Regulatory Impact Statement

Insurance Income of Controlled Foreign Companies

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It addresses the question of whether the insurance business income of controlled foreign companies is being taxed as intended.

Given that this is a base maintenance measure, consultation has been very limited to reduce any revenue risk. The limited consultation has not produced issues that have impacted the options considered in this Statement.

The policy options identified in this Statement are likely to impose some additional costs on businesses, compared to the status quo. However, these additional costs relate to ensuring that appropriate tax is paid on passive profits derived by a controlled foreign company. It was always intended that such amounts would be taxed, and a change in this area would make the law work as intended.

The option for retrospective change would involve the reversal of tax losses already claimed by taxpayers. This reversal of losses is consistent with the intent of the law to tax passive profits of controlled foreign companies.

There are no appreciable social, environmental or cultural impacts anticipated.

There are no other significant gaps, dependencies, constraints, caveats or uncertainties concerning the regulatory analysis undertaken. The proposed option does not impair private property rights, reduce market competition, provide disincentives to innovate and invest, or override common law principles.

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STATUS QUO AND PROBLEM DEFINITION

1. The question addressed in this Statement is whether the insurance business income of controlled foreign companies is being taxed as intended.

2. There is a problem with the taxation of interests in controlled foreign companies (CFCs). The income of CFCs that carry on a business of insurance and use reinsurance to reduce their risk is not fully taxed. To date, the problem has generated approximately $70 million of tax losses that do not represent real economic losses (this corresponds to $20 million in tax foregone).

3. The problem occurs mainly because income of a CFC is taxed only if it is listed in section EX 20B of the Income Tax Act 2007. Reinsurance income is not listed in that section. A CFC in the business of insurance is very likely to have some reinsurance. At the same time, insurance claims paid out by the CFC are tax-deductible.

Example: Overseas Ltd is a CFC that carries on an insurance business. It receives premiums of $10 million and, because of a significant event, pays out claims of $50 million. It also pays a reinsurance premium of $5 million and makes a reinsurance claim for $40 million. Before tax, there is a net loss of $5 million ($10 million + $40 million - $5 million - $50 million). Because the reinsurance claim is not taxed, the tax measure of the loss is -$45 million ($10 million - $5 million - $50 million).

4. Some other types of insurance income of CFCs are also not taxed.

5. If the status quo is maintained, taxpayers would obtain windfall gains since the tax losses would be used to reduce the tax payable on other income. Further tax losses would also arise.

OBJECTIVES

6. The first objective is to ensure that the CFC rules work as intended in respect of insurance business income (which is “passive income”).

7. The intent of the CFC rules is to tax the New Zealand owner of a CFC on the CFC’s income, at the time it arises. However, only passive income, such as interest income, is taxed in this way. Active income (for example, income from manufacturing or retailing) is not taxed in New Zealand at the time it arises.

8. Where passive income is taxed, tax deductions are allowed for expenses incurred in earning passive income. This is to ensure that taxation is based on profit arising from passive activities (true income) rather than gross turnover.

9. The second objective, which is related to the first, is to prevent the erosion of the government's revenue by collecting the appropriate amount of tax on CFC income. In the context of the problem that this Statement deals with, the appropriate amount of tax would not be collected if significant tax deductions were available for costs or losses that are not economically suffered.

10. The third objective is to retrospectively amend law only in unusual circumstances in order to give taxpayers certainty about the law whenever possible. In general, taxpayers should be able to rely on the law in force at the time that they enter into transactions or file tax returns. Retrospective changes to the law introduce uncertainty and can be seen as unfair to particular taxpayers. The degree of uncertainty depends on the scale and scope of the change, and the surrounding circumstances.

REGULATORY IMPACT ANALYSIS

11. Two options for dealing with the problem have been identified:

- Option 1 – a prospective law change that would tax all CFC income from a business of insurance; and

- Option 2 (preferred) – a retrospective law change that would tax all CFC income from a business of insurance.

12. *Table 1* (page 5) lists the various impacts of the options, and their ability to meet the objectives stated in the previous section. None of the options would have appreciable social, environmental or cultural effects.

