



9 March 2007

International Tax Review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Dear Sir

RE New Zealand's International Tax Review: a direction for change

The Investment Savings and Insurance Association ("ISI") appreciates that opportunity to comment on the Government discussion document entitled "New Zealand's International Tax Review: a direction for change" dated December 2006.

ISI represents the issuers and managers of life insurance, superannuation and managed funds and we generally support the discussion document proposals to introduce an active/passive exemption in the taxation of controlled foreign countries ("CFCs") which would limit CFC tax payable to only passive income.

Our comments relate specifically to proposals for distinguishing between active and passive income.

We recommend:

- that insurance activities carried on outside of New Zealand by a New Zealand resident company should fall within the active exemption so long as the activities do not cover New Zealand risks of related organisations, and
- that the active exemption for insurance activities should extend to the income derived from the writing of insurance and from investments held to meet policyholder liabilities that may arise.

GENERAL COMMENTS

The discussion document proposes a new direction for the taxation of taxing income derived by controlled foreign companies. The document suggests an active/passive distinction be introduced. Offshore active income would be exempted from accrual taxation, and passive income would be taxed as it accrues.

The stated objective of introducing the active passive rules is to relax the current CFC regime. This is to address concerns that the current rules provide a disincentive for business to expand offshore and to counteract migration of companies offshore to more user friendly jurisdictions. In support of the proposed change the Discussion Document cites the fact that over recent times the level of outbound investment from New Zealand has lagged behind other OECD countries.

The difficulty with the current CFC rules is that they fully attribute income derived by foreign controlled companies to their New Zealand owners. Owners pay New Zealand tax on the underlying income of the foreign companies calculated by using New Zealand tax rules and after allowing a credit for any foreign tax paid. Dividend income is also taxed but a credit is allowed for tax paid in New Zealand on CFC income and for tax paid offshore on distributions.

The principal exemption from the above requirement relates to investment in so called grey list countries which are eight higher taxing jurisdictions including Australia, US, UK, Japan and Germany. Investment in these countries is exempted from the CFC rules on the grounds that tax is imposed in these countries at comparable rates to New Zealand and that only minimal tax would arise from complying with the rules. It is a pragmatic compliance measure.

The net effect is that if the overseas operations are outside the grey list, and some tax benefit is enjoyed in that jurisdiction relative to the case if trading was within New Zealand, then the tax benefit is clawed back to the New Zealand owners. This is a major issue for New Zealand corporates with international operations competing on the world stage.

Further for operations in jurisdictions outside of the grey list where there is still a comparable taxing regime to New Zealand the existing rules impose significant compliance costs on New Zealand resident companies with little or no tax gain.

To manage this issue, many international jurisdictions with CFC rules have an active passive exemption which limits CFC tax payable to only passive income. The absence of such a regime in New Zealand for non grey list countries is at odds with many other OECD countries.

Active-passive Regime

The Discussion Document confirms the Government's commitment to introducing an active-passive regime. Under that regime active income would be excluded from the CFC regime. The Government's preference is to also extend the exemption to dividends derived from active offshore business provided it can get comfortable that the tax base will not be eroded.

Income taxed under the CFC regime would comprise:

- a) passive income which would include interest, dividends, rent and royalties; and
- b) “*base company income*” which is designed to counteract the transfer of New Zealand income offshore and targets profits derived offshore from related party transactions.

The Document does not recommend whether the taxable passive and base company income would be determined on a transactional basis (where taxable CFC income derived by an offshore company is identified on an item by item basis) or an entity basis (so that certain companies which are regarded as undertaking active business are excluded from the CFC regime).

Ultimately the success of an active-passive regime will depend on the way in which passive income is defined. It is hoped that there will be a common sense approach and that only income from avoidance type arrangements is brought within the passive net. Passive income should logically be confined to New Zealand sourced income which is diverted offshore to low tax jurisdictions for tax benefit. It should not include income genuinely earned from business undertaken offshore and passive income which is taxed offshore at comparable rates to New Zealand.

SPECIFIC SUBMISSION POINTS

1. Distinction between active and passive income

Chapter 4 of the discussion document describes the options for distinguishing between active and passive income. Paragraphs 4.43 to 4.45 deal specifically with the business of insurance. While the document does not reach any conclusions for insurance companies it does outline the fact that most other countries with active income exemptions provide a special case for insurance companies.

The ISI submits that insurance activities carried on outside of New Zealand by a New Zealand resident company should fall within the active exemption so long as the activities do not cover New Zealand risks of related organisations.

Active insurance activities with non related parties are not undertaken in the foreign jurisdiction for any tax avoidance opportunity.

2 Extent of the active exemption

Chapter 5 of the document provides two options for determining the active exemption. The transactional and entity approaches. While the discussion document does not provide a recommended option we understand that Policy Officials currently have a preference for the transactional approach.

Based on a transactional approach income of the offshore operation are segregated and passive income is taxed unless certain safe harbour thresholds are met. Key therefore is what amounts will fall within the active exemption.

The insurance business by its very nature requires the maintenance of sufficient reserves to enable the insurer to meet any policyholder claims that may arise. An insurer will invest these reserves to retain sufficient funds to pay claims as they arise.

The ISI submits that the active exemption for insurance activities should extend to the income derived from the writing of insurance and from investments held to meet policyholder liabilities that may arise.

Yours faithfully

Vance Arkininstall
CHIEF EXECUTIVE