
- Employee share scheme rules – where the part of the qualifying employment is performed outside Australia, then only part of the discount is taxed in Australia

¹²⁰ Ibid, para 21,460; ITAA1936, s530

¹²¹ Ibid, para 21,470; ITAA 1936, s 530A

¹²² Ibid, para 22,125.

¹²³ Ibid, para 22,125

- Interest withholding tax exemptions – temporary residents are not required to withhold 10% withholding tax for interest payments to offshore lenders (applies to payments made after 6 April 06).

b) Conduit Foreign Income

The fundamental principle of the Australian taxation system is that non-residents are only taxed in Australia on Australian source income, and are not taxed on non-Australian source income.

This rule applies where an Australian corporate tax entity receives an unfranked dividend; it may be able to declare some or the entire entire unfranked dividend to be conduit foreign income. The implications of the declaration is that the dividend:¹²⁴

- Is non-assessable non exempt income of a foreign resident shareholder; and
- Is not subject to dividend withholding tax in Australia.

¹²⁴ Hirschhorn, *Conduit Foreign Income*, The Tax Specialist Vol 10 No 5, 5 June 2007, p243.

X. POTENTIAL TAX AVOIDANCE

The estimated total funds that are parked by individuals in offshore havens total \$8.7 trillion to \$15 trillion dollars.¹²⁵ Therefore the European Union (EU) has declared a war on tax havens like Liechtenstein, Monaco, Andorra and Switzerland.¹²⁶ New Zealand and Australia have their own weapons (anti avoidance rules) to fight this war.

A. New Zealand Perspective

The New Zealand tax legislation contains specific and general anti- avoidance provisions.¹²⁷ The specific anti avoidance rules are covered under part subpart GC of the Income Tax Act 2004 (ITA 2004). This part of the Act contains provisions which were specifically legislated to counter tax avoidance arrangements involving the international tax regime. These include CFC, FIF and Transfer pricing measures. Transfer pricing refers the practice of shifting profits from one jurisdiction to another through the manipulation of prices paid for goods, services and intangibles generally between associated persons.¹²⁸ Since transfer pricing is a specialist area on its own, it will not be covered in this paper.

1. The specific anti avoidance rules

The specific anti avoidance provisions applicable to CFC's are covered by sections GC7, GC8, GC9 and GC10 of the ITA 2004. These anti avoidance rules have their own specific applications.

The applications of the specific anti avoidance provisions are as follows:

- Section "GC7 – Arrangements in respect of CFCs" applies to arrangements where two or more New Zealand residents that control the interest in CFC, are held by another person(s) to prevent the foreign company from being a CFC, the interests

¹²⁵ O'Grady S, *EU declares war on tax havens on \$189b battle*, The New Zealand Herald, 5 March 2008, p B6

¹²⁶ Ibid

¹²⁷ Income Tax Act 2004 – Part G

¹²⁸ CCH New Zealand Master Tax Guide 2007, pg 1011.

are deemed held by the residents in equal shares.¹²⁹ This part of the legislation overcomes difficulties in relation to interest held by nominees.

- Section “GC8 - Arrangement to defeat application of CFC attributed repatriation provisions”. This part of the specific anti avoidance rules applies to arrangements where the CFC enters into a financial arrangement via a third party to defeat the attribution rules. Back to back loans aimed to benefit a New Zealand resident investor in CFC would be caught under this provision.
- Section “GC9 - Variations in control or income interests in foreign companies”. This section is aimed at nullifying attempts by taxpayers to manipulate their control interests and income interests in controlled foreign companies by successive variations to those interests before and after a quarterly measurement day.¹³⁰
- Section “GC10 - Attributed CFC income and FIF income: arrangements in respect of elections”. The effect of this section is to overcome arrangements between associated parties where the parties either avoid or make elections (in relation to measurement of ownership interests) in order to avoid the CFC and FIF regimes.

The above specific anti-avoidance rules may not be able to cover many other creative ways of avoiding or deferring the tax on the offshore investments. In such circumstances, general anti avoidance rules may be applied by Inland Revenue.

2. General anti avoidance provisions

The general anti avoidance rules are primarily covered by section BB3, BG1 and GB1 of the ITA. The general anti-avoidance provisions are split into two essential components: the voiding of the tax avoidance arrangements; and the Commissioner’s ability to counteract any advantage obtained under such arrangements.¹³¹ Section BG1 of the ITA simply states

¹²⁹ Ibid, p 1289

¹³⁰ See n 128, p 1289

¹³¹ See n 128, pg 1273.

that “a tax avoidance arrangement is void as against the Commissioner for income tax purposes.”

New Zealand courts have considered the application of tax avoidance arrangement in a number of cases.¹³² The most recent case was *Accent Management Limited And Ors v CIR*¹³³ where judgement was found in favour of the Commissioner.

The definition of tax avoidance arrangements was initially considered in the Australian case, *Newton v Commissioner of Taxation*¹³⁴ which formed the basis of the application of the definition in New Zealand. The New Zealand Parliament intended definition of tax avoidance arrangement was considered in *Elmiger And Another v CIR*¹³⁵ where the Judge considered the judgement by Lord Denning in the *Newton* case and applied this to the New Zealand case. The *Newton* case judicially created the “Predication Test” which created a defence for taxpayers where the taxpayer was able to argue ordinary family or business dealing as an automatic defence to the application of section BG1.

A later case, *CIR v Challenge Corporation Ltd*¹³⁶ created a “scheme and purpose approach” where the courts were able to consider the intention of New Zealand Parliament in considering the application of the anti avoidance provisions.

There are three elements which must be satisfied to prove a breach of section BG1 of the Act.¹³⁷ These elements are:

- An arrangement
- Entered into for the purpose or effect of tax avoidance, and
- That purpose or effect must not be a merely incidental purpose or effect.

