The Tax Treatment of New Zealand Firms' Offshore Subsidiaries

SEHJ VATHER*

I INTRODUCTION

In 2008, the New Zealand Government introduced the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill ("the Bill"),[1] which proposes to change the way in which New Zealand residents are assessed to tax on income derived by offshore companies under their control. The Bill, which had its second reading in August 2009, calls for extensive tax exemptions in respect of income derived by foreign subsidiaries in the course of an active business, such as manufacturing. This article considers the mechanics of the Bill, as well as the numerous tax avoidance risks that will arise as a consequence.

Background

New Zealand residents are subject to New Zealand income tax on their worldwide income (that is, income sourced in New Zealand and overseas).[2] A credit is allowed for foreign tax paid on foreign-sourced income.[3] New Zealand tax is also imposed on all income sourced in New Zealand, irrespective of whether the person deriving that income resides overseas.[4] The only income not subject to New Zealand tax is foreign-sourced income derived by non-residents.

In the past, this has created an incentive for New Zealand residents to avoid tax by diverting foreign-sourced income to offshore companies that they control. For example, a New Zealand resident would be subject to New Zealand tax on income derived from shares in a United States company. In an attempt to avoid New Zealand tax, the resident could form a company in a low-tax jurisdiction such as Hong Kong and transfer

---

* BCom/LLB(Hons), Solicitor, Bell Gully. The author wishes to thank Dr Michael Littlewood for his help and guidance in writing this article.

1 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2). This was passed at the time of publishing as the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, on 6 October 2009. See the author's postscript in Part V. Note that references in this article are made to the Bill.

2 Income Tax Act 2007, ss BD 1(4), BD 1(5)(c).

3 Ibid s LJ 1.

4 Ibid ss BD 1(4), BD 1(5)(c).

ownership of the shares to the Hong Kong company.[5] The Hong Kong company (a non-resident person) would then derive and accumulate dividends sourced in the United States (foreign-sourced income). In the absence of specific tax rules to address this form of tax avoidance, the income would not be subject to New Zealand tax because of its status as foreign-sourced income derived by a non-resident. The underlying income would only be subject to New Zealand tax if the Hong Kong company repatriated its earnings to its New Zealand shareholder by way of dividend. Accordingly, New Zealand tax on the foreign-sourced income would have been either deferred indefinitely or avoided altogether if the New Zealand resident subsequently emigrated or sold the company.

New Zealand, like all Member States of the Organization for Economic Cooperation and Development ("OECD"), addresses this tax avoidance problem in its tax legislation. The rules are known as the controlled foreign company rules ("CFC rules").[6] A controlled foreign company ("CFC") is an offshore company that is controlled by one, or a small group of, New Zealand residents.[7] In addition to capturing most tax haven companies controlled by New Zealand individuals, the term "CFC" encompasses virtually all offshore subsidiaries controlled by New Zealand firms. Under current law, all income derived by a CFC is attributed to its New Zealand shareholders (in proportion to their shareholdings).[8] This means that a New Zealand-resident company or individual cannot escape New Zealand tax on foreign-sourced income simply by diverting it to a tax haven company (as in the Hong Kong example above). The CFC rules currently render the New Zealand resident liable to New Zealand income tax on its share of the foreign company's income as it accrues in the foreign company.[9] By attributing CFC income to New Zealand shareholders, the CFC rules preclude the use of tax haven companies to avoid tax on foreign-sourced income.

Passive Income and Active Income

As illustrated, the key intendment of CFC rules is to prevent cross-border tax avoidance structures in which residents accumulate foreign-sourced income in offshore companies situated in tax havens. The sort of income most susceptible to such tax avoidance is 'passive' income, examples of which include dividends, interest, royalties, and rent. The derivation of passive income generally requires little or no physical activity on the part of the income earner. As a result, ownership of the underlying assets that give

5 Hong Kong does not impose tax on foreign-sourced income earned by its residents. Accordingly, it is an ideal location to establish a CFC that derives income from elsewhere.

6 Income Tax Act 2007, subpart EX.

7 A precise definition of "controlled foreign company" is provided at ibid s EX 1.

8 Ibid ss CQ 1–CQ 3.

9 The New Zealand shareholder is allowed a foreign tax credit for foreign taxes paid or payable in respect of attributed CFC income: ibid s LK 1.

rise to such income (such as shares, intellectual property, or offshore bank deposits) can all quite easily be transferred to a tax haven company, which would then derive the passive income stream in a tax-free environment.

The CFC rules of all OECD countries aim to prevent such cross-border tax avoidance by assessing residents to tax on passive income derived by foreign companies under their control. This nullifies the tax avoidance benefits of shifting passive income to tax haven CFCs. The tax treatment of 'active' income, however, is different. With the exception of New Zealand, no country in the OECD assesses residents to tax on active income derived by CFCs.[10] The reason is that active income usually denotes genuine commercial activity and requires active involvement on the part of the income earner. Whereas passive income is geographically mobile, active income cannot simply be 'shifted' to a tax haven CFC. The archetypal example of a CFC that derives active income is an offshore subsidiary that manufactures goods in a foreign country and sells them to customers or associated companies around the world. The derivation of offshore active income (as in the case of a manufacturing CFC) is generally not driven by a resident's desire to avoid tax. Rather, active CFCs are usually established for legitimate commercial reasons, such as to benefit from low-cost labour or to expand a firm's business into another region.

The OECD norm of attributing only passive CFC income means that resident companies are not subject to tax on active income derived by their offshore subsidiaries (unless the income is repatriated by way of dividend). Resident companies are thus able to shelter foreign-sourced active income in offshore subsidiaries. As a result, resident firms with active CFCs can take advantage of the favourable tax regimes often provided by developing countries to attract inward foreign direct investment ("FDI"). Exempting such firms from attribution of active CFC income reduces their tax burden,[11] and enables them to compete more effectively against international competitors.

The Problem with New Zealand's CFC Regime

New Zealand is the only country in the OECD whose CFC rules comprehensively attribute both passive and active CFC income to resident shareholders. The purpose of attributing passive income to residents is, as mentioned, to prevent cross-border tax avoidance.

The question, then, is: what do New Zealand CFC rules achieve by also assessing residents to tax on active income derived by CFCs? Presumably, the answer is 'capital export neutrality'. The idea is that favourable tax regimes offered by developing countries should not distort

10 Policy Advice Division of the Inland Revenue Department, *New Zealand's International Tax Review: A Direction for Change* (2006) 7 ["*December 2006 Document*"]. Notable examples of OECD countries include Australia, Japan, the United Kingdom, and the United States.

11 This assumes that the CFC's jurisdiction imposes a lower rate of tax than its parent company's home country.

a New Zealand resident's choice as between investing domestically and investing offshore. If an investor is aware that returns from offshore active investments are exempt from New Zealand tax (due to a CFC regime that attributes only passive income), a major incentive arises to invest actively in low-tax jurisdictions, as opposed to directing that same capital within New Zealand. However, with a comprehensive CFC regime that attributes both passive and active income, New Zealand investors are 'neutral' as between exporting their capital on the one hand, and investing domestically on the other.

Unfortunately, capital export neutrality carries a cost. The fact that New Zealand is the only country in the OECD that does not exempt active CFC income from attribution has adversely affected New Zealand's economy in three ways.

First, relative to other OECD countries, New Zealand has consistently underperformed in respect of its outbound FDI. According to United Nations data, New Zealand appears to be the only OECD country that has sustained a decline in outbound FDI, as a percentage of gross domestic product ("GDP"), between 1990 and 2004.[12] Between 1993 and 2004, Australia enjoyed steady growth in outbound FDI (from 12 per cent of GDP to 32 per cent), whereas New Zealand's outbound FDI fell (from 12 per cent of GDP to 10 per cent).[13] In 2004, the OECD weighted average of outbound FDI was 32 per cent of GDP, which far exceeded New Zealand's 10 per cent.[14] Although several reasons may exist for New Zealand's decline in FDI, one contributing factor is likely to be its stringent CFC rules. By assessing residents to tax on income derived by offshore active subsidiaries, New Zealand's CFC regime has stifled the internationalization of resident firms and hindered outbound FDI.

Secondly, comprehensive taxation of both passive and active CFC income induces New Zealand firms to migrate to Australia (or elsewhere) before expanding into other regions, in order to benefit from Australia's exemption of offshore active CFC income. Systematic emigration of dynamic organizations adversely impacts on New Zealand's economy and tax base.

