Regulatory Impact Statement

Improved Taxation of Controlled Foreign Companies

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question it addresses is whether taxpayers are taxed on the profits of foreign companies that they control in a fair way.

There has been extensive consultation about the options discussed in this statement. The preferred options have the support of the taxpayers that we have consulted and the New Zealand Institute of Chartered Accountants.

As a result of consultation, a preferred option allowing companies to elect for taxation on all of their passive income was extensively modified to reduce compliance costs. This was done by allowing the election to be made only in respect of one or some foreign companies, rather than all of them. There have also been changes to the finer details of preferred options identified in this statement.

There are no significant gaps, assumptions, 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 this statement addresses is whether taxpayers are taxed on the profits of foreign companies that they control in a fair way.

2. New Zealand owners of foreign companies (Controlled Foreign Companies or CFCs) are taxed directly on the profits of those companies. The purpose of this is to prevent taxable income being artificially removed from the New Zealand tax base. The relevant taxing provisions are in the Income Tax Act 2007.

3. In 2009, the taxation of CFCs was changed. Since that time only passive profits have been taxed. This more directly reflects the purpose of the CFC rules. Passive profits are from certain income that may be easily shifted between countries, such as interest or royalties.

4. In contrast, active profits are not taxed. Active profits include profits such as manufacturing income, which is harder to shift because it comes from fixed assets and workforces. Removing New Zealand tax on active CFC income has also put New Zealand multinationals on a more equal footing with their competitors abroad.

5. To reduce compliance costs, there is an active business test. A CFC passes the test if its (gross) passive income is less than 5% of its (gross) total income. If it passes the test, all income from the CFC is ignored and none of its expenses are tax deductible. That is, the CFC is effectively removed entirely from the tax base. The test can be conducted using general purpose financial accounts or income tax calculations.

6. Two technical problems have been identified with the CFC rules, both of which involve taxing income while not allowing deductions for related expenditure.

7. The first problem arises when an active CFC borrows to fund its business. If the borrowing is in a foreign currency, it is possible that exchange rate changes will generate a gain on the borrowing. Such a gain is passive income and may cause the CFC to fail the active business test, so that the gain is taxable. In contrast, an exchange rate loss would not cause the CFC to fail the active business test and so would not be deductible.[1] If the exchange rate fluctuated over the course of a loan but ended up where it began, there would be no overall economic income but there would be an overall tax liability. This is overtaxation.

8. The first problem has been observed in practice, and has created significant amounts of income (many tens of millions of dollars) that should not have been taxed, but were subject to tax under the law. A temporary solution was instituted in 2011, with retrospective effect, to relieve the first problem. That solution involves carrying exchange rate losses forward or backwards to cancel out exchange rate gains. However, this solution is limited in its scope and will expire automatically in 2013. Also, it may be ineffective if exchange rate changes do not even out over a reasonably short period.

9. The second problem arises when an otherwise active CFC spends money in one year to earn passive income in a different year. For instance, a retailer might decide to set up a consumer finance operation that will generate passive interest income. Money spent to set up

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[1] There is overtaxation even when a CFC is *partly* active and would not pass the active business test. This is because gains are always fully taxed but losses are only deductible to the extent that the CFC is engaged in passive business. The options discussed in this Statement would address the problem for both wholly and partly active CFCs.

the operation (before any income flows in) would be non-deductible because the retailer would pass the active business test. Once financial income starts to be derived, the retailer will fail the active business test and the income will be fully taxed. The effect would be taxation on gross income rather than tax on net profits, and amounts to overtaxation by not allowing tax deductions for relevant expenditure.

10. The potential for overtaxation, caused by both problems, may discourage businesses from entering into sensible, commercially sound arrangements. In the extreme, this may prevent the offshore expansion of New Zealand multinationals. More commonly, it will lead to companies using costly or unwieldy structures to avoid the overtaxation. It could also result in higher financing costs and greater expenses paid to accounting or legal professionals.