¹³² *Accent Management Limited And Ors v CIR* [2007] NZCA 230; *Peterson v CIR* (2005) 22 NZTC 19,098; *CIR v Auckland Harbour Board* (2001) 20 NZTC 17,008; *O'Neil v CIR* (2001) NZTC 17,051

¹³³ [2007] NZCA 230

¹³⁴ (1958) 98 CLR 1

¹³⁵ [1966] NZLR 683

¹³⁶ (1986) 8 NZTC, 5,001, 5,103

¹³⁷ *CIR v Challenge Corp Ltd* (1986) 8 NZTC 5,223 (PC)

A further fourth requirement is that the arrangement “*frustrates the underlying scheme and purpose of the legislation*”. This requirement is imposed by Inland Revenue as an administrative requirement.¹³⁸

In order to apply the general anti-avoidance provisions, the Commissioner will consider each of the above elements in relation to the facts. Where the tax avoidance arrangement has been identified, reconstruction of tax liability can be carried out by the Commissioner to counteract the tax advantage obtained by the taxpayer.¹³⁹

In most cases concerning CFC and FIF, where decisions are made due to commercial or personal reasons, it would be difficult for the Commissioner to prove tax avoidance. However if one of the reasons for the transactions or the structure was to avoid tax, the Commissioner may be able to invoke the general anti-avoidance provisions. The New Zealand courts have followed the approach taken in *IR Commrs v Duke of Westminster*¹⁴⁰ where the Court ruled that legal form, (which is the legal arrangement actually entered into) compared to economic substance (economic consequences) is used to decide a cases. The only exception to the form over substance approach is when a sham is established.¹⁴¹

The CFC and FIF rules apply to international boundaries, however this does not preclude the Commissioner from forming a view that what had occurred abroad could have the purpose or effect of tax avoidance in New Zealand.¹⁴² The CFC and FIF rules have a number of exemptions and properly meeting the requirements of these exemptions would rule out the application of general anti-avoidance provisions. In *CIR v Auckland Harbour Board*¹⁴³ the House of Lords looked at the intent of Parliament in relation to specific financial arrangement legislation and considered the language in which the Parliament had expressed itself.

¹³⁸ TIB Vol 1 No 8 – appendix C

¹³⁹ ITA 2004 – section GB1

¹⁴⁰ [1936] AC 1.

¹⁴¹ See n 128, pg 1275.

¹⁴² *BNZ Investments Ltd v CIR* (2000) 19 NZTC 15,732

¹⁴³ (2001) 20 NZTC 17,008; [2001] 3 NZLR 289 (PC)

Justice Richardson in *CIR v Challenge Corporation Ltd*¹⁴⁴ commented that

“Clearly the Legislature could not have intended that sec 99 should override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself.”

...

“Section 99 thus lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end, the legal answer must turn on an overall assessment of the respective roles of the particular provision and sec 99 under the Statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to Statutes mandated by sec 5(j) of the *Acts Interpretation Act* 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations”.

The legislation in relation to CFC and FIF rules are specific with a number of specific anti-avoidance rules, and therefore tax avoidance cases in relation to CFC and FIF have been rare. The only reported decision of any significance in relation to use of CFC's and FIF for tax avoidance was *CIR v BNZ Investments Ltd*¹⁴⁵

3. *CIR v BNZ Investments Ltd*¹⁴⁶

The taxpayer company, BNZ Investments Ltd (BNZI), funded by share capital taken up by its parent BNZ from outside borrowings, made a series of redeemable preference share ("RPS") investments in entities provided by Capital Markets Limited ("CML"). CML then utilised the funds for various offshore downstream transactions and made use of some special purpose companies in tax haven jurisdictions. These transactions resulted in funds being deposited with prime overseas banks, with interest earned ultimately repatriated to the taxpayer as exempt dividends. The net result was that BNZI received a greater tax free return on its initial investment than it would otherwise have done. The interest paid by BNZ to its customers for the funds borrowed to purchase the shares was deductible for income tax.

¹⁴⁴ (1986) 8 NZTC 5,001 (CA)

¹⁴⁵ (2001) 20 NZTC 17,103

¹⁴⁶ (2001) 20 NZTC 17,103

The Commissioner invoked the general anti-avoidance provisions of section 99 of the Income Tax Act 1976, avoiding the transactions concerned and treating the receipts as taxable to BNZI. The taxpayer appealed the assessment to the High Court. The High Court ruled in the favor of the taxpayer on the basis that the taxpayer was not a party to an “arrangement” within the meaning of section 99.¹⁴⁷

The Judge was critical that the Commissioner failed to look beyond the application of section 99¹⁴⁸ to apply the specific provisions to the “downstream transactions”. This was stated as follows:¹⁴⁹

“Regrettably, the submission does not then proceed to a close transaction – specific analysis of how the various downstream transactions were “specifically contemplated by the Act” to a manner and degree which would exclude s 99”.

“Instead, the submission diverted to meet generalities as originally advanced by the Commissioner in the case stated”.

The Judge considered the Commissioner’s propositions in relation to the CFC and FDWP regime.¹⁵⁰

The taxpayer contested the Commissioner’s propositions on the basis that the downstream transaction to the taxpayer was repatriation of capital. The taxpayer submitted that they had taken steps to ensure compliance with Determination G5 and the CFC regimes as envisaged by the Act.¹⁵¹

¹⁴⁷ Income Tax Act 1976

¹⁴⁸ Ibid

¹⁴⁹ See n 142, para 87, 88

¹⁵⁰ Ibid Para 89 – “The Commissioner had advanced the proposition that the scheme and purpose of the Act was that income derived by Act was that income derived by a New Zealand resident company from an interest bearing deposit overseas, deposited and returned via a chain of intermediate companies and entities, would be subject to tax in New Zealand once and once only along the chain. The Commissioner has invoked in support general provisions of the statute relating to income; interest, attributed foreign income derived through CFC provisions backed by the FDWP regime; and in fact under the accruals rules (excluding “excepted financial arrangements”), bearing in mind MCN transactions and Determination G5. The Commissioner had stigmatised the transactions as effecting conversion of offshore income (which would have been taxable if derived onshore) into non assessable income, with the foreign tax regime and accruals rules excluding, by transactions having no commercial purpose, thus frustrating the Act”.

¹⁵¹ Income Tax Act 1976

The Commissioner submitted “substance over form” arguments where the Commissioners contentions were that economic effect should prevail.¹⁵²

The Commissioner’s principal submissions was tax avoidance on all transactions and that the chain of special purpose entities were placed solely to manipulate debt/equity distinctions and to avoid the 1988 international tax regime and application of accrual provisions.¹⁵³ The Commissioner contended were as follows:¹⁵⁴

“All four types of transaction in issue avoided the international tax regime by using overseas companies (ie not majority owned by New Zealand residents). Accrual provisions were avoided by ensuring transactions are in the form of equity instruments not debt instruments...”

...