Thirdly, and perhaps most importantly, where a country such as China has qualities that prompt foreign firms to establish manufacturing subsidiaries there (for example, low-cost labour and a favourable tax regime), a New Zealand manufacturer wishing to do the same will be denied the benefits of the favourable tax regime. Unlike Australian, American, Japanese, or European competitors with active subsidiaries in the same low-tax jurisdiction, the New Zealand company would not be able to benefit from the favourable tax regime because its subsidiary's active profits would be attributed to the parent and subject to tax in the parent's home country

---

12 Policy Advice Division of the Inland Revenue Department, *December 2006 Document*, supra note 10, 12.

13 Ibid 13.

14 Ibid 12.

(New Zealand). The greater tax burden that results from a comprehensive CFC regime inhibits the profitability and price-competitiveness of New Zealand firms with active offshore subsidiaries, resulting in a significant competitive disadvantage relative to their OECD counterparts. As a consequence, New Zealand firms lose market share to foreign competitors, which further induces them to migrate to Australia or the United States to benefit from those countries' active income exemptions.

The Government's Solution: Distinguishing between Active and Passive Income

The Government has proposed to bring New Zealand's CFC rules into alignment with the rest of the OECD by exempting active CFC income from attribution. In implementing such a proposal, two alternative approaches are available. The first is the 'exemption approach', which would exempt active income from New Zealand tax *permanently*. This would entail: (a) exempting from attribution active income derived by CFCs; and (b) exempting from New Zealand tax the dividends paid to New Zealand companies by their CFCs. In other words, a New Zealand parent company would at no point be assessed to tax on its subsidiary's active income; hence the permanence of the exemption. The second alternative is the 'deferral approach', which would merely allow a deferral of New Zealand tax on active CFC income. In other words, while active income derived by a CFC would not be attributed to its New Zealand shareholders, New Zealand tax would be imposed when the CFC pays a dividend from active earnings to its New Zealand shareholders. New Zealand residents would be assessed to tax currently on passive income derived by CFCs, while their liability to tax in respect of active income would be deferred.

The Bill proposes to exempt active CFC income permanently, with no tax being imposed on dividends repatriated by CFCs to their New Zealand parent companies.[15] The exemption method is simpler and will provide a better competitive advantage to multinational New Zealand companies. It should also be noted that Australia's CFC regime also permanently exempts active CFC income. If New Zealand adopts an exemption method rather than a deferral method, it would bring the two tax systems into closer alignment. This would minimize the current incentive for New Zealand firms to migrate to Australia before expanding overseas.

The next key aspect of the Government's proposal in the Bill relates to the mechanism by which the new rules will distinguish between active and passive income. Once again, two alternatives are available. The first is a 'transactional approach', whereby each individual item of income derived by a CFC is examined to determine whether the item is active or passive in nature. The active income stream would be exempt from New Zealand

15 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 396.

tax while the passive income stream would be attributed to New Zealand shareholders as it accrues in the CFC. The second approach is an 'entity approach', whereby the CFC is examined as a whole to determine whether it is an 'active CFC' or a 'passive CFC'. If the entity is an active CFC, its entire income will be exempt from attribution, irrespective of the actual nature of any specific item of income. Whereas the transactional approach examines the income derived by a CFC, the entity approach considers qualitative aspects of the entity itself. The transactional approach is more precise because it exempts only active income. However, relative to the entity approach, the transactional approach imposes a greater compliance burden because each transaction entered into by a CFC needs to be examined individually to determine whether it is active or passive in nature.[16]

After considering numerous public submissions on the issue, the New Zealand Government has opted for a hybrid transactional approach.[17] If less than five per cent of the CFC's gross income is passive in nature, the CFC will be treated as an 'active entity'.[18] In such circumstances, all income of the CFC (including the zero to five per cent passive income) will be exempt from New Zealand tax.[19] If a CFC's passive income crosses the five per cent threshold,[20] a transactional approach will be used; only the passive income stream will be attributed to New Zealand shareholders, while the active income stream will remain exempt. The five per cent threshold is referred to as the "active business test".[21]

In addition, all dividends repatriated by a CFC to its New Zealand parent company will be exempt from New Zealand income tax, regardless of whether the CFC passes the active business test or whether the dividends were paid out of active or passive earnings.[22] This is because: (a) the Government has opted for a permanent tax exemption in respect of active income derived by CFCs; and (b) passive income, in any event, will have

16 Also, if the CFC has paid any foreign taxes in the jurisdiction in which it is situated, those foreign taxes would have to be apportioned between the active and passive income streams. The foreign tax credit available to the New Zealand shareholder would only constitute the amount of foreign tax attributable to the CFC's passive income stream.

17 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cls 122–123, 408. See also Policy Advice Division of the Inland Revenue Department, *New Zealand's International Tax Review: An Update* (2007) 16 ["*May 2007 Document*"].

18 'Gross income' is the CFC's total revenue, whereas 'net income' equals revenue less expenses. The Government's proposal to set the five per cent passive income threshold against gross income (rather than net income) means that a CFC classified as an 'active entity' has relatively more scope to earn passive income.

19 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cls 122–123, 408.

20 That is, if a CFC's passive income stream constitutes five per cent or more of its gross income for the financial year.

21 Policy Advice Division of Inland Revenue, *Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill: Commentary on the Bill* (2008) 5 ["*Commentary on the Bill*"].

22 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 396.

already been subject to New Zealand tax when it originally accrued in the CFC.[23]

Irrespective of whether a CFC's passive income stream crosses the five per cent threshold, the Government's proposal ensures that in no circumstances will active income be subject to New Zealand tax. The hybrid transactional approach accords with the policy objective of exempting from New Zealand tax all active income derived by CFCs. The purpose of the five per cent grace afforded to 'active CFCs' is to engender operational efficiency in the new regime.[24] To this end, the simplicity inherent in the proposed rules is sensible. A CFC that satisfies the active business test will face minimal compliance costs because all of its income will be exempt from New Zealand tax.

Issues with the Proposal

The proposed active income exemption gives rise to two fundamental questions. First, how will the law actually distinguish between active income and passive income for the purposes of the active business test? For each item of income derived by a CFC, the CFC rules must provide a legal test to ascertain whether it is active or passive in nature. The second question is: how will the new rules safeguard the integrity of the exemption against manipulative taxpayer behaviour? If active income derived by CFCs is exempt from New Zealand tax, taxpayers will tend to adopt arrangements aimed at bringing their offshore income within the scope of the active income exemption in circumstances other than those envisaged by the Government. The legal distinction between active and passive income should be sufficiently robust to guard against exploitative structures and artificial cross-border arrangements. Together, these two questions form the focus of this article.

New Zealand is the last remaining country in the OECD to exempt active CFC income from attribution to resident shareholders. In assessing the proposed new CFC rules, we are therefore in a position to examine the existing CFC regimes of other OECD countries for guidance. In this regard, there are two countries of particular significance: Australia, New Zealand's closest and most important sister economy, and the United States, which invented 'CFC rules' and whose mature tax system provides an ideal backdrop against which to examine New Zealand's proposed active income exemption. The CFC regimes of Australia and the United States are especially relevant because, like New Zealand's proposal, both countries

23 There is, however, one circumstance in which passive income will completely escape New Zealand tax. If a CFC's passive income stream constitutes less than five per cent of its gross income, then: (a) pursuant to the active business test, the passive income will not be attributed to New Zealand shareholders as it accrues; and (b) dividends paid from the CFC's retained passive earnings will not be subject to tax in the hands of its New Zealand parent because dividends from CFCs will be exempt. The Government is willing to entertain this concession on the grounds of "simplicity and to minimise compliance costs": Policy Advice Division of the Inland Revenue Department, *May 2007 Document*, supra note 17, 8.

24 Policy Advice Division of the Inland Revenue Department, *New Zealand's International Tax Review: Developing an Active Income Exemption for Controlled Foreign Companies* (2007) 12 ["*October 2007 Document*"].

adopt transactional income-based approaches in exempting active offshore income from attribution. In contrast, the United Kingdom's CFC regime adopts an entity approach, which focuses on qualitative aspects of the CFC as an entity rather than the nature of its underlying income. Consequently, the United Kingdom's CFC rules are of little pertinence to this article's analysis of New Zealand's income-based proposal.

This article begins by discussing the mechanics by which the Bill proposes to distinguish between active and passive income. This follows on to a discussion of tax avoidance problems that typically arise with an active income exemption. Along the way, comparisons are drawn between New Zealand's proposal and corresponding provisions in the CFC regimes of Australia, the United States, and, to a lesser extent, the United Kingdom.

