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**New Zealand's International Tax Review - extending the active income exemption to non-portfolio FIFs**

The Society is grateful for the opportunity to comment on the above issues paper (the issues paper).

***Submission: percentage ownership threshold for eligibility for active income exemption for FIF interests should be 10 percent rather than 20 percent (see Chapter 4 of the issues paper)***

A threshold of 20 percent has been suggested in order for income interests in foreign investment funds (FIFs) to qualify for the extension of the active income exemption. This threshold is too high and should instead be 10 percent. This would ensure consistency with:

- a) internationally accepted notions of "portfolio" investment,
- b) the position as regards investment in controlled foreign companies (CFCs) and
- c) commercial considerations.

***Explanation***

***Inconsistency with international standards***

It is common for international tax systems to use a threshold of 10 percent as the distinction between a portfolio and non-portfolio investment. The expectation is that an investor would usually get some form of tax relief in respect of a non-portfolio (also termed direct) investment. Such relief may take the form of, for example, an underlying foreign tax credit or some form of participation exemption.

Some of New Zealand's major trading partners take this approach, by way of example:

- a) *Australia*: Section 23AJ of the Income Tax Assessment Act 1936 contains an exemption for non-portfolio dividends received by an Australian resident company. Non-portfolio dividend is defined broadly in s317 as a dividend paid to a company where the company has a voting interest of at least 10 percent in the payer.
- (b) *United Kingdom*: Part 9A of the Corporation Tax Act 2009 creates different classes of exemption depending on, among other things, whether the interest is a non-portfolio holding or a portfolio holding. Portfolio holdings are defined broadly as holdings, which represent

less than 10 percent of their class of share by reference to, for example, capital contributed and income rights.

- b) *United States*: Section 902 of the Internal Revenue Code provides for an indirect or “deemed paid” credit on foreign dividends received by a US corporate shareholder where such shareholder owns 10 percent or more of the voting stock of the relevant foreign corporation.

Both the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) make a distinction between a portfolio investment and a direct investment for the purposes of statistical reporting in relation to foreign direct investment (see the IMF’s *Balance of Payments Manual* (5<sup>th</sup> edition, 1993) and the OECD’s *Benchmark Definition of Foreign Direct Investment* (4<sup>th</sup> edition, 2008)). The recommended percentage threshold distinguishing the two concepts is 10 percent of the ordinary shares or voting power of a corporation with the presumption being that, once an investor achieves an ownership interest of 10 percent or greater, the investor may influence or participate in the management of the corporation.

The OECD’s *Benchmark Definition of Foreign Direct Investment* (4<sup>th</sup> edition, 2008) explains the concept of foreign direct investment as follows:

### 3.3 Foreign Direct Investment

*117. Foreign direct investment reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise. **The direct or indirect ownership of 10 percent or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such relationship.** [Emphasis added.]*

The IMF’s *Balance of Payments Manual* (5<sup>th</sup> edition, 1993) provides the following guidance in relation to direct investment:

*374. Direct investment capital transactions include those that create or dissolve investments as well as those that serve to maintain, expand or reduce investments. Thus, when a non-resident who previously had no equity in an existing resident enterprise purchases 10 percent or more of the shares or voting power of that enterprise from a resident, the market value of equity holdings acquired and any other capital invested should be recorded as direct investment. **When a non-resident holds less than 10 percent of the shares of an enterprise as a portfolio investment and subsequently acquires additional shares resulting in a direct investment interest (10 percent or more), only the purchase of additional shares is recorded as a direct investment transaction.** [Emphasis added.]*

Ten percent as a generally accepted notion of a portfolio investment was also acknowledged in the various discussion documents and issues papers which preceded the introduction of the new portfolio investment entity (PIE) rules and changes to the offshore investment rules. For example, it was noted as follows in *Taxation of investment income - the treatment of collective investment vehicles and offshore portfolio investments in shares*, a government discussion document (December 2005):

*3.17 This requirement raises boundary concerns about the precise meaning of the term “portfolio investor”. The current taxation of offshore investment income rules - for example, the underlying foreign tax credit rules - and international norms on the taxation of portfolio investment, suggest that a “portfolio investor” is typically one holding equal to or less than a 10 percent actual ownership interest in any given asset or investment, taking into account any situation where there is a “market value circumstance”. While the government considers that this is a reasonable and generally accepted concept of portfolio investment, submissions are welcome on this point. [Emphasis added.]*