“In addition, it was said, the offshore companies although not under control of New Zealand residents were certain to do the bidding of CML. EPBG’s role simply was to ensure the CFC regime did not apply”

The taxpayer argued “new source of income” (which is where the taxpayer has new source of income, he is entitled to arrange his affairs in such a way as to attract least possible liability to tax¹⁵⁵), and that the Commissioner had a “jurisdictional limitation”- and could not re-characterise transactions that occurred in other countries.¹⁵⁶

The Judge ruled that the “new source” doctrine argued by the taxpayer to be obsolete¹⁵⁷. In relation to “jurisdictional limitation” the Judge stated:¹⁵⁸

“The Commissioner does not have power, except in cases specially provided for by New Zealand legislation for New Zealand tax purposes, to re-characterise such transactions as something else. If it

¹⁵² See n 142, para 94 – “ The ‘economic effect’ was by preordained and interdependent transactions ‘dependent economically upon non tax being paid upon the interest earned and returned to the investor’. There was deliberate manipulation of the arbitrary distinction between debt and equity, deliberate avoidance of the new CFC tax regime, and an attempt to design around the accrual rules. The structures, it is said, were ‘inherently artificial and had no genuine commercial imperative other than to avoid paying tax’ on the share of interest paid to BNZ”.

¹⁵³ See n 142, para 97

¹⁵⁴ Ibid, para 98

¹⁵⁵ Ibid, para 91

¹⁵⁶ Ibid, para 92

¹⁵⁷ Ibid, para 122

¹⁵⁸ Ibid, para 123

is a contract under Cook Island's law, then it is a contract in those terms, and the Commissioner must live with that. That, however, does not somehow hamstring the Commissioner in application of s 99.

Further the Judge held that the Commissioner should have reconstructed against the entities in the downstream transaction rather than BNZI.

“... changed their tax position by arrangements relative to that which would have existed if they had earned interest, received dividends under the FDWP regime, or being taxed as CFC's . Those were specific liabilities, which were the subject of specific anti avoidance provisions, which should have been used rather than an attempt to use s 99 ...”

However it must be noted that the transactions in relation to this case took place in 1988 and 1989. The CFC rules applied from 1 April 1988 and were a fairly new set of rules. The FIF rules applied from 1 April 1993, and therefore the entities were able to avoid the CFC rules by not having controlling interest of the offshore entities.

The Commissioner appealed the case to the Court of Appeal, but in this instance again the majority rulings were in favor of the taxpayer in finding no tax avoidance arrangement.

4. *Dandelion Investments Limited v CIR*¹⁵⁹

The taxpayer in this case, entered into a transaction in 1986 that involved the purchase of shares in a UK company, financed by a loan of \$2,800,000 secured by a promissory note. The funds were further applied by the UK company to a series of offshore (Cook Islands) transactions, the net effect of which was to return the funds to the lender, to provide the appellant with a tax free dividend of \$484,000 and to enable a deduction for the payment of interest of \$570,080 to be claimed by the appellant in its return of taxable income for the year ended 31 March 1986. The Commissioner invoked section 99¹⁶⁰ alleging there was a tax avoidance arrangement. The Court of Appeal ruled that the Commissioner was correct in invoking section 99¹⁶¹ as it was a tax avoidance arrangement.

¹⁵⁹ (2003) 21 NZTC 18,010

¹⁶⁰ Income Tax Act 1976

¹⁶¹ Ibid

Again the above transaction occurred in 1986 before the CFC rules were legislated, and there were no specific anti avoidance rules in relation to these types of transactions. The Commissioner had no choice but to invoke general anti avoidance provisions.

If however, there were CFC rules, the Commissioner may still have had to apply the specific or general tax avoidance provisions as New Zealand does not have a “look through provisions” in relation to offshore investments.

5. *New Zealand Forest Products Finance NV v CIR*¹⁶²

Another important case in relation to offshore investment rules was *NZ Forest Products Finance NV v CIR*¹⁶³ (NZFP) where the New Zealand registered company formed a wholly owned subsidiary in Netherlands Antilles to raise finance overseas to avoid high domestic interest rates. NZFP was the guarantor of the loan.

The main issue in this case was whether NZFP should pay NRWT on interest payments by the subsidiary to overseas lenders. The Commissioner contended that the offshore subsidiary was a New Zealand tax resident on the basis that the true centre of management of the company was in New Zealand.

The years concerned were 1985 to 1990 which were mostly pre-reform years. The company residency rules changed from 1 April 1988. At this time the CFC and FIF rules were not in force. This was noted by the Judge that the rule prior to 1 April 1988 required the company to have its “head office in New Zealand” and the later rule required the company to have its “centre of management in New Zealand”.¹⁶⁴

The High Court found for the taxpayer holding that the company's centre of administrative management and control for all tax years (i.e. before and after the legislative amendment to the definition of residence of companies) was in the Netherlands Antilles. The company was a foreign subsidiary of NZFP with all its control and management, including its day-to-day management by ABN in Curaçao (director of the subsidiary),

¹⁶² [1995] 2 NZLR 357

¹⁶³ Ibid

¹⁶⁴ *NZ Forest Products Finance NV v CIR* [1995] 2 NZLR 357, para 13 and 14

taking place outside New Zealand. The Court considered that all directors and shareholders meetings took place outside New Zealand; the day-to-day administration of the subsidiary in terms of administrative details and accounting functions was under the control of ABN (which was completely independent of NZFP), and all transactions of the company were carried out outside New Zealand.¹⁶⁵

Under the current offshore investment rules, the profits of the offshore subsidiary would be assessable to the parent company (NZFP) even if the foreign subsidiary was not a tax resident of New Zealand. However NRWT would still be not payable in New Zealand if the subsidiary is non-resident for tax purposes.

6. *The Look through Provisions*

The CFC, FIF and FDWT regimes were enacted to overcome tax avoidance of the types illustrated in *Dandelion Investments*¹⁶⁶ and alleged tax avoidance in *BNZ Investments Ltd v CIR*.¹⁶⁷ Despite the specific legislations to overcome the problems created by the deregulation of the New Zealand economy in the 1980's it is still possible for Companies to overcome the specific CFC/FIF legislations and achieve tax advantages that these legislations were to rectify.

Mr Philip Barclay Gurney¹⁶⁸ described that one way a New Zealand taxpayer can defer taxation on CFC income is by setting up a subsidiary or holding company in a grey list country – say Australia. Like other Grey list countries, Australia exempts branch income derived by an Australian company from a listed country¹⁶⁹ which includes branch in one of the broad- exemption listed countries. Income from the 58 limited exemption countries will have to pass the active income test.