II DISTINGUISHING ACTIVE AND PASSIVE INCOME

As noted above, the proposed CFC rules, as set out in the Bill, adopt a hybrid transactional test. Passive income will be attributed to New Zealand shareholders only if it constitutes five per cent or more of the CFC's gross income. If a CFC's passive income stream falls below the five per cent threshold, the entire CFC will be exempt from attribution. The five per cent threshold is referred to in commentary as the active business test. If the nature of a given item of income lies within the statutory definition of passive income, it will factor into the five per cent active business test as passive income. That item of income will then be either: (a) attributed currently to the New Zealand shareholders; or (b) exempt altogether if the CFC's total passive income stream constitutes less than five per cent of its gross income. Thus, a key aspect of the new rules is the means by which they distinguish active from passive income.

The Bill defines passive income positively, leaving active income as an undefined residual concept.[25] Any item of income that does not fall within the statutory definition of passive income will be considered active for the purposes of the active business test, and will be exempt from attribution to New Zealand shareholders. The following discussion of the proposed definition of passive income is divided into five sections: income from shares, interest income, royalties, rent and other income from property, and insurance-related income.

Income from Shares

Income derived from foreign shares has historically been highly susceptible to cross-border tax avoidance. Foreign-sourced dividends can easily be

25 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119.

accumulated in tax haven companies controlled by residents of high-tax countries. It comes as no surprise, then, that the Bill brings dividends within the concept of passive income.[26] In addition, gains derived from the sale of shares held on revenue account (that is, shares acquired in trade or for the purposes of resale) will be classed as passive income.[27] Such an approach accords with the CFC rules of the United States,[28] Australia,[29] and the United Kingdom.[30]

Interest Income

Interest and interest substitutes (such as income from fixed-rate equity, finance leases, or other financial arrangements) will likewise be classed as passive income.[31] In this regard, the broad definition of interest stems from the Government's aim to counter the ease with which income from mobile financial assets could otherwise be shifted to tax haven CFCs to escape New Zealand tax.[32]

Given that the proposed rules treat interest as passive income, interest earned by an active subsidiary engaged in the business of moneylending will be treated as passive and be attributed to its New Zealand parent company. Even though the interest income is the product of an active business (and is therefore active in nature) the CFC rules will treat it as passive for the purposes of the active business test. By not affording active financing subsidiaries a special exception for 'active' interest income, New Zealand's proposal departs from the approach taken in the United States and Australia.

1 An Active Financing Exception: The United States and Australian Approaches

By way of background, the United States CFC regime distinguishes between legitimate business activity and artificial tax haven operations in much the same way as New Zealand's proposed rules. Passive income, which includes the usual dividends, interest, rent, and royalties, is attributed to United States shareholders as it accrues in a CFC.[33] In the case of legitimately active CFCs, the regime implements a deferral system

26 Ibid.

27 Ibid.

28 Internal Revenue Code 26 USC § 954(c)(1)(A).

29 Income Tax Assessment Act 1936 (Cth), s 446(1)(a).

30 See generally Income and Corporation Taxes Act 1988 (UK), s 747.

31 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119.

32 Policy Advice Division of the Inland Revenue Department, *October 2007 Document*, supra note 24, 25.

33 Internal Revenue Code 26 USC § 951(a)(1). Note that United States tax legislation uses the term "foreign personal holding company income" to describe what is more commonly known as passive income. See ibid § 954(c).

whereby United States income tax is assessed only on dividends repatriated to United States shareholders.[34]

Unlike New Zealand's proposal, the United States CFC regime affords active financing CFCs (that is, offshore subsidiaries that are actively engaged in lending money and deriving interest income) an exception to current attribution of their interest income to their United States parents. In effect, this "active financing exception" excludes from the definition of passive income interest income derived by an active banking business conducted in a CFC.[35] The rationale underlying this exception is that while the rules generally treat interest as passive income, in the case of an active financial institution, interest is derived in the course of an active business.

To prevent exploitation of this major concession, the United States CFC regime contains a raft of onerous requirements that must be met before a United States resident may take advantage of it. For example, the CFC must either have a United States banking licence or derive more than 70 per cent of its gross income directly from active and routine lending transactions with unrelated customers outside the United States.[36] In addition, a "substantial activity" test requires the CFC to be substantially responsible for the management of its own income-producing activities, and to conduct its active financing business substantially within its own jurisdiction.[37] In this regard, a number of factors are taken into account, including the number of employees located in the CFC's country, their administrative responsibilities, and the extent to which they engage in advice, negotiation, credit analysis, and debt collection.[38]

The specific focus of these requirements is to preclude manipulative transactions that systematically shift interest income to active financing CFCs in low-tax environments.[39] Historically, the presence of an active financing exemption has led to a "proliferation of US-controlled banking companies in various tax haven jurisdictions".[40] It is understandable, then, that American lawmakers today are concerned (perhaps to the extent of paranoia) that the active financing exception will be viewed and exploited as a loophole by taxpayers. To that end, they have limited the reach of the active financing exception by using the stringent tests outlined above, which many commentators regard as overly complex.[41]

Australian CFC rules take a similar approach to the United States. In general, Australia exempts offshore active income from current attribution

34 Contrast the United States deferral system with New Zealand's proposed exemption method, under which no New Zealand tax will be imposed on dividends repatriated by CFCs to their New Zealand parents.

35 Internal Revenue Code 26 USC § 954(h).

36 Ibid § 954(h)(2)(A)–(B).

37 Ibid § 954(h)(3)(C).

38 See also McLaughlin, "Truly a Wolf, or Just a Sheep in Wolf's Clothing? The Active Financing Exception to Subpart F" (2002) 21 Va Tax Rev 649, 657.

39 Internal Revenue Code 26 USC § 954(h). See also Isenbergh, *International Taxation* (2000) 175.

40 United States Congress Joint Commission on Taxation, *General Explanation of the Tax Reform Act of 1986* (1987) 966.

41 See eg McLaughlin, supra note 38, 671.

to resident shareholders.[42] However, 'tainted income' (that is, passive income) is attributed to shareholders as it accrues in a CFC, rendering those shareholders liable to tax on their proportionate share of the CFC's tainted income.[43] Australian CFC rules define tainted income positively.[44] The term includes interest, rents, royalties, and dividends.[45] Although interest is treated as tainted income, an exception exists for foreign subsidiaries of an "Australian Financial Institution"[46] (which, in essence, is a registered bank or lender).[47] Interest income will not be tainted if it is earned by an Australian Financial Institution's offshore subsidiary that is solely or principally engaged in the banking or moneylending business.[48] The exception is analogous to the United States active financing exception.

2 An Active Financing Exception for New Zealand?

At present, the Bill provides no exception for active financing CFCs that derive interest income. Such income will be treated as passive even in the context of an active moneylending business. Although the Government has intimated that it may introduce an active financing exception in the future,[49] at this stage it has reserved any decision on the matter. The Government's indecision stems from its reluctance to enact the "complex" countermeasures necessary to safeguard an active financing exception from taxpayer exploitation.[50] Such exploitation usually takes the form of tax haven CFCs that ostensibly serve as 'group-lending subsidiaries', which actively seek capital to finance associated companies. By charging interest on loans advanced to associated companies situated in high-tax jurisdictions, such CFCs could shelter large amounts of income from tax.

While the risk of exploitation is real, the Government should realize that there are some circumstances in which residents may wish to establish active financing CFCs for legitimate non-tax avoidance purposes. For example, a banking corporation resident in New Zealand may choose to expand into another country by establishing a banking subsidiary there. In the absence of an active financing exception that exempts the subsidiary's active interest income from New Zealand tax, that bank will be competitively disadvantaged as against other banks operating in the CFC's region, including subsidiaries of Australian or American banks.[51] It

42 Income Tax Assessment Act 1936 (Cth), ss 432–433. An "active income test" is used, which is mirrored in New Zealand's proposal.

43 Ibid s 456.

44 Ibid s 446.

45 Ibid s 446(1).

46 Ibid s 449(1).

47 Ibid s 317.

48 Ibid.

49 Policy Advice Division of Inland Revenue, *Commentary on the Bill*, supra note 21, 17; Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), Explanatory note, 5.

50 Policy Advice Division of the Inland Revenue Department, *October 2007 Document*, supra note 24, 29.

51 This proposition assumes that the tax rate in the subsidiary's jurisdiction is lower than New Zealand's tax rate.

should be noted that, in reality, most New Zealand banks are owned by non-residents who would gain very little from an active financing exception. However, it should equally be noted that the dismally minute involvement of New Zealand-owned banks in local and offshore banking markets is unlikely to change unless the Government implements economic policy that is more conducive to the banking industry.