11. Businesses without access to tax advice and the means to create structures that avoid the current problems, might end up with overtaxation. The outcomes are not intuitive and so are less likely to be anticipated by people without comprehensive tax knowledge.

12. There are also businesses with arrangements that were already in progress when the new CFC rules were introduced. Avoiding overtaxation might involve costly restructuring for those entities, such as breaking fixed-term loans.

OBJECTIVES

13. The main objective is to tax the passive profits of CFCs in a fair way. This means including the relevant passive income in the tax base, but also allowing tax deductions for related expenditure. This is in accordance with the general principle, applied in most instances in the Income Tax Act 2007, that taxable income in the case of a business is profit, not gross turnover.

14. A secondary objective is simplicity for taxpayers and tax administrators applying the rules.

REGULATORY IMPACT ANALYSIS

15. We do not regard the status quo as a viable option because it would arbitrarily overtax some taxpayers by a considerable amount. This overtaxation goes back to when the revised CFC rules were introduced in 2009. Any option would need to be retrospectively applied to address this concern.

16. We have identified the following preferred options to resolve each problem:

- *Preferred option for problem 1:* Tax gains on borrowings, such as exchange rate gains, only to the extent that a tax deduction for losses would otherwise be allowed.

- *Preferred option for problem 2:* Allow taxpayers to elect out of the active business test. This means tax deductions would be available for all expenditure incurred to earn passive income, but also that all passive income – even small amounts – would be taxable.

17. Both the preferred options provide fairer outcomes than the status quo. They seek to tax income and related expenditure in the same way, and to tax on the basis of profits rather than gross turnover.

18. The preferred option for problem one would be simpler to apply than the existing temporary solution, and apply in a wider range of circumstances. It should be very simple to apply for active businesses.

19. The preferred option for problem two involves some additional compliance costs for taxpayers. They would have to calculate income and deductions in some years where previously they did not. Efforts have been made in the detailed design of the policy to reduce these costs; for instance, the election not to apply the active business test is allowed on a per-CFC basis, rather than on a per-taxpayer basis (some taxpayers have many CFCs).

Alternative solutions for problem 1

20. We considered a number of other options for the problem of taxing gains on borrowing. In particular, we considered extending the existing interim solution, ignoring exchange rate gains and losses entirely, and exempting all borrowing-related gains of active businesses.

21. The existing interim solution is very complex. It involves separately identifying the exchange rate components of income or losses, and carrying the components forward or back to offset each other. It also has a narrow scope; that is, to limit side effects that might undermine the Government's revenue.

22. Ignoring all exchange rate gains or losses was rejected as an option because of the unacceptable level of tax avoidance risk. It is a general requirement in our tax system that tax liabilities are to be calculated in New Zealand dollars. This principle was relaxed when CFC rules were first introduced in New Zealand. The result was the generation of artificial tax losses worth several hundreds of millions of dollars through the manipulation of currency gains and losses. The rules were quickly changed to require conversion to New Zealand dollars for all material amounts.

23. Exempting all borrowing-related gains of active CFCs would also not solve the whole problem. This is because even CFCs that do not pass the active business test, but have some active business, are overtaxed under the status quo. They are fully taxed on gains but get limited deductions for losses.[2] The preferred option would deal with these cases, and partly tax the gains in the same way as losses are partly deducted.

Alternative solutions for problem 2

24. We also considered a number of other options for the problem of there being no deduction for expenditure incurred in earning active income in another year. We considered following an Australian-style approach. Broadly speaking this would mean calculating tax every year but carrying forward the income or loss in years where a business passes the active business test, rather than requiring the tax to be paid in those years. In addition, we considered a version of the preferred option in which a taxpayer, electing to opt out of the active business test, would have to do so for either, all of their CFCs, or none. These approaches were rejected.

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[2] Deductions for interest expenditure are based on the proportion of the CFC's assets that generate passive income. If, say, 60% of the assets generate passive income, 60% of interest deductions are allowed. In contrast, without a change to the law 100% of exchange rate gains on a loan would be taxed.