¹⁶⁵ New Zealand Income Tax Law and Practice, para 23-000

¹⁶⁶ *Dandelion Investments Ltd v CIR* (2003) 21 NZTC 18,010

¹⁶⁷ (2000) 19 NZTC 15,732

¹⁶⁸ Gurney P, *Circumventing the Controlled Foreign Company and Foreign Investment Fund Regimes in Australia and New Zealand: Has Legitimate Tax Avoidance Been Possible?*, New Zealand Journal of Taxation Law and Policy, No 04:01, Sept 2004

¹⁶⁹ Currently there are 58 limited exemption countries listed in Australian legislation and seven broad exemption listed countries.

As long as the New Zealand Company sets up an Australian holding company that sets up a branch in one of the non-grey list countries which are included in the list of the Australian listed countries, and passes the Australian active income test the tax on the income from the non-grey list country is exempt from New Zealand tax.

The current New Zealand tax legislation does not have a “look through” provision. The above structure will achieve a deferral of income tax on income earned from offshore entities as long as no dividend is paid back to New Zealand. The New Zealand control test is based on a concept of five or fewer New Zealand residents holding control interest in a CFC. The associated tax residents each holding an interest, are treated as one New Zealand resident for this purpose. Therefore, the associated party rules are relevant when determining whether 5 or fewer New Zealand tax residents control the CFC.

The Australian CFC rules include an “associates inclusive control interest” rule which brings in a wide range of entities within the scope.¹⁷⁰ Regardless of whether the associated entities are Australian tax residents, they are caught within the scope of the CFC, FIF and Transferor Trust rules.

The same result could be achieved for FIF investments where the New Zealand investor could hold shares in Australian listed Companies that would invest in non-grey list countries. The income is derived in non-grey list country and channeled back to the Australian company by way of dividends or loan (except for portfolio investment in shares¹⁷¹).

David Dunbar, a senior lecturer at Victoria University of Wellington discusses in one of his articles¹⁷² the possibility of avoiding the CFC and FIF regimes in order to achieve tax outcomes. He discusses the following possibilities:

¹⁷⁰ For a good example for the application of the associate control interest rules, refer to *Dismin Investments Pty Ltd v FC of T* [2001] ATC 4377; [2001] FCA 690

¹⁷¹ Grey list exemption has been removed for portfolio investment in shares – refer to TIB volume 19, No 4

¹⁷² Dunbar D, *The CFC and FIF Regimes: An Historical Examination of the Conflict Between Taxpayers & The IRD – Are the McLeod Committee Recommendations An Acceptable Solution?: Part Two*, New Zealand Journal of Taxation Law and Policy- Vol 10, Pg 95

1. Open Ended Investment Companies (OEICs)

According Mr Dunbar; OEICs were promoted to New Zealand investors in early 2000. He explains the workings of the OEICs as follows:

“OEICs are tax efficient investment vehicles which enable 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 the United Kingdom capital gain tax (CGT).”

OEICs have been described to be similar to unit trusts but are limited liability companies where investors hold shares rather than unit trusts and the shares can be issued and cancelled depending on the level of application and redemption.

Another advantage of OEICs as explained by Mr Dunbar, are that an OEIC falls under the New Zealand Securities Commission exemption which means they do not require to have an investment statement or prospectus.

2. Australian Unit Trusts and New Zealand Resident Taxpayer

The key features of using the “look through” advantage described by Mr Dunbar are as follows:

- For New Zealand tax purposes, unit trusts are deemed to be a company and taxed according to the non-qualifying company rules. However an Australian unit trust is treated as an ordinary trust – which is similar to New Zealand trust rules.
- A New Zealand resident (Australian non-resident) beneficiary of an Australian unit trust is taxable in Australia on income which is attributable to source in Australia.
- Therefore if the Australian unit trust sources the income from a New Zealand non-grey list country and attributes the income to New Zealand tax resident beneficiary, no Australian income tax is payable on the income.

- One way that distribution from an Australian unit trust can be treated tax free is if the Australian unit trust distributes the income in the form of non-taxable bonus issue of shares.

3. United Kingdom Unit Trusts and Non-Grey List Investments

Mr Dunbar describes the use of authorised unit trusts (Foreign, Colonial and Schroeder's) for tax planning as follows:

- Foreign, Colonial and Schroeder's are exempt from UK capital gains tax.
- These unit trusts can invest in non-grey list countries.
- Mr Dunbar makes reference to documentation by M Smith and R Turner¹⁷³ which describes UK taxation on approved unit trusts as follows:

"may in certain circumstances distribute their income as if it were a payment of yearly interest income 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 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."

The examples discussed above are some of the ways a New Zealand investor can invest offshore in a non-grey list country and still take advantage of grey list exemptions.

The grey list exemption for portfolio offshore investment in shares (of 10% or less) has been removed¹⁷⁴ therefore the tax advantages of investing offshore in a non-grey list country through a grey list country will not be available for these investments. However, grey list exemption still applies to CFC and non-portfolio FIF investments.

¹⁷³ M Smith and R Turner, "*Investment Funds*", (June 2002) International Bureau of Fiscal Documentation, Supplement No 7, 1, pp 66-67, para 3.2.1.1.1.

¹⁷⁴ IRD Tax Information Bulletin, Vol 19 No 3, April 2007, Pg 28

B. The Australian Perspective

1. Tax Avoidance Possibilities

Unlike New Zealand, Australian legislation does not explicate separate anti-avoidance measures in relation to the accruals taxation system, but instead builds such controls into the CFC/FIF rules themselves.¹⁷⁵ For CFC rules, examples of such provision are the associate's rules¹⁷⁶, separate treatment of each listed and unlisted country investments.¹⁷⁷

There are built in anti-avoidance provisions under sections 343 to 348 which deal with transfers of properties in relation to trusts. Section 345¹⁷⁸ is another example of the anti avoidance provisions built into the CFC rules. Under this section if an Australian entity (prime entity) uses another entity to transfer property to a trust, the property is deemed to be transferred by the prime entity.¹⁷⁹ There are also provisions for transfer of property under a scheme.¹⁸⁰

Transfer pricing rules apply to transactions between associated parties that are not on an arms length basis. However the transfer pricing rules will not be applied by the Commissioner to non-arms length loans between CFCs if:

- Both CFCs are resident in the same listed country;
- Both CFC are controlled by the same Australian resident taxpayer; and
- The non-arms length loan does not result in the reduction of any designated concession income or other amount that would have been taken into account in calculating the attributed income of either CFC.