An active financing exception for CFCs would be one step in the right direction. Yet no such exception is provided in the Bill because the accompanying rules that would be required to protect the exception from exploitation "tend to be complex".[52] Such reasoning is somewhat objectionable. 'Complexity' is too cursory a reason not to provide an exception when one may well be justified on the merits. Moreover, complexity as a basis to deny relief to genuinely active banking CFCs seems misguided, not only because such rules are in fact fairly straightforward (for example, the 70 per cent threshold), but also because New Zealand is in a position simply to benchmark its rules against those already provided in the CFC regimes of Australia and the United States.

Royalties

Intellectual property is geographically mobile and highly susceptible to international tax avoidance arrangements. Without CFC rules, a resident firm could transfer ownership of patents or trademarks to a tax haven subsidiary. Royalties subsequently paid to the subsidiary (by either its parent or third-party customers) would result in an erosion of New Zealand's tax base.

The starting point under Australian CFC rules is that royalties are passive income.[53] However, where royalties are derived from a non-associate in the course of an active business in circumstances where the CFC either created or substantially developed the intellectual property in question,[54] the rules treat the royalties as active income. Such income is exempt from current attribution to Australian shareholders.

Similarly, New Zealand's new CFC rules will treat royalties as passive income unless they fall within certain specified exceptions.[55] Broadly, the key exception (aimed at active CFCs) requires:[56] (a) the CFC to have "created", "developed", or "added substantial value to" the property; (b) the CFC to be "regularly engaged" in such activity;[57] and (c)

52 Policy Advice Division of the Inland Revenue Department, *October 2007 Document*, supra note 24, 29.

53 Income Tax Assessment Act 1936 (Cth), s 446(1)(g).

54 Ibid s 317.

55 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119.

56 Ibid.

57 The term "regularly engaged" is used in Policy Advice Division of Inland Revenue, *Commentary on the Bill*, supra note 21, 20; and in Policy Advice Division of the Inland Revenue Department, *October 2007 Document*, supra note 24, 30. However, the term "pattern of activity" is used in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119.

the property in question to have no prior "link" to New Zealand. The Bill provides that property is "linked to New Zealand" if it has been owned by a New Zealand resident, was created or developed in New Zealand, or has had substantial value added to it in New Zealand.[58] In this way, the Bill's treatment of royalties targets the archetypal tax avoidance scheme in which a resident company transfers ownership of intellectual property to an offshore CFC in a low-tax jurisdiction, allowing the CFC to accumulate royalties outside the tax net of the parent's country.

Rent and Other Income from Property

Under the proposed rules, rental income will almost always be treated as passive income.[59] The main exception is where rental income is derived from real property or equipment situated in the same jurisdiction as the CFC.[60] The aim of this exception is to provide relief to CFCs that are actively engaged in the business of renting within their own jurisdiction.[61]

In addition, the Government proposes to bring within the ambit of passive income gains derived by a CFC from the disposal of revenue account property.[62] However, if the revenue account property is of a kind that is incapable of giving rise to passive income (for example, trading stock in a retail business), any gain derived from its disposal will not be treated as passive income and will be exempt from New Zealand tax.[63]

Insurance-Related Income

An offshore insurance business derives two main types of income: (a) insurance premiums from customers; and (b) investment income from its reserves. Investment income in turn can include either passive income yields from underlying investments or a change in the value of revenue account investment assets.

Under the new CFC regime, insurance premiums will be treated as passive income.[64] As regards investment income, "there will be no special rules for investment income derived by a CFC that is carrying on an insurance business".[65] Almost invariably, the ordinary CFC rules will classify such investment income as passive income. The Bill also defines passive income, in the context of CFCs engaged in the insurance business,

---

58 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119.

59 Ibid.

60 Ibid.

61 Policy Advice Division of Inland Revenue, *Commentary on the Bill*, supra note 21, 22.

62 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119. Revenue account property generally refers to property purchased with the intention or for the purpose of resale.

63 Ibid.

64 Ibid.

65 Policy Advice Division of the Inland Revenue Department, *October 2007 Document*, supra note 24, 37.

as including "income from a change in value of revenue account property used in the business".[66] The overall result is that virtually all income derived by an offshore insurance subsidiary will be treated as passive, even if the CFC is engaged in an active insurance business.

In general, there are two circumstances in which active insurance subsidiaries are incorporated in a foreign country. First, a resident insurance firm may wish to establish a subsidiary in another country in order to expand into that geographic region. Such firms are engaged in legitimate commercial activity and should be afforded the same tax concessions as other international enterprises engaged in active business, such as retail or manufacturing.

Secondly, a resident company (usually the holding company of a large group of companies) may decide to self-insure by establishing in an optimal location a subsidiary charged with assessing risk and providing insurance to related companies in the group. This situation poses the greatest tax avoidance risk. The holding company would presumably choose a tax haven, such as the Cayman Islands, in which to establish a group insurance subsidiary. The subsidiary would extract insurance premiums from associated companies situated in high-tax jurisdictions and, in this way, systematically reduce the income of those companies and minimize the group's exposure to tax. Tax haven CFCs that serve such tax avoidance structures are often labelled 'captive insurance companies'.

The United States CFC rules treat insurance premiums and investment income derived by foreign subsidiaries as passive income.[67] However, an exception is provided for active insurance CFCs.[68] All premiums and investment income derived by an active insurance CFC from unrelated persons are treated as active and are exempt from attribution.[69] To ensure that the exception is not exploited by tax avoidance structures, a CFC must satisfy stringent criteria to fall within the exception. In essence, the CFC must: (a) be a subsidiary of an United States insurance firm;[70] (b) be engaged in the insurance business; (c) be licensed in its country of residence to sell insurance; and (d) derive more than 50 per cent of its premiums from unrelated persons in respect of risks connected with the CFC's country of residence.[71] Once it is shown that a CFC satisfies these criteria, the exception applies only to items of income that the CFC derives from unrelated persons. These requirements render it virtually impossible for resident companies to use captive insurance companies to exploit the active insurance exception. The rules ensure that the exception extends only to genuine insurance businesses carried on by foreign subsidiaries of resident insurance firms.

---

66 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119.

67 Internal Revenue Code 26 USC § 954(i).

68 The United States CFC rules use the term "qualifying insurance company" to describe an active insurance CFC whose income is exempt from attribution to resident shareholders. See ibid.

69 Ibid.

70 Ibid.

71 Ibid § 953(e)(3).

The United Kingdom also provides an exception for CFCs engaged in the insurance business. As mentioned, the United Kingdom's CFC regime is fundamentally different to New Zealand's proposed rules. The United Kingdom's CFC regime focuses not on the passive nature of *income* derived by a CFC, but rather on qualitative aspects of the CFC as an *entity* that indicate tax avoidance motives.[72] For present purposes, it suffices to state that the United Kingdom's CFC regime exempts the income of an active insurance CFC from attribution, provided that the CFC derives at least 50 per cent of its gross income from the provision of insurance to unrelated persons resident in the CFC's jurisdiction, or in respect of property situated in the CFC's jurisdiction.[73]

As regards Australia's CFC regime, insurance premiums earned by CFCs are treated as passive income to the extent that: (a) the insured person is resident in Australia; (b) the insured property is situated in Australia; or (c) the insured event could only happen in Australia.[74] Premium income that does not fall within those categories is not treated as passive income and is exempt from Australian tax. However, investment income derived from the reserves of an active insurance CFC appears not to be afforded any special exception, and is presumably treated as passive income in the normal way.

Perhaps in light of the concessions afforded to active insurance CFCs by the United States, the United Kingdom, and Australia, the New Zealand Government has, at the eleventh hour, inserted a similar concession into the Bill. The concession is described as an "interim measure"[75] and will give the Commissioner a discretion to exempt from attribution all income derived by an insurance CFC.[76] Although the Bill, as a starting point, classifies all premium and investment income derived by an insurance CFC as passive income,[77] it empowers the Commissioner to deem otherwise if: (a) the CFC's parent company is a registered insurance provider in New Zealand; and (b) the CFC is registered as an insurance provider in its country of residence.[78] In addition to these requirements, the Commissioner must, before exercising its discretion, consider: (a) whether most of the CFC's premiums are from insurance contracts covering risks arising in the CFC's jurisdiction; and (b) whether the value of the CFC's investment assets are "commensurate" with the value of its insurance contracts.[79]

By providing a discretionary concession for active insurance CFCs, the Government has envisaged the possibility of New Zealand insurance companies operating genuinely active offshore subsidiaries engaged in

72 Income and Corporation Taxes Act 1988 (UK), s 748.

73 Ibid sch 25, para 11(6)–(7).

74 Income Tax Assessment Act 1936 (Cth), s 448(1)(d).

75 Policy Advice Division of Inland Revenue, *Commentary on the Bill*, supra note 21, 17.

76 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 484.