13. The prospective change in option 1 would allow taxpayers to keep windfall gains already obtained, while not allowing any such windfalls in future. The retrospective change in option 2 would remove the ability of taxpayers to keep windfall gains already obtained and also not allow any such windfalls in future.

14. The retrospective change in option 2 would take away a tax benefit that has already arisen. However, that benefit is a windfall that results from a legislative oversight. It does not represent an economic loss and it is highly unlikely taxpayers would have been relying on the windfall when making investment decisions. In addition, the amount involved is significant (approximately $20 million of tax foregone).

CONSULTATION

15. Taxpayers known to be affected were advised of the problem before filing returns. They were also informed of the possibility that the law would need to be changed to correct it. There was some brief discussion of the issues at that time. The discussion did not give rise to any need to change the options considered in this Statement.

16. Consultation with other taxpayers beyond this group has not been undertaken in order to protect the tax base.

17. There may be further public consultation on the detail of legislative measures if a legislative change is pursued, to prevent unintended consequences. Typically this would

occur after a general announcement of the change, to limit the opportunity for exploitation of the gap in the tax rules.

CONCLUSIONS AND RECOMMENDATIONS

18. Officials recommend option 2, since the legislation would work as intended, government revenue would be protected and there are good policy grounds for a retrospective change that removes windfall gains.

IMPLEMENTATION

19. The recommended option would require a legislative change. It is intended that such a change would be included in the Taxation (Annual Rates, Returns Filing and Remedial Matters) Bill, if time permits.

20. There would be minimal implementation required for either of the options. Systems changes should be limited to changes in training material and other documentation for Inland Revenue staff.

21. If the retrospective option is pursued there would be some reassessment of past income tax, which would be a manual exercise. On the basis of current information, this would involve only a small amount of work by Inland Revenue and will be met entirely within existing baselines and workloads.

22. We do not anticipate an appreciable ongoing increase in compliance costs for taxpayers. There may be a one-off cost to deal with the reassessment of past income tax if the retrospective option is pursued. We do not anticipate that this would be significant in the context of other tax work.

23. The proposals for legislative change would ensure existing legislation works as intended.

24. The effectiveness of any change would be monitored through Inland Revenue's normal audit and risk assessment procedures.

MONITORING, EVALUATION AND REVIEW

25. As explained in the previous section, the options for change would ensure that the legislation would work as originally intended. Its effects would be monitored through Inland Revenue's normal auditing and risk assessment of taxpayers. There is no intent to have a separate formal monitoring or review process for this initiative.

Table 1: Impacts of status quo and options

	Status quo	Option 1: Prospective change	Option 2: Retrospective change
Objectives			
CFC rules work as intended	No (passive profits not properly assessed because the reinsurance component of the insurance business is not included).	Partially (passive profits properly assessed, but only in future).	Yes.
Revenue protected	No ($70 million of unintended tax losses not corresponding to real economic losses, and more could arise).	Partially (taxpayers can keep benefit of $70 million of unintended losses, but no more will arise).	Yes.
Retrospective change limited where possible	N/A.	Yes.	No (tax returns, filed based on the law in place at the time, would be amended).
Fiscal effects (note: the revenue effect, if all $70 million of losses were used up against taxable income, would be approximately $20 million).	$70 million tax loss will be in baselines for the 2012 Budget. Implicitly, forecasts will include further losses (though much less than $70 million unless there is another major event such as the Canterbury earthquakes).	$70 million loss will be in baselines for the 2012 Budget, but forecasts will not include additional losses.	$70 million loss will not be in baselines for the 2012 Budget, and forecasts will not include additional losses.
Economic effects	Taxpayers will have a windfall gain of approximately $20 million, and further (likely smaller) windfalls in future.	Taxpayers will have a windfall gain of approximately $20 million.	Taxpayers will be taxed in line with their actual profit or loss.
Compliance	None anticipated.	None anticipated.	May discourage voluntary disclosure by taxpayers of unintended tax effects.
Social, environmental and cultural effects	None anticipated.	None anticipated.	None anticipated.