If the above conditions are not met, the Commissioner can apply transfer pricing rules to non-arms length transactions in relation to a CFC, CFT or FIF transactions or schemes.

¹⁷⁵ See n 168

¹⁷⁶ Income Tax Assessment Act 1936, section 318.

¹⁷⁷ Ibid, sections 320 and 321

¹⁷⁸ Ibid

¹⁷⁹ Ibid, section 245(1)

¹⁸⁰ Ibid, section 245(5)

Like New Zealand, Australia has General Tax Avoidance Rules (GARR). These rules can be used to supplement the built in anti avoidance provisions or can be applied alone to schemes that meet the criteria.

The Australian Tax Office (ATO) Practice Statement Law Administration (PS LA 2005/24) provides a guideline for the application of the GAAR. The GAAR is contained in Part IVA of ITAA 1936 and is applied according to its terms. The GAAR is applied to scheme which is defined very broadly as:¹⁸¹

scheme" means:

- (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
- (b) any scheme, plan, proposal, action, course of action or course of conduct;

A scheme involves not only a series of steps but also the taking of one step¹⁸² and will also include a failure to do something.¹⁸³ The identification of a scheme requires an objectively determined purpose or dominant purpose which is tested against a person who entered into or carried out the scheme, or any part of the scheme. Whether the scheme is narrow or wider is not relevant in determining the test as long as the tax benefit in question is sufficiently connected with the scheme.¹⁸⁴

The identification of the tax benefit requires consideration of ‘alternative hypothesis’ – which is what, may have happened or might reasonably be expected to happen if the particular scheme had not been entered into or carried out. There are eight factors that are required to be considered in applying the purpose test and these are considered against the facts.¹⁸⁵

¹⁸¹ Ibid, section 177A

¹⁸² The GAAR Provisions - PS LA 2005/24, pg 9, *Federal Commissioner of Taxation v Hart* [2004] HCA 26; 217 CLR 216; 206 ALR 207; 2004 ATC 4599; 55 ATR 712 at [43]

¹⁸³ Ibid, p 9; *Corporate Initiatives Pty Ltd v Commissioner of Taxation* [2005] FCAFC 62; 142 FCR 279; 219 ALR 339; 2005 ATC 392; 59 ATR 351 at [26]

¹⁸⁴ Ibid p 11

¹⁸⁵ Ibid, p 12; ITAA 1936, section 177D

The eight factors to be considered are stated in section 177D(b) are as follows:

- (i) the manner in which the scheme was entered into or carried out;
- (ii) the form and substance of the scheme;
- (iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;
- (iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;
- (v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;
- (vi) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;
- (vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and
- (viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi)

The eight factors above consist of three overlapping sets. The first set is about how the scheme was implemented: how its results were obtained. It comprises the first three factors in subparagraphs (i), (ii) and (iii) which deals with manner, form and substance, and timing. The second set comprises the next four factors in subparagraphs (iv), (v), (vi) and (vii) which deal with the effects of the scheme: the tax results, financial changes, and other

consequences of the scheme. The third set is the eighth factor in subparagraph (viii) which deals with the nature of any connection between the taxpayer and other parties¹⁸⁶.

The Commissioner must have regard to each of the eight factors above in reaching an objective conclusion about purpose. However not all matters will be equally relevant in every case. Some matters may point in one direction and others may point in another direction and it is the evaluation of these matters that section 177D requires in order to reach a conclusion.¹⁸⁷

The First three factors determine how the scheme was implemented. The first factor enables contrivance or artificiality to be identified by comparing the manner in which the scheme was entered. If a scheme was entered into and carried out in the manner in which ordinary business or family dealings are conducted, the manner of the scheme will not indicate the purpose of obtaining a tax benefit.¹⁸⁸

The second factor compares a discrepancy between the business and practical effect of the scheme on the one hand, and its legal form on the other, which may indicate the scheme, has been implemented in a particular form to obtain a tax benefit.¹⁸⁹

The third factor enables considerations of the extent to which the timing and duration of the scheme goes towards delivering the relevant tax benefits or are related to the commercial opportunities or requirements.

The next four factors look at the effect of the scheme. The fourth factor expressly focuses on the tax benefit and any other tax consequences resulting from the scheme.¹⁹⁰ The fifth, sixth and seventh factors focus on the non-tax effect of the scheme, not only for relevant taxpayers, but also for all connected parties. These factors look to the practical financial, legal, economic and any other outcomes achieved by the scheme for the taxpayer and connected parties. The absence of any practical change in the overall financial, legal or

¹⁸⁶ Ibid, p 17, para 91

¹⁸⁷ Ibid, p 16, para 87; *Peabody v Federal Commissioner of Taxation* (1993) 40 FCR 531 at 543; 112 ALR 247 at 258; 93 ATC 4104 at 4113-4114; 25 ATR 32 AT 42

¹⁸⁸ Ibid, p 18, para 93

¹⁸⁹ Ibid, p 18, para 95

¹⁹⁰ Ibid, p 20, para 105

economical position of a taxpayer and connected parties is likely to add weight to the dominance of the tax purpose when all the paragraphs in section 177D (b) factors are weighed together.¹⁹¹

The eighth factor inquires into the nature of the connection between the taxpayer and any other person whose financial position is reasonably expected to change as a result of the scheme. This factor requires consideration of the circumstances in determining whether the parties are dealing with each other at arms length in connection with the scheme.¹⁹²

Like New Zealand, the Australian government considered the *Newton's*¹⁹³ case when Explanatory Memorandum accompanying the Bill introducing Part IVA was introduced.¹⁹⁴ This case brought in the predication test where Lord Denning articulated:¹⁹⁵

“ ... In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented *in that particular way* [emphasis added] so as to avoid tax. If you cannot so predicate, but that have to acknowledge that the transactions are capable of explanation by reference to ordinary business and family dealings, without necessarily being labeled a means to avoid tax, then the arrangement does not come within the section”

Section 15AA of the interpretation act applies to interpreting tax law; which is that when interpreting ambiguous provisions the courts could draw upon the purpose and intention of the legislation and so cut down the opportunities for those seeking to exploit the tax system by appealing to literal interpretation of the legislation. Therefore a purposive approach is taken when interpreting the GAAR. Based on the *Newton's* predication test (which was considered by Parliament at the outset) within the field of ordinary dealing, a taxpayer would be free to take up opportunities to reduce tax offered to them by other provisions of the Act.