77 Ibid cl 119.

78 Ibid cl 484.

79 Ibid.

the business of insurance. Exempting the income of such CFCs from attribution will enhance the international competitiveness of New Zealand insurance companies operating in foreign regions.[80]

III TAX AVOIDANCE PROBLEMS

At present, all CFC income is indiscriminately attributed to New Zealand shareholders, who are liable to New Zealand tax on the income as it accrues in the CFC. To that extent, there is no incentive for residents to divert foreign-sourced income to offshore corporate entities because no tax benefit would arise from doing so.[81] This will change with the introduction of an active income exemption. With a CFC regime that permanently exempts active income derived by CFCs, New Zealand firms suddenly have a lot to gain from offshore active subsidiaries. It is clear that the Government intended to grant tax relief to genuinely active offshore subsidiaries, such as a manufacturing plant in China. Nonetheless, a major problem is the cross-border tax avoidance opportunities that flow from such an exemption.

Without adequate safeguards, there would be considerable scope to exploit the active income exemption. Resident firms could disguise offshore passive income as active income, or route income through an active tax haven company, in order to avoid New Zealand tax. Extensive rules are needed to protect the integrity of an active income exemption against such abuse. Two important concepts that arise in this context are 'income shifting' and 'transfer pricing'.

Income Shifting and Transfer Pricing

Income shifting operations involve international structures and cross-border transactions that deflect income from high-tax jurisdictions to low-tax jurisdictions for the purpose of minimizing overall exposure to tax. The result is that income is taxed in a country different to the one in which the actual economic activity giving rise to that income took place.

Artificial transfer pricing is the most common means by which income shifting occurs. It can be defined as the artificial pricing of cross-border transactions between two related parties. For example, in the absence of transfer pricing rules, a parent company that purchases goods from its foreign manufacturing subsidiary can set the price of that transaction at any figure that most benefits the parent. If the parent's country imposes higher levels of income tax than the subsidiary's country, then to minimize overall tax the parent would ensure that it pays an artificially high price to its

80 This assumes that the rates of tax in those foreign regions are lower than New Zealand's.

81 However, an incentive still exists for a foreign owner of a New Zealand-resident company to extract income away from New Zealand to other tax haven companies under the foreign person's control.

subsidiary for the goods. In this way, the parent would inflate its expenses, thereby lowering its income tax liability while allowing its subsidiary to enjoy a corresponding boost in income. Income is thus artificially redistributed from a high-tax jurisdiction to a low-tax jurisdiction. The parent could then allow that income to accumulate indefinitely in its offshore subsidiary. Given that the sales price would be active income in the hands of the subsidiary (an active manufacturing CFC), the income would not be attributed to its parent and would escape domestic tax.

To prevent such manipulation, the tax regimes of most jurisdictions circumscribe the artificial setting of prices between associated persons.[82] The general requirement is that cross-border transfer prices between associated companies must be set at 'arm's length' market values.[83] Transfer pricing rules often provide the final defence against abuse of tax concessions pertaining to active CFC income.

In the New Zealand context, artificial transfer pricing is likely to become a much more significant tax issue. At present, all CFC income is comprehensively attributed to and taxed in New Zealand. Consequently, there is little incentive for New Zealand residents to shift income to offshore subsidiaries. However, the moment active CFC income is exempted from New Zealand taxation, a major incentive arises for taxpayers to inflate transfer prices paid to CFCs (or reduce sales prices charged to CFCs) in order to shift active income to CFCs in low-tax jurisdictions. To that extent, transfer pricing rules complement the CFC rules, in that both sets of rules guard against income shifting and cross-border tax avoidance.

The Problem of Re-invoicing

An active income exemption for CFCs creates an incentive for resident taxpayers to shift ostensibly active income to foreign subsidiaries situated in tax havens or low-tax jurisdictions. While a country's transfer pricing rules make the process of income shifting a little more challenging, the rules alone are by no means sufficient. It is often difficult, if not impossible, for a country's tax office to prove that a cross-border transfer price between two associated companies is not at 'arm's length'. As a result, countries with tax concessions for active CFC income usually incorporate further mechanisms into their CFC rules to deal with artificial income shifting before it becomes necessary to resort to the transfer pricing rules. In this regard, the concept of 're-invoicing' is relevant. Re-invoicing is a specific means by which an international group of companies can engage in systematic income shifting. It is the process by which goods bought or sold internationally are channelled through a tax haven CFC that imposes an artificial mark-up to derive an active income stream.

82 New Zealand's transfer pricing rules are set out in the Income Tax Act 2007, ss GC 6–GC 14. In the United States, transfer pricing rules are set out in the Internal Revenue Code 26 USC § 482.

83 Income Tax Act 2007, ss GC 6–GC 14.

A typical re-invoicing operation would consist of a production company in a high-tax country (for example, Australia) and a foreign subsidiary in a low-tax country (for example, Hong Kong).[84] The Australian parent would produce a product, such as milk foods, to be sold around the world. Instead of selling the goods directly to international customers and deriving income in Australia that would be subject to a high rate of tax, the Australian parent company would instead use its Hong Kong subsidiary as a conduit. The Hong Kong CFC would serve little to no real commercial purpose. It would purchase the milk foods from its Australian parent at a low price and resell the products to international customers at a mark-up, thereby deriving a stream of income in Hong Kong (a low-tax country).

To comply with Australia's transfer pricing rules, the Australian parent would need to explain why it did not sell the milk foods to its foreign subsidiary at a higher price (for example, the arm's length price at which the subsidiary on-sold the goods to third-party customers). To justify the low export price, the Australian parent could assign various administrative responsibilities to the Hong Kong CFC, such as marketing, distribution, translation of product information into foreign languages, and legal services (for example, drafting sales contracts). The discounted transfer price could further be justified perhaps by showing that the CFC bought the goods from the parent in bulk, assumed the risk of product shipment to international customers, or assumed the risk of after-sales product liability. By shifting these geographically mobile administrative and risk-bearing functions to the Hong Kong CFC, the Australian parent would be in a position to justify the discounted transfer price it charged its subsidiary for the milk foods. The Hong Kong CFC's income would consist of sales, which does not fall within the definition of passive income. Therefore, absent any specific rules to deal with this situation, the subsidiary's income would be active and permanently exempt from Australian tax.

The CFC in the above example is, in effect, a 'foreign base company'. A foreign base company is an offshore company — usually a group subsidiary situated in a favourable tax environment — that serves as an international base to which income is diverted from the rest of the group. As illustrated, this is typically achieved by using the foreign base company as a conduit to derive income that has actually been generated by the production or distribution of goods in other jurisdictions. Companies with international sales and distribution channels often engage in re-invoicing to exploit the active income exemption by shifting group income to foreign

84 Hong Kong does not impose tax on foreign-sourced income earned by its residents. However, if a Hong Kong-resident company derives income that is part foreign-sourced and part locally sourced (for example, if the Hong Kong company concluded a sales contract overseas, but marketed the product from Hong Kong, drafted the contract in Hong Kong, and bore the risk of shipment and product liability), it is likely that Hong Kong would then begin to impose tax on the income. Nonetheless, Hong Kong tax is fixed at a flat rate of only 16 per cent, which would probably result in a substantial tax saving for the company's foreign parent in any event. Although Hong Kong may not be a pure tax haven, its low tax rate and close proximity to China and South-East Asian countries still renders it an ideal location for re-invoicing CFCs.

base companies. In this way, income is shifted from the countries of actual production or distribution, to a tax haven CFC that is responsible for little to no real economic activity. The term 're-invoicing' denotes the fact that the foreign base company engages in commercially superfluous transactions that involve the resale of goods across borders to avoid tax in the country in which the goods are actually produced or sold. Foreign base companies often assume commercial risk or provide nominal marketing, distribution, or legal services, in order to justify their profits for the purposes of any transfer pricing or anti-avoidance rules. In substance, however, foreign base companies are tax avoidance vehicles.

New Zealand does not yet have an active income exemption for CFCs. This means that re-invoicing is not a concern because the income derived by foreign base companies is attributed currently to resident shareholders, who are then assessed to New Zealand tax on the attributed income.[85] Residents derive no tax benefit from re-invoicing. However, this will change with the introduction of an active income exemption. Foreign base company income would escape New Zealand tax because income derived from re-invoicing does not fall within the meaning of passive income as defined in the Bill.[86] Other OECD countries have encountered similar tax avoidance problems with the implementation of active income concessions in their CFC regimes. In this respect, the means by which the United States and Australia have addressed the problems of re-invoicing and foreign base companies are of particular value.

The American Approach to Foreign Base Companies

The United States CFC regime exempts from attribution active income derived by CFCs. Passive income is defined positively by the CFC rules, and income that falls within that definition is attributed currently to resident shareholders.