25. If applied in a way that was fully symmetrical, an Australian-style approach would require a full tax calculation in each year by every taxpayer for every CFC, which would increase compliance costs significantly. The additional compliance cost could be reduced if a less symmetrical outcome is accepted. But, in the New Zealand context, this would amount to the introduction of an implicit subsidy for outbound direct investment that would be more than the removal of barriers that was intended by the 2009 CFC reforms.

26. An alternative version of the preferred option was initially proposed, requiring taxpayers to make a single election in respect of all of their CFCs. This was to prevent passive losses being shifted into entities that had made the election, while related income accumulated slowly in entities (active businesses) that had not. In consultation, it was indicated that this would be very difficult to comply with. The preferred option allows the election to be made for an individual CFC (or CFCs) and not others, but deals with the risk of loss-shifting by "ring-fencing" the loss to CFCs in respect of which an election has been made. That is, the loss cannot be used except by entities whose entire passive income (even small amounts) is taxable.

27. We note that the problems and options discussed in this Statement are likely to affect a relatively small number of taxpayers. These are mostly large corporate taxpayers who have offshore operations and have taken out foreign currency loans via those operations, or have both active and passive lines of business. We do not envisage any social, environmental or cultural effects of any of the options discussed.

28. The options discussed are summarised in the tables at the end of this document.

CONSULTATION

29. There has been extensive consultation about the options discussed in this Statement. This has included consultation with the New Zealand Institute of Chartered Accountants, through its tax committee, and with taxpayers who are directly affected.

30. As a result of the consultation, changes have been made to some of the options discussed in this paper. Mostly these changes are at the level of fine detail, but the option to allow people to opt out of the active business test was modified significantly because of consultation. In particular, the initial proposal was to require all companies in a group of companies to opt out of the active business test if any one member wished to opt out. This was felt to be impractical, particularly for groups with a large number of CFCs. The option has been changed so that a single CFC can opt out, but the use of the resulting losses is restricted (to the CFC itself or to other entities that have opted out).

31. People we have consulted with support the preferred option in this statement. There remain disagreements on some matters of detail, but those consulted have indicated that they do not wish these concerns to stand in the way of implementing the preferred option.

32. The Treasury agrees with the analysis and conclusions in this Statement.

CONCLUSIONS AND RECOMMENDATIONS

33. We have considered a number of options for making taxation of CFCs fairer. In particular, we have looked at options to ensure gains on borrowing of an active business are taxed in the same way as losses on borrowing. We have also looked at ensuring that where

passive income of a CFC would be taxed, related expenditure would be deductible, even if not incurred in the same year as the income arises.

34. We recommend taxing gains on borrowing only to the extent that losses would be tax deductible. We also recommend allowing CFCs to be fully taxed on all their passive income, even small amounts, so that they can obtain tax deductions for all related expenditure. These options are recommended to be applied retrospectively. They would be fairer, relatively simple, comprehensive and balance additional compliance costs with protection of the Government's revenue. They have the support of the taxpaying community.

IMPLEMENTATION

35. The options discussed in this paper would need to be legislated for. It is intended that they would be included as amendments to the Taxation (Annual Rates, Returns Filing and Remedial Matters) Bill, which is currently going through the Parliamentary process.

36. The preferred options could be implemented with minimal administrative implications, other than changes to documentation and training for Inland Revenue staff. They are at a level of detail that means there would be no systems changes required.

37. Because the changes would be retrospective to prevent overtaxation in past years, there would be a small amount of work required to alter past tax positions. This would involve manual processing, and would be met within existing baselines and workloads.

38. Compliance costs for taxpayers will be reduced, in the case of the first preferred option, relative to the temporary solution that will soon expire. For taxpayers with CFCs engaged in active business, it will be common for no tax calculations to be required at all, even when there are exchange rate gains on borrowing.