¹⁹¹ Ibid p 20, para 107 and 108

¹⁹² Ibid, p 21, para 110

¹⁹³ *FC of T v Newton* (1958) 98 CLR 1

¹⁹⁴ PS LA 2005/24, pg 57

¹⁹⁵ Ibid, p 57; *FC of T v Newton* (1958) 98 CLR 1, p 8

The CFC and FIF rules have a number of provisions that specifically allow a taxpayer to take advantage. Examples of such provision are the Temporary Residents rules which allow temporary residents to be exempt from Australian tax on certain foreign sourced income or capital gains, the *de minimis* exemption rules; active income tests rules, and listed and unlisted country rules.

On the other hand an arrangement that exhibited contrivance or artifice would show its tax avoidance purpose on its face, and could fall within the GAAR. A taxpayer therefore would not be free to take up the opportunities offered by the specific CFC, CFT and FIF provisions that require artifice or contrivance to achieve.

Once the Commissioner has identified a tax avoidance scheme, subject to section 177F¹⁹⁶, the Commissioner has the discretion to make a determination canceling a tax benefit that has been obtained. There are time limits to amending assessments. The Commissioner is allowed to amend an assessment at any time before the expiry of 6 years after the date on which the tax became due and payable.¹⁹⁷ Where the Commissioner is successful in applying the GAAR, the taxpayer is liable to an administrative penalty of 50% of the scheme shortfall amount, or 25% if the scheme shortfall if it is reasonably arguable that GAAR does not apply.¹⁹⁸

2. Australian Case Law

Like New Zealand, there has been a limited number of cases through the Australian Courts in relation to offshore investment rules (CFC, CFT and FIF).

The application of the CFC rules was considered in a major Australian case - *Dismin Investments Pty Ltd v FCT*¹⁹⁹. This case was in relation to the attribution of income by way of capital gain and the application of the specific provision that determines the amount of income that is attributed. The case was first heard in the Federal Court.

¹⁹⁶ Income Tax Assessment Act 1936

¹⁹⁷ The GAAR Provisions - PS LA 2005/24, pg 27, para 139; Income Tax Assessment Act 1936, section 177G(1)

¹⁹⁸ Ibid p 27, para 142; Tax Administration Act 1953 (TAA 1953) section 284-160

¹⁹⁹ 2000 ATC 4782

The summary of the facts of the case as stated by Heerey J was as follows:

1. In 1989 two Canadian Companies - Carling and Molson formed a partnership called The Molson Partnership to carry on the business of brewing in North America. The ultimate owner of Carling was Dismin Investments Pty Ltd ("Dismin") an Australian Company. The ownership was structured through interposed entities where Dismin owned Mindis NV (Netherland Company) which in turn owned Mindis BV (another Netherland Company); which owned FBG Canadian Investments Inc which in turn owned Carling.
2. In 1993 each of the partners sold their 10% interest in the Partnership to the United States brewer Miller Brewing Inc ("Miller").
3. Mindis BV was resident of a listed country within the meaning of s 320(1) and Dismin was an "attributable taxpayer" in relation to Mindis BV.

It was not disputed whether Mindis was a CFC in relation to Dismin but the taxpayer disputed the attribution of capital gains on sale of shares in the partnership as an attributable income. The interesting point from this case is that even though the taxpayer interposed a number of entities in between Carling and Dismin, the CFC rules applied by looking through the entities in the Netherlands and Canada. In the Federal Court the Commissioner was successful.

The taxpayer appealed the decision of the Federal Court in the Full Federal Court.²⁰⁰ In this Court the Commissioner changed his stance and agreed with the taxpayers contentions in the Federal Court but also wanted to introduce new arguments and evidence to argue the case based on new propositions. The Full Federal Court did not allow new evidence and propositions and therefore the taxpayer was successful in the Full Federal Court.

²⁰⁰ *Dismin Investments Pty Ltd v FC of T* [2001] ATC 4377; [2001] FCA 690

Another important Australian case involving CFC's was *Consolidated Press Holdings Ltd & Anor v FC of T*.²⁰¹ This case was first heard in the Federal Court. There were two issues in dispute in this case. The first involved the application of thin capitalisation rules in relation to a CFC, and the second was whether the debt defeasance by the CFC was active business income or passive business income.

It was interesting to note that the Judge went behind the intention of the CFC legislation for both issues and considered the policy statement documents to determine the intention of Parliament in relation to the rules. Without going through the lengthy facts of the case, I will discuss the two issues separately.

The first issue involved a CFC resident in a tax haven (Bahamas) that borrowed funds from various non-resident and resident associates and breached the thin capitalisation threshold. The Commissioner attributed the income of the CFC to the Australian taxpayer after disallowing the interest expense that exceeded the required threshold (i.e. calculated the attributable income based on Australian tax rules). The taxpayer disputed the Commissioner's assessment on the basis that the associated non-residents had returned their portion of attributed income in Australia and therefore there was in essence double taxation.

The Judge considered the prime purpose of the thin capitalisation rules (Division 16F), and the prime purpose of the CFC rules, and concluded that under the thin capitalisation rules there should be a disallowance for interest, or part of the interest paid to a CFC, or associate as long as that interest did not form part of the assessable income of the recipient. The Judge also stated that the duty of Parliament is to ensure that tax legislation is expressed in clearly and in plain language.

The second issue, which was in relation to distinction between active and passive income was where the taxpayer issued public bonds in the Swiss bond market during 1984 and 1985, with the bonds maturing during 1994 and 1995. Part way through the term of the bond (1989) the bonds were trading at a substantial discount and there were huge foreign exchange losses. To reduce the risk of further losses, the company entered into a debt

²⁰¹ 98 ATC 5009

defeasance arrangement which resulted in the company deriving a debt defeasance profit. The issue in question was whether the activity of the company (raising finance) was an active or passive business activity and whether the profits were taxable as attributable income (if passive investment).

The Judge found in the favour of the taxpayer on the basis that it was not in the business of borrowing and lending and the company was formed for the sole purpose of raising finance for the active activity of its associates. It was also held that the company was not in the business of debt factoring as it did not derive any factoring interest income.

The Commissioner appealed the decision in relation to the debt defeasance to the Full Federal Court and the taxpayer cross appealed the thin capitalisation issue. The Federal Court after considering the case of the Commissioner and the taxpayer dismissed both appeals.

It is noted that none of the above cases involved application of GAAR to the offshore investment rules, but rather a purposive approach to the specific provisions were used to reach to a conclusion.