#### Consistency with CFC rules

As noted in paragraphs 1.5 and 7.1 of the issues paper, one of the main objectives of the reform is that the FIF rules should be easy for taxpayers and advisors to understand and operate. There is therefore an attraction to a threshold of 10 percent interest to qualify for the active income exemption, as the rules would then dovetail with the new rules relating to CFCs and offshore portfolio investments and become less complex as a result. A straightforward threshold of 10 percent could then broadly apply as follows, irrespective of whether the entity concerned is a FIF or a CFC:

- a) If the relevant shareholding is below 10 percent, it is characterised as a portfolio interest and would not qualify for the active income exemption. The fair dividend rate method would be the default income calculation method in those circumstances.
- b) If the relevant shareholding is 10 percent or greater, it is characterised as non-portfolio and it may therefore be possible to apply the active income exemption. It would otherwise be necessary to apply the particular rules relating to CFCs and FIFs respectively for income calculation purposes.

If a threshold of 20 percent applied for income interests in FIFs to qualify for the active income exemption, there would be an additional middle ground to administer for income interests of between 10 and 20 percent. The availability of the active income exemption for income interests held in this middle ground would depend on whether the foreign entity concerned was a CFC or a FIF. This may give rise to scenarios where a particular investor may become entitled to the active income exemption in respect of its investment, based on circumstances out of its control.

For example, based on the current proposals, a New Zealand investor with a 15 percent equity interest in a FIF would not be entitled to apply the active income exemption. However, a New Zealand investor with a 10 percent equity interest in a CFC would be entitled to apply the active income exemption. The status of the latter entity as a CFC may be due to the fact that, for example, three other non-associated New Zealand resident investors hold interests of 15 percent each in the same company. However, it may be that all of the New Zealand investors in the CFC are acting on a completely independent basis. It seems anomalous for the investor in the foreign entity to be disadvantaged based on the identity and residence of its fellow shareholders.

A more principled approach would be for all such investors over the 10 percent threshold to have the active income exemption potentially open to them. There is no apparent disadvantage to the Commissioner if this approach is adopted as it will remain necessary in all such cases for the relevant investors to have access to sufficient information before they can use the exemption; otherwise, the active income exemption will not apply, and the investor will have to use an alternative method. (See Chapter 6 of the issues paper)

Other commercial considerations

As noted in paragraphs 2.7 to 2.9 of the issues paper, there are likely to be good commercial reasons for New Zealand companies not to operate through a wholly or majority-owned subsidiary as part of their overseas operations or expansion (for example, because that expansion is by way of a joint venture with a foreign counterparty that already has a presence in the relevant foreign market). In circumstances where a New Zealand resident has made an investment of strategic significance (for example, where a significant contribution of management expertise or technical input is involved) that investment would typically amount to at least a 10 percent interest in the relevant foreign entity. However, there are likely to be other commercial reasons for an investor to deliberately ensure that its investment stake remains below a particular statutory threshold following completion. Two relevant examples are in the areas of corporate takeovers and restrictions on foreign investment.

As noted in paragraph 4.13 of the issues paper, the threshold of 20 percent is of fundamental importance under New Zealand's Takeovers Code (the Code). The "fundamental rule" under rule 6 of the Code is that a person who holds or controls more than 20 percent of the voting rights in a code company may not increase the percentage of voting rights so held or controlled otherwise than in accordance with the Code. Similar thresholds are used for the purposes of takeovers regulation for similar purposes in other jurisdictions. Of particular relevance is the position in Australia where an identical threshold of 20 percent is also employed in this context.

In the foreign investment context, it is common for countries to monitor levels of foreign ownership or control with respect to sensitive assets in the home jurisdiction and to implement notification and approval processes to protect such assets accordingly. New Zealand's Overseas Investment Act 2005 broadly uses a threshold of 25 percent for the purposes of regulating overseas investments in sensitive land or in significant business assets which then require consent under that Act. In Australia, a "substantial interest" test of 15 percent (or 40 percent where aggregation is relevant) is used in conjunction with certain monetary thresholds to regulate foreign investment.