39. Direct compliance costs for taxpayers will increase in the case of the second preferred option, but this is balanced against a fairer tax outcome (less overtaxation) and reduced impediments to efficient business structures. Some compliance costs are incurred to claim tax deductions for expenditure incurred and to track those deductions to ensure they are used by the right entity. The tracking is necessary to reduce the risk of the Government's tax revenue being undermined.

MONITORING, EVALUATION AND REVIEW

40. The options implemented would be monitored through Inland Revenue's normal audit and risk review procedures.

41. There are no plans for formal review of implementation. The changes are minor amendments in the scheme of the controlled foreign company rules. Any concerns about ineffectiveness following implementation could be raised by taxpayers through normal channels, including directly approaching the Policy Advice Division of Inland Revenue.

Table 1: Impacts of status quo and options (gains on borrowing)

	Status quo	Preferred option: Income taxed only if deductions allowed	Alternative options
Objectives			
Tax profits of CFCs in a fair way	Sometimes not. Income related to borrowing may be taxed on a gross basis, unless the narrowly focussed interim solution applies and exchange rate movements average out over a short period.	Mostly yes. Over time, for a CFC with active business, losses and gains on borrowing should be treated in the same way (mostly both ignored).	No. Risks of undertaxation in some cases, risks of overtaxation for CFCs with some active and some passive lines of business.
Simple for taxpayers and administrators to apply	No. Interim solution is complex, and purely active CFCs are unnecessarily brought into the tax system.	Mostly yes. For purely active businesses, the test should be very simple to apply. For businesses that are not purely active, an apportionment calculation is required, but this is to achieve a lower tax charge.	Yes.
Fiscal effects	Depends on exchange rate movements over the period until the expiry of the interim solution.	Nil. Achieves policy intention of CFC changes introduced in 2009, and is consistent with current baselines.	Not estimated.
Economic effects	May encourage use of inefficient and costly business structures or lead to unexpected tax charges. At the margin, reduce offshore expansion of companies from a New Zealand base.	Nil to minor effects. A more symmetrical tax outcome, without the need for special structuring, should better align pre- and post-tax decision-making. Asymmetries may remain in unusual cases.	As for status quo, but also possibility of inefficient diversion of resources into schemes for generating artificial tax losses.
Compliance	See second objective above.	See second objective above.	See second objective above.
Social, environmental and cultural effects	None anticipated.	None anticipated.	None anticipated.

Table 2: Impacts of status quo and options (tax deductions for expenditure incurred in earning passive income in a different year)

	Status quo	**Preferred option: All passive income taxed, deductions for all related expenditure**	**Alternative options**
Objectives			
Tax profits of CFCs in a fair way	Sometimes not. Some expenditure related to taxed income may not be tax-deductible because it is not incurred in the same year as the income is earned.	Mostly yes. Taxpayers will have the option to be in the tax base even when they have no passive income, which will enable more related expenditure to be tax deductible.	Sometimes not (could lead to undertaxation).
Simple for taxpayers and administrators to apply	Yes.	Some additional compliance costs. Tax calculations required to claim additional tax deductions, and tracking of use of deductions to ensure use in qualifying entities (tracking required to protect Government revenue).	No. Would require detailed tax calculations in more cases.
Fiscal effects	Nil for past expenditure (in baselines). Positive, but unable to estimate, for future expenditure.	Estimated $10 million cost in year of introduction (relates to past deductions). No ongoing costs.	Not estimated.
Economic effects	May encourage use of inefficient and costly business structures or lead to unexpected tax charges. At the margin, reduce offshore expansion of companies from a New Zealand base.	Nil to minor effects. A more symmetrical tax outcome, without the need for special structuring, should better align pre- and post-tax decision-making. Asymmetries may remain in unusual cases.	Nil to minor effects, but possibility with some options of unintended tax incentives to undertake cross-border activity.
Compliance	See second objective above.	See second objective above.	See second objective above.
Social, environmental and cultural effects	None anticipated.	None anticipated.	None anticipated.