Some academic articles²⁰² have identified certain entities which do not fall within the definition of a CFC. One such type of entity described by Philip Gurnay is Liechtenstein Anstalt. Mr Gurnay has described this as follows:

“One possible way to own assets and make investments through a controlled foreign entity, whilst avoiding the application of both the Australian or New Zealand CFC and FIF legislation, is to utilize an entity that does not fit into the definition of a “company” or a “trust” for CFC/FIF purposes. It is probable that the Liechtenstein *Anstalt* has already been used for exactly this type of purpose by taxpayers resident in Australia. The *Anstalt* is generally set up as a foundation without shares and functions in a similar manner to a company, but with beneficiaries rather than shareholders. Since the beneficiaries do not have to be specified by name, a high level of confidentiality is assured.”

²⁰² See n 168

Until now, no test cases have been through the Australian or New Zealand Courts in relation to the legality or application of the offshore investment rules to these types of entities, however, these types of entities are under the watchdog of the European Union.²⁰³

²⁰³ O'Grady S, *EU declares war on tax havens on \$189b battle*, The New Zealand Herald, 5 March 2008, p B6

XI. A COMPARISON BETWEEN AUSTRALIA AND NEW ZEALAND

A. The CFC Rules

On implementation, the Australian and New Zealand CFC rules had a similar purpose, which was to prevent tax avoidance by using tax havens. However the Australian and New Zealand CFC rules are quite different. A comparison of the rules is as follows:

1. **Control Rules:** In both countries, control is restricted to five or fewer residents who control the overseas company.
2. **Attributable Taxpayer:** Under the New Zealand rules, income is attributed to the taxpayer based on the “income interest” held by the taxpayer – concept of beneficial ownership. Where the taxpayer holds an income interest of 10% or more, income is required to be attributed under the CFC rules. There is separate definition of associated persons for the purpose of the accruals taxation rules.

By comparison in Australia, the attribution rules are based on “associate inclusive control interest” – control ownership. An Australian taxpayer can be an attributable taxpayer if the associate inclusive control interest is 10% or more or alternatively if the taxpayer holds a minimum of 1% associate inclusive control interest and is one of the 5 or fewer shareholders of the CFC.

3. **Exemptions:** Under the New Zealand rules, a CFC in a grey list country is exempt from branch equivalent regime unless the CFC has taken advantage of overseas ‘specified tax preferences’. CFC income from a non-grey list country is taxable in New Zealand.

The Australian exemption rules are quite different to New Zealand rules. Income from an Australian CFC from a listed country is exempt from the accruals taxation except for “eligible designated concession income”. As for unlisted country CFC’s, where the CFC passes the active income test, CFC income is not attributed to the

Australian resident. If the CFC fails the active income test, then only tainted income is attributed to the Australian resident.

There are *de minimis* exemptions under the Australian rules where the total income from CFC – for a listed country CFC with turnover less than \$1m, the total CFC income does not exceed 5% of gross turnover or for listed country CFC, with turnover over \$1m, the CFC income does not exceed \$50,000. This exemption is only applicable for listed country CFCs.

New Zealand does not have *de minimis* exemptions in relation to CFCs.

4. CFC Losses: CFC losses under the branch equivalent method attributable to a New Zealand taxpayer is ring fenced to the country of the origin of the losses. The losses can be carried forward and used against the income from a CFC from the same country.

CFC losses for an Australian taxpayer are applied in the same manner as income quarantining restrictions which operate for resident taxpayers for foreign tax credit purpose. The losses are quarantined to the class of income – CFC losses can be offset only against CFC income

5. Tax Accounts: New Zealand taxpayers can keep a branch equivalent tax account to trace tax credits. Australian taxpayer can keep attribution accounts for a very similar purpose.
6. Trust Measures: Under the New Zealand tax rules, unit trusts are deemed to be companies and therefore are caught under the CFC rules. As for investments in non-resident trusts, either the New Zealand settlor or trustees can be taxed for income derived overseas.

Unlike New Zealand, Australia has a separate measure called “the transferor trust measures” that taxes non-resident trusts on an accrual basis for accumulation of income in foreign trusts. However there are *de minimis* exemptions that apply to the income from the transferor trusts.

B. The FIF Rules

1. What is a FIF? – A New Zealand FIF is defined as an interest in a foreign company, foreign superannuation scheme and the foreign life insurance policy. In contrast, the Australian FIF is an interest in a foreign company or a foreign trust. Foreign life insurance policies are dealt with separately under the FIF rules.
2. Exemptions: There are a number of exemptions from the FIF rules. These are transitional resident rules (the previous, 4 year exemptions for life insurance policies and foreign superannuation schemes are now subsumed by transitional resident rules), de-minimis exemption (\$50,000), foreign exchange control exemptions, shares in Australian publicly listed entities, Australian regulated superannuation exemptions etc. The grey list exemption for FIF interest were abolished for holding where the interest is less than 10%; however the grey list exemption still applies for FIF interests where the holding is 10% or more.

The Australian FIF rules provide exemptions for “active business” – this is where the foreign company is engaged in eligible activities and qualifies for an active business exemption. There are exemptions also in relation to US FIFs, publicly listed banks, principally engaged life insurance companies or authorised general insurance companies, *de minimis* exemption (\$50,000), temporary resident, and employment related superannuation fund.

3. Methods of Calculation: New Zealand FIF rules allow 6 different methods for calculating FIF income or losses. These are fair dividend rate method, Cost method, comparative value method, deemed rate of return method, accounting profits method and branch equivalent method.
The Australian FIF rules allow three different methods. These are market value method, deemed rate of return method and calculation method. The market value method is very similar to New Zealand comparative value method.

4. FIF Losses: The New Zealand FIF loss quarantining rules depend on the calculation methods used by the taxpayer. Losses cannot be claimed under FDR²⁰⁴ Cost and CV²⁰⁵ methods if the FIF interest is fewer than 10% in a portfolio type investment. The other restriction is when BE method is used where the FIF losses are quarantined on a jurisdictional basis. Otherwise there is no restriction on claiming the losses using the other methods against ordinary income.

The Australian FIF loss quarantining rules are stricter. The losses are quarantined under both the market value and calculation methods on a fund by fund basis.²⁰⁶

C. Economic Policies Point of View

The overriding economic policies of the New Zealand Government are improving the economic and social wellbeing of New Zealanders. The New Zealand offshore investment rules are based on the principle of National Welfare Maximisation. The Government encourages New Zealand residents to invest locally compared to investing offshore on the basis that every dollar invested locally creates wealth in the economy (creates employment, exports and reduces imports). It is also true that taxes paid in New Zealand contribute to New Zealand welfare, where as taxes paid overseas do not.