To attack the use of offshore re-invoicing operations, the United States CFC regime introduces the concept of 'foreign base company sales income'. It is necessary to examine this concept closely, because New Zealand's proposal contains nothing similar — this is a serious gap that would permit abuse on a large scale.

The United States CFC regime assesses United States residents to tax on foreign base company sales income derived by their CFCs.[87] Foreign base company sales income is CFC income that arises from the re-invoicing of goods. Even though such income is not strictly passive in form, the regime extends the attribution rules to capture such income.[88] The United

85 However, re-invoicing is a concern where a non-resident controls a New Zealand subsidiary and uses a tax haven re-invoicing CFC to shift income away from New Zealand.

86 If an item of income is not passive in nature, under the proposed rules the income will not be attributed to resident shareholders and will be exempt from New Zealand tax.

87 Internal Revenue Code 26 USC § 954(d).

88 Ibid.

States statutory definition of foreign base company sales income is fairly convoluted. One writer has paraphrased the essence of the United States definition:[89]

> [I]ncome that results from channelling sales of goods through a low-tax foreign entity that has no significant economic relation to sales. Broadly, it is income derived from purchases and sales of property between related persons.

In other words, foreign base company sales income is income derived by a CFC from the sale or purchase of property to or from a related person. It includes not only sales profits earned through re-invoicing, but also commissions, fees, and other related gains.[90] For example, assume that a United States producer sells goods to customers in China. If it sells direct to its customers, assume that the United States company earns a US$10 profit, which would be subject to United States tax.[91] Now, assume that the United States company incorporates a CFC in Hong Kong, through which all future sales to China are transacted. The United States producer first sells the manufactured goods to its Hong Kong subsidiary at a profit of US$4. The CFC then resells the products to China at a profit of US$6. Although the price has remained the same for Chinese customers (the overall profit is still US$10), the United States company has managed to shift US$6, or 60 per cent, of its profit to a low-tax 'active' CFC. Without foreign base company rules, the United States producer would succeed in deferring United States tax on 60 per cent of its original profit. However, the United States CFC regime treats income derived by a CFC from the sale of property purchased from a related person as foreign base company sales income. Here, the Hong Kong CFC has derived its sales income from goods purchased from its United States parent (a related company). Accordingly, even though the CFC's income is not passive in nature, it is still attributed to its parent. It would be assessed to United States tax on the income earned by its Hong Kong subsidiary, and no tax advantage would be gained from the re-invoicing operation.

The rules work in the same manner for both importers and exporters. If a United States company imports goods from an unrelated manufacturer in China for US$10, and resells those goods to United States customers for

89 Isenbergh, supra note 39, 176. See also Internal Revenue Code 26 USC § 954(d)(1).

90 Ibid § 954(d)(1).

91 For simplicity, the example ignores source-country tax (which would be tax imposed by China). This article also ignores the application of double tax agreements between countries. In any event, the OECD Model Convention (often used as a template on which countries negotiate their respective double tax agreements) restricts the imposition of tax on business profits solely to the country of residence (rather than source). In this example, this translates to the United States having the sole right to tax profits that the United States manufacturer derives from China. The key exception provided in the OECD Model Convention is where an enterprise has a "permanent establishment" (such as a branch or office) in the source country, in which case the source country assumes the right to tax an appropriate share of the business profits. See Organization for Economic Co-operation and Development Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital: Condensed Version* (7 ed, 2008) art 7.

US$20, the United States company would earn a US$10 profit, which would be fully subject to income tax. To shift income offshore and exploit the CFC regime's concessions for active income, the United States company could establish a subsidiary in Hong Kong. The Hong Kong CFC would then purchase goods from China at the same price (US$10) and re-invoice the goods to its United States parent for US$19. The effect is that the United States parent would purchase the goods for US$19 and sell them to United States customers for US$20, resulting in a US$1 profit. The Hong Kong CFC would correspondingly earn US$9 in active sales income. In effect, the United States parent has shifted 90 per cent of its active income to the Hong Kong CFC. Nonetheless, the CFC's income would be treated as foreign base company sales income because it is derived from the sale of goods to a related person (namely, its United States parent). The US$9 earned by the Hong Kong subsidiary would be attributed to the United States parent, which would then be assessed to United States tax on the amount.

The above examples assume that the CFC is nothing more than a bare re-invoicing entity that serves no real economic purpose. However, under United States law, if the CFC in fact adds "substantial" value to the production process, the resultant income is not treated as foreign base company sales income and is not subject to current attribution.[92] The CFC rules do not bite if the CFC actually manufactures the goods, or processes or alters them in some significant way. Whether a CFC adds substantial value or is merely a re-invoicing subsidiary ultimately turns on the facts of each case:[93]

> Mere packaging or labelling, or even minor assembly, do not suffice ... while such activities as transforming wood pulp into paper [or] steel rods into nuts and bolts ... *do* constitute sufficient processing operations.

While those examples present clear-cut dichotomies, borderline cases inexorably arise. The United States Treasury Regulations[94] provide a safe harbour: if production costs (including direct labour costs) of a CFC amount to 20 per cent or more of the total cost of goods sold, the CFC is considered to be engaged in bona fide manufacturing activity and its income is deemed not to be foreign base company sales income.[95]

In summary, the United States CFC regime nullifies the tax avoidance effects of foreign base companies that re-invoice goods to or on behalf of their United States parents. Unless the CFC adds substantial value to the goods before reselling them, income derived therefrom falls within the meaning of foreign base company sales income and is subject to current attribution.

---

92 Internal Revenue Code 26 USC §§ 954(b)(5), 954(d)(1).

93 Isenbergh, supra note 39, 177 (emphasis in original).

94 These are promulgated by the Internal Revenue Code 26 USC § 7805.

95 Treasury (Tax) Regulations 26 CFR § 1.954-3(a)(4)(iii).

In addition to foreign base company provisions, United States legislation contains extensive transfer pricing rules to address the problem of re-invoicing.[96] International transfer prices between related persons must be set at arm's length market prices. As mentioned, transfer pricing rules complement the CFC rules in that both regimes seek to prevent cross-border income shifting. In relation to the problem of re-invoicing, transfer pricing rules prevent, for example, a United States parent company from selling goods to a Hong Kong foreign base company at an artificially low price. The transfer pricing rules would empower the United States Internal Revenue Service ("IRS") to intervene and reset the sales price to a different value for tax purposes.[97] The IRS might deem the price to be that at which the goods were eventually on-sold by the Hong Kong CFC to a third-party customer.[98] Accordingly, the transfer pricing rules would boost the taxable income of the United States parent, thereby mitigating the income shifting effects the CFC might have otherwise caused.

The Australian Approach to Foreign Base Companies

The Australian CFC rules exempt active income from Australian tax, but attribute 'tainted' CFC income to resident shareholders as it accrues in a CFC.[99] The statutory definition of tainted income covers passive income, which is the type of income most susceptible to cross-border tax avoidance (for example, interest, dividends, royalties, and rent).[100] To address the problem of re-invoicing, Australian CFC rules expand the meaning of tainted income to include 'tainted sales income', which captures CFC income derived from the re-invoicing of goods.[101] As discussed, such income is generally referred to as foreign base company sales income.

Australian law defines tainted sales income as income derived by a CFC from the sale of goods that the CFC: (a) purchased from or sold to an associate;[102] and (b) did not "substantially alter".[103] This provision captures typical re-invoicing structures, such as an Australian manufacturer using a Hong Kong CFC to sell goods at a mark-up to customers in China. Even if the Hong Kong CFC is engaged in active business, its income would still be attributed to the Australian parent because, pursuant to the tainted sales income rules, the goods from which the CFC derived its income would have been: (a) purchased from an associate; namely, the parent

96 See Internal Revenue Code 26 USC § 482.

97 Ibid.

98 The price of a sales contract between the Hong Kong CFC and, say, an unrelated Chinese customer is axiomatically 'arm's length'.

99 Income Tax Assessment Act 1936 (Cth), ss 432–433. An "active income test" is used, which is mirrored in New Zealand's proposal.

100 Ibid s 446(1).

101 Ibid s 447.

102 The associate may be resident in Australia (for example, the parent company) or elsewhere (for example, another offshore subsidiary in the group).

103 Income Tax Assessment Act 1936 (Cth), s 447(1)–(4).

company; and (b) not substantially altered by the CFC. However, if the CFC substantially alters the goods (or if the CFC actually manufactures the goods),[104] the sales income would not be tainted and would be exempt from Australian tax.