In order to maximise national welfare, New Zealand taxes offshore income on a see-saw basis – full accrual taxation for offshore investment income and lower rate of tax on capital imports (non residents investing in New Zealand). However in recent months, New Zealand has changed its stance and is promoting offshore investment of New Zealand firms. This will result in changes to the CFC rules by implementing active income exemptions for offshore business activities.

In contrast to New Zealand, Australia is a large economy and very rich in natural resources. When the offshore investment rules were implemented, Australia also had

²⁰⁴ Fair Dividend Rate

²⁰⁵ Comparative Value

²⁰⁶ Income Tax Assessment Act 1936, s 532, 572

National Welfare Maximisation as one of the reasons. From the outset, Australia had the active and passive income distinctions in its CFC and FIF rules. By doing this Australia was promoting use of scarce capital owned by Australians in active business. On the other hand, capital that was idle (passive investments overseas) was penalised by accruals taxation.

The recent changes in the New Zealand offshore investment rules and the proposals for introduction of active and passive distinction for CFCs will promote harmonization of the Australian and New Zealand offshore investment rules. This will complement the Closer Economic Relations (CER) between Australia and New Zealand.

D. Tax Avoidance and Case Law

In contrast to Australia, New Zealand has specific anti avoidance provisions that prevent abuse of the offshore investment rules. Australia on the other hand has these rules built into the specific offshore rules. A good example is the Australian associate's rules for CFC's whereas New Zealand has separate associated party rules.

Both countries have had very limited number of Court cases in relation to the breach of offshore investment rules. New Zealand has had two cases where GAAR was applied. Australian on the other hand has had two cases where specific offshore investment rules were applied. Both Australia and New Zealand have had cases where tax havens were used to reduce tax liability.

Possible reasons for such a small number of cases in relation to the offshore investments rules in both countries could be that these cases get settled before they reach the Courts, or there is very little audit activity carried out by the tax authorities in this area of tax.

New Zealand does not have "see through" provisions; therefore it is possible for companies to invest in tax havens via grey list countries. Most grey list countries have

offshore investment rules (CFC, FIF) therefore there are possibilities that accruals taxation may apply in the grey list country.

The offshore investment rules, especially the CFC rules are based on the concept of investing in offshore companies or trusts. Tax avoidance is possible in both Australia and New Zealand by using investment vehicles available overseas that are not Trusts or Companies. Liechtenstein offers a form of legal entity called *Anstalt* which falls outside the definition of a CFC in both countries. However these types of structures can be challenged by the tax authorities in both countries under the GAAR.

XII. THE EFFECTS ON PRACTICE

A. The Complexity of the rules

The offshore investment rules for both countries are complex and it can cost taxpayers large sums in consultation fees to get the rules right. At times, some taxpayers and tax agents are not even aware that such rules exist.

Under the self assessment regimes in both Australia and New Zealand, a very small proportion of the taxpayers get selected for audits in relation to offshore investment rules and therefore a large number of taxpayers may be getting away undetected. This is evidenced by the small number of cases that have gone through the Courts in both countries.

Regardless of the compliance costs to taxpayers, the increased globalisation means these rules are here to stay. The tax revenue at stake is too high to ease or remove these rules.

XIII. CONCLUSION

Both Australia and New Zealand implemented their offshore investment rules at similar times – late 1980's. During the early 1980's both countries identified increase in tax avoidance due to the removal of exchange controls and therefore had implemented anti tax avoidance measures in the tax legislation.

From the economic policy point of view, both countries justified the implementation of the offshore investment rules based on the principle of National Welfare Maximisation. The policies of both countries were based on the see-saw principle where the overseas investments of the tax residents were taxed on a higher tax rate than the investment into the home country by overseas residents. The policy encouraged investments in the home economy by overseas investors and discouraged overseas investments by tax residents. However both countries had their own “grey listed” countries (with similar tax rates and rules) where specific exemptions were available.

To curb tax avoidance, New Zealand implemented the FIF and CFC rules whereas Australia implemented the FIF, CFC and Transferor Trust rules. Unlike Australia, the New Zealand tax rules treat unit trusts like companies and New Zealand has separate rules for qualifying and non-qualifying trusts.

The major difference between the Australian and New Zealand offshore investment rules is that the Australian rules provide a distinction between active and passive investments. New Zealand does not distinguish between active and passive investments. However, recently there have been discussion documents issued by the Policy Advice Division of New Zealand Inland Revenue proposing the implementation of an active and passive distinction to CFC rules. The New Zealand FIF rules have also moved closer to the Australian rules – especially by enacting specific exemptions for publicly held and actively traded interests in FIFs trading generally in Australia.

Even though the offshore investment rules are anti-tax avoidance measures, New Zealand has gone further by implementing certain specific anti-avoidance provisions in

relation to the CFC and FIF rules. Australia does not have such specific anti-avoidance rules but its CFC, FIF and Transferor Trust rules are robust enough to deal with tax avoidance in this area. Both countries have general anti avoidance rules (GAAR) where the FIF and CFC rules do not capture a tax avoidance arrangement or scheme.

The Australian GAAR requires the “dominant purpose” test to be met. Altogether there are eight factors that are required to be considered before alleging tax avoidance under the GAAR. By contrast, the New Zealand GAAR is not as rigorous. In order to apply the GAAR, the arrangement is required to have tax avoidance as its purpose or effect or as one of its purposes or effects.

In both countries, the offshore investment rules have not been tested vigorously in the Courts. Both countries have very small number of cases in relation to the application of FIF, CFC and the Australian Transferor trust rules.

The design of a tax system should be such that the taxpayers find it easy to comply and difficult not to comply. The compliance cost on the taxpayer should be nominal so that more resources are put towards trading rather than complying with tax laws. The current offshore investment rules are complex for all parties involved. The recent changes to the FIF rules in New Zealand has not simplified but complicated the rules even further by bringing in a number of exemptions for certain type of entities and two new calculation methods. The Australian active and passive distinction in itself is a complex set of rules.

Having acknowledged the complexity of the rules, the globalisation of the world economy, opening up of the large economies like China and India and increases in immigration, requires the implementation of stringent offshore investment rules. Lack of stringent rules can have an adverse effect on the tax base of the home country. A large economy like Australia with an abundance of natural resources may be able to weather the erosion of the tax base, but a small country like New Zealand needs to be more vigilant.

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