In addition to base company sales rules, Australian tax legislation contains extensive transfer pricing provisions that require international transactions between associated companies to be set at arm's length market prices.[105] If, in the above example, the Hong Kong CFC earns substantial profits by re-invoicing goods to end-customers in China, the Australian parent would need to justify, pursuant to the transfer pricing rules, why it did not sell the goods to its CFC at higher prices. Even if the Australian parent is able to justify the transfer prices by showing that its Hong Kong CFC adds value through, say, marketing, packaging, or risk-bearing functions, the Australian Taxation Office would still be able to invoke the base company sales rules to assess the Australian company to tax on the re-invoicing income of its CFC. The base company sales rules protect the active income exemption against exploitative cross-border arrangements in circumstances in which transfer pricing rules are, per se, inadequate.

IV NEW ZEALAND'S PROPOSED APPROACH TO FOREIGN BASE COMPANY INCOME

Whereas at present all CFC income is comprehensively attributed to New Zealand shareholders, the Government has proposed to implement an active income exemption. More specifically, non-passive income derived by a foreign subsidiary will be neither attributed to its parent company nor subject to tax when repatriated by way of dividend. The permanence of such an exemption gives rise to significant risks of tax avoidance.

The Government, in developing the proposed new rules, did turn its mind to the problem of re-invoicing. Before continuing, however, it would be helpful to review this problem in the New Zealand context. Suppose that a New Zealand importer of goods pays a third-party Chinese manufacturer \$10 per unit. If active CFCs were exempt from tax, the New Zealand importer would benefit from establishing a CFC in Hong Kong, which could then buy goods from the Chinese manufacturer at \$10 per unit and resell them to its New Zealand parent at \$14 per unit. The \$4 per unit profit derived by the CFC would not fall under any of the positively defined categories of passive income and would therefore be active and exempt from New Zealand tax. If the New Zealand parent can justify the inflated \$14 transfer price (for example, by proving that the CFC sources Chinese manufacturers, undertakes quality checks, performs Mandarin–English

104 Ibid s 447(1).
105 Ibid s 136AD.

translations, bears the risk of shipment, and provides product warranties), it would succeed in increasing its deductions by $4 per unit and shifting a significant amount of income to a low-tax jurisdiction. Such re-invoicing through foreign base companies would exploit the active income exemption and erode New Zealand's tax base.

For this reason, countries that afford residents a tax exemption (or deferral) on active CFC income — such as Australia and the United States — usually bring foreign base company sales income within the concept of passive income. Although income derived from re-invoicing is 'active' in form, the CFC regimes of those countries nonetheless require it to be attributed to resident shareholders on a current basis. This nullifies the tax benefits of reselling goods through a foreign base company. In this regard, foreign base company sales rules are an invaluable fortification of any CFC regime that allows an active income exemption.

It is seriously problematic, then, that New Zealand's new CFC rules will provide no measure of protection against re-invoicing CFCs. The concept of passive income will not extend to foreign base company sales income.[106] In other words, New Zealand residents will not be assessed to tax on income derived by CFCs from goods sold to or purchased from associated persons.

Even though the Government acknowledges that "other countries that exempt the offshore active income of CFCs typically impose base company rules in relation to ... the sale of [goods]",[107] it concludes that such rules are not necessary:[108]

> Our current transfer pricing rules for the sale of goods provide a level of protection against ... re-invoicing arrangement[s].... The tangible nature of sale-of-goods transactions should also protect against sham transactions.... The absence of base company rules on the sale of goods will benefit CFCs carrying on export and distribution activities.

The Government's analysis here seems dubious in three respects. First, the Government has presumed that transfer pricing rules are an adequate safeguard against re-invoicing. Secondly, the Government considers that sale of goods transactions are somehow resistant to sham income shifting due to their "tangible nature". And thirdly, the Government's approach directly contradicts a fundamental policy objective reiterated several times in its proposal — namely, to ensure protection of New Zealand's tax base. Each of these aspects will be considered in turn.

106 Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill 2008 (No 233-2), cl 119.

107 Policy Advice Division of the Inland Revenue Department, *October 2007 Document*, supra note 24, 42.

108 Ibid.

Inadequacy of Transfer Pricing Rules

The Government's position is that transfer pricing rules will adequately safeguard the active income exemption against the use of re-invoicing CFCs situated in tax havens or low-tax jurisdictions. As we shall see, such a proposition is somewhat objectionable.

Transfer pricing rules seek to ensure that international prices between associated persons are set at arm's length market prices. This prevents a parent company from, say, purchasing goods from a subsidiary at artificially high prices, thereby boosting the parent's deductions and shifting income offshore. Although transfer pricing rules may hinder an offshore re-invoicing operation, they are by no means sufficient. The rules merely require that transfer prices are justifiable by reference to independent market prices. For a re-invoicing operation to succeed in the absence of proper foreign base company sales rules, a taxpayer need only show that the prices at which it transacts with its CFC are justified, perhaps by assigning certain managerial or risk-bearing functions to the CFC.

Take the example above, in which a New Zealand company that previously imported goods directly from China now operates a foreign base company in Hong Kong. The CFC buys goods from China and sells them to its New Zealand parent at a mark-up, thereby deriving a profit and shifting income away from New Zealand. In the absence of foreign base company rules, the New Zealand parent need only demonstrate that the increased transfer prices it now pays its CFC for the imported goods are at 'arm's length'. It could do this by shifting various commercial responsibilities to the CFC or including contractual documentation provisions that render the CFC liable for most of the commercial risk in each transaction. By shifting these geographically mobile functions to the CFC, the parent company could prove that the CFC does in fact add value, and that the increased transfer prices are justifiable by reference to arm's length market prices. Having satisfied the transfer pricing rules (New Zealand's only defence against this sort of scheme), the parent could continue, indefinitely and systematically, to accumulate active profits in its CFC. Those profits would be permanently exempt from New Zealand tax. The absence of base company sales rules will allow such re-invoicing operations to flourish.

If foreign base company rules applied to such income, however, the result would be different. In Australia and the United States, foreign base company sales income is attributed currently to resident shareholders along with other passive CFC income. Re-invoicing income is caught by the CFC rules unless the CFC has substantially altered the goods. Substantial alteration usually requires a change in the actual identity of the goods.[109] In the above example, the Hong Kong CFC has not "substantially altered" the goods; as with most re-invoicing operations, the goods have remained

109 See Isenbergh, supra note 39, 177. Examples include transforming wood pulp into paper, or steel rods into nuts and bolts. The question is always one of fact.

substantially the same, and have merely been enhanced in a few ancillary respects. If the Bill made provision for foreign base company sales rules, the New Zealand parent would be assessed to tax on the CFC's re-invoicing income. In this way, foreign base company sales rules would nullify the tax avoidance effects of re-invoicing schemes.

Foreign base company sales rules are able to isolate and effectively deal with re-invoicing transactions in a way that transfer pricing rules cannot. With respect, the Government seems to have erred in considering that transfer pricing rules are, without more, a sufficient means to address the problem. The enforcement of transfer pricing provisions is costly and notoriously difficult. The statutory notion of 'arm's length consideration' is amorphous at best,[110] and case law on transfer pricing is of limited precedential value given that each new case involves unique products and unique facts. The awkward application of transfer pricing rules can be avoided altogether by implementing foreign base company rules that apply directly to the sale of goods. An active income exemption without such rules will likely result in a proliferation of re-invoicing schemes and a marked increase in transfer pricing disputes.

Susceptibility of Sale of Goods Transactions to Sham Structures

The Government erroneously considers that sale of goods transactions are not susceptible to sham income shifting operations, due to the "tangible nature" of goods.

This proposition seems misconceived. Sale of goods operations are as susceptible to international tax avoidance schemes as any other sort of operation. For example, a New Zealand company that imports watches from Japan, televisions from China, or clothes from India, could permanently avoid large amounts of New Zealand tax simply by establishing a re-invoicing CFC in a low-tax jurisdiction such as Hong Kong. The CFC could purchase the goods from Japan, China, or India at the same prices as before, and then resell them to its New Zealand parent at a profit. The New Zealand company's expenses would rise, its taxable income would fall, and the Hong Kong foreign base company would derive a steady, albeit artificial, stream of exempt active income. In the absence of foreign base company sales rules, the CFC would not have to "substantially alter" the goods to escape New Zealand tax; it need only justify its mark-up (in accordance with transfer pricing rules) by demonstrating that it adds value through the performance of administrative functions or the assumption of commercial risk.

While it is uncertain what the Government means by "sham transactions", it is clear that the active income exemption is not intended to enable resident firms to avoid New Zealand tax by re-invoicing goods

110 See Income Tax Act 2007, ss GC 6, GC 13.

though tax haven CFCs. Further, the fact that goods are "tangible" does not render sale of goods transactions any less susceptible to tax avoidance structures. Although re-invoicing subsidiaries may, for the purpose of justifying transfer prices, masquerade as legitimate entities that add value to cross-border transactions, their existence and profit streams are generally the result of exploitative tax avoidance goals. Whilst such entities are not 'sham companies' in a legal sense, they are nevertheless shams to the extent that the commercial purposes that they ostensibly serve differ from the real economic reason for their existence (which is to minimize a group's overall liability to tax).

Preventing Exploitation of the Active Income Exemption

The Government considers that an "absence of base company rules on the sale of goods will benefit CFCs carrying on export and distribution activities".[111] Although this argument aligns with the business-friendly undertones of the new CFC regime, it directly contradicts the Government's overarching policy goal of "attaining an assurance that there [are] robust rules to prevent the erosion of the domestic tax base".[112]

Granted, offshore distribution centres sometimes do serve legitimate non-tax avoidance purposes by sourcing goods from, or selling goods to, third parties situated within close geographical proximity. Given that such CFCs rarely "substantially alter" goods, base company sales rules would deny them the benefits of an active income exemption, even though they earn active income. This seems unfair. The question, then, is whether the marginal inequity that would be suffered by genuine CFC distributors warrants a total absence of foreign base company sales rules. From a policy perspective, the issue is whether the cost of the base company sales rules outweighs their benefit.

The major benefit of attributing foreign base company sales income along with passive income is that it prevents erosion of the domestic tax base, which accords with the above-mentioned policy goal of the Government. As already illustrated, an absence of base company sales rules will leave a large loophole in the CFC regime, allowing New Zealand importers and exporters to escape tax by re-invoicing goods through tax haven CFCs.

Further, it is not to be taken lightly that many of New Zealand's closest economic partners — including Australia and the United States — enforce some form of base company rules on CFC income derived from sale of goods transactions with related persons. It is telling that Australia and the United States, which generally enact tax laws that are lighter and more business-friendly than New Zealand's, both enforce foreign base company

111 Policy Advice Division of the Internal Revenue Department, *October 2007 Document*, supra note 24, 42.

112 Policy Advice Division of the Internal Revenue Department, *December 2006 Document*, supra note 10, 17. The essence of this statement is reiterated on numerous occasions throughout the various Government publications.

rules that extend the reach of domestic tax to CFC income derived from the re-invoicing of goods. In contrast, the New Zealand Government intends to exempt offshore re-invoicing income from New Zealand tax altogether. Going further than Australia and the United States in this respect seems out of line with the rest of New Zealand's more 'exacting' tax laws. It may transpire that, in the New Zealand context, the lack of foreign base company sales rules will be viewed by taxpayers not as a "benefit" (as suggested by the Government) but as a tax anomaly — one that provides an effective means to shift large amounts of income offshore.

The author argues that the benefit of foreign base company sales rules, through their ability to attack the problem of artificial re-invoicing, outweighs their cost — namely, the exclusion from the active income exemption of a small number of bona fide CFCs that import and export goods. Although harsher tax consequences would result from attributing foreign base company sales income, the Government can take solace in the fact that both Australia and the United States adopt the same approach in their CFC regimes. It follows that the existence of base company sales rules in New Zealand will never, per se, be a determinative factor in an organization's decision to emigrate from New Zealand.

V CONCLUSION

This article has examined the Government's proposed active income exemption for CFCs. The proposal centres on the concept of passive income, which is a legal term of art designed to safeguard the exemption from exploitative tax avoidance arrangements. Concluding remarks on the merits of the proposal can be divided into two segments: first, whether the mechanics of the proposal, as set out in the Bill, are workable and achieve the Government's objectives; and second, whether an active income exemption, as a policy choice in itself, is a wise move for New Zealand.

Mechanics of the Proposal

The mechanics of the Government's proposed active income exemption are based largely on the CFC regimes of Australia and the United States. The Bill focuses on the underlying income of CFCs and seeks to assess New Zealand shareholders to tax only on passive income derived by CFCs. Passive income is defined to include those forms of income most susceptible to cross-border tax avoidance, such as dividends, interest, rent, and royalties.

The Government has opted for an active business test, which will attribute a CFC's passive income to its New Zealand shareholders only if the passive income stream accounts for five per cent or more of the CFC's gross income. In order to apply the active business test, residents will need to classify each item of income derived by their CFCs as either active or passive in nature. The Government has proposed to define passive income positively. Any item of income that does not fall within this definition will, in effect, be exempt from New Zealand tax. Accordingly, the expansive definition of passive income proposed in the Bill is necessary to safeguard the active income exemption from taxpayer manipulation.

On the whole, the mechanics of the proposal strike an appropriate balance between sound policy and business practicality. However, the lack of foreign base company sales rules is cause for some concern. If passive income is not defined to include base company sales income (that is, income derived by CFCs from sale of goods transactions with associated persons), all New Zealand importers and exporters of goods will be able to avoid large amounts of tax by transacting with offshore third parties through re-invoicing CFCs situated in low-tax jurisdictions. This contravenes the Government's policy goal of preventing erosion of the domestic tax base.

Transfer pricing rules are a weak and largely ineffective method of dealing with the problem of offshore re-invoicing. An artificial income stream derived by a CFC from related-party sales can easily be justified by assigning various administrative and risk-bearing functions to the CFC. The only direct way to attack the problem of re-invoicing is to assess New Zealand residents to tax on CFC income derived from related-party sale of goods transactions. An exception should exist for CFCs that "substantially alter" the goods being sold. Whilst foreign base company sales rules will ensure that income derived from re-invoicing is attributed currently to New Zealand shareholders, the 'substantial alteration' test will allow genuinely active manufacturing subsidiaries (as well as other bona fide CFCs that add substantial value to the production process) to continue to benefit from the active income exemption.

Another point raised in this article concerns the classification of interest as passive income. While such a classification is appropriate as a general rule, an exception should be afforded to legitimate offshore banking subsidiaries that derive predominantly interest income in the course of active business. The CFC regimes of both the United States and Australia provide an active financing exception for banking subsidiaries. Even though such CFCs derive income that would otherwise be classified as passive, the income is treated as active if certain requirements are met (for example, if the CFC has a banking licence and derives at least 70 per cent of its gross interest income from unrelated persons). If New Zealand's proposal does not follow a similar path, it will exacerbate the already dismal involvement of New Zealand-owned banks in local and international finance markets.

Merits of the Policy

New Zealand law currently attributes all CFC income, including active income, to resident shareholders. In contrast, every other country in the OECD effectively exempts active CFC income from attribution. As a consequence, New Zealand organizations with active subsidiaries in low-tax jurisdictions are denied significant tax benefits and are thus disadvantaged relative to global and local competitors operating in those regions. This competitive disadvantage, on a macro scale, seems to have stunted New Zealand's outbound FDI and induced many successful firms to relocate to Australia.

The OECD norm of attributing passive CFC income is intended to eliminate the tax avoidance effects of accumulating passive income in tax haven CFCs. However, in addition to attributing passive CFC income, New Zealand uniquely attributes active CFC income as well. Presumably, this is because the Government wishes to nullify the tax incentives offered by developing countries to attract inward FDI. Attribution of active offshore income advances the policy goal of encouraging New Zealand firms to invest domestically rather than offshore (in other words, it engenders capital export neutrality). Although there is merit to such a policy, the reality is that it is no longer viable. The lure of low-cost labour is often so enticing that resident firms establish active manufacturing subsidiaries in developing countries notwithstanding New Zealand's unfavourable CFC rules. When this happens, comprehensive taxation of CFC income inhibits the profitability and success of New Zealand firms relative to international competitors. In any event, Australia exempts active CFC income, which means that the benefits of capital export neutrality are far outweighed by the costs to our economy of successful New Zealand firms migrating to Australia.

An active income exemption for CFCs is long overdue. The goal of New Zealand's CFC regime should be to attack tax avoidance structures, not to distort global market forces. An active income exemption is unlikely to hurt New Zealand's manufacturing industry any more than strict employment laws, geographic isolation, and Asia's oversupply of low-cost labour already have. The current state of New Zealand's manufacturing industry is unsatisfactory in any event, and the transient economic costs of losing some manufacturing activity to low-tax countries are likely to be far outweighed by the long term gains of retaining successful organizations in New Zealand and having their higher returns on FDI feed into the economy.

Author's Postscript

Prior to publication, on 6 October 2009, the Bill was enacted as the Taxation (International Taxation, Life Insurace, and Remedial Matters) Act 2009. For the purposes of the arguments contained in this article, no significant changes were made to the Bill. The content of this article remains relevant under the newly enacted rules.