It would not be uncommon for a cross-border investment to be made at a level that does not trigger such thresholds, provided that is consistent with other commercial considerations. For example, a business contemplating a 20 percent investment may be advised to take a 19.9 percent interest, so as not to trigger some foreign regulatory regime. Under the current proposals, a 19.9 percent interest would not qualify for the active income exemption, despite:

- a) investment at such a level clearly being strategic in nature and carrying with it the advantages of foreign direct investment described in Chapter 2 of the issues paper;
- b) tax systems internationally generally using a 10 percent threshold to distinguish between portfolio and non-portfolio investment.

The same logic, in principle, applies to an investment, for which the commercial objectives could be satisfied by taking an interest of around 15 to 20 percent, but where the investor decides to take a 14.9 percent interest so as not to trigger a regulatory requirement that applies to interests of 15 percent or greater. There are therefore commercial reasons for the threshold for the active income exemption to be 10 percent, consistently with international norms for distinguishing portfolio from non-portfolio investment in the tax context.

### ***Recommendation***

The percentage ownership threshold for eligibility for active income exemption for FIF interests should be 10 percent rather than 20 percent. This would be consistent with the threshold applicable in respect of CFC interests.

### ***Submission: considerations relating to the PIE rules should be dealt with by treating certain interests held by PIEs as portfolio interests***

The issues paper discusses the need to ensure that PIEs not benefit from the active income exemption, in respect of interests held in either CFCs or FIFs. This should be addressed by way of a specific rule directed at the treatment of CFC and FIF interests held by PIEs, and not by imposing a 20 percent threshold for the active income exemption in respect of FIF interests held by non-PIEs, or by changing the PIE criteria to prevent PIEs from holding such interests.

### ***Explanation***

Paragraph 4.11 of the issues paper mentions the entity shareholding investment requirement rule which requires a PIE to hold less than a 20 percent ownership interest (by voting interests) in any company in which it invests (excluding other PIEs or foreign entities akin to PIEs). There is a concern that if the threshold for using the active income exemption was set at 10 percent, a PIE could hold an interest of between 10 and 20 percent in an active FIF or CFC and not be taxed on foreign income derived from that interest at all. The reasoning in paragraphs 4.11 and 4.12 appears to use this concern to justify a threshold of 20 percent for the FIF active income exemption.

Although it is acknowledged that this is a valid concern in the context of PIEs, it is not a justification for setting the threshold at 20 percent in relation to all investments, including those not made by PIEs. Exceptional cases may require exceptional treatment, but the exceptions should not dictate the general rule.

To address the particular case of PIEs, a provision should be introduced so that an income interest held by a PIE (in a FIF or in a CFC) does not qualify for the active income exemption. A PIE would instead be taxed as if its interest were a portfolio (less than 10 percent) interest in the FIF or CFC. This would be consistent with the fact that a PIE is really, in policy terms, a collection of portfolio investors, and therefore any investment it makes should be portfolio in nature. Such a provision would alleviate the specific concern identified in respect of PIEs and would also remove the need for an unduly restrictive rule that prevents PIEs from holding income interests of 10 percent or more in CFCs (see the first bullet point on page 3 of the issues paper).

### ***Recommendation***

Specific rules should be introduced to cater for any scenario where a 10 percent threshold gives rise to an unacceptable outcome - one example is where a PIE holds an income interest in a CFC or FIF which would otherwise qualify for the active income exemption.

### ***Submission: there should be an aggregation rule for income interests held by way of joint venture even where the participants are not associated (see Chapter 4 of the issues paper)***

There should be an aggregation rule for income interests held by investors through a joint venture or some other form of co-investment arrangement.

### ***Explanation***

There are likely to be several examples of New Zealand resident investors holding their interests in foreign companies through some form of co-investment arrangement. This may take the form of, for example, an unincorporated joint venture or a contractual arrangement such as a co-investment agreement.

For example, a large New Zealand corporate (NZ Co 1) enters into an 80:20 unincorporated joint venture with a closely held corporate (NZ Co 2) to help commercialise a new product developed by NZ Co 2. In order to take the product offshore, these joint venture participants establish a further (incorporated) joint venture with a foreign company (F Co) in which F Co holds 70 percent, and NZ Co 1 and NZ Co 2 between them hold 30 percent. Assuming NZ Co 1 and NZ Co 2 are not associated, NZ Co 1's income interest in the foreign entity would be 24 percent, being 80 percent of 30 percent (so NZ Co 1 potentially could meet the active income exemption) while NZ Co 2's income interest would be 6 percent, being 20 percent of 30 percent (so that it would not be eligible for the exemption even if the threshold were 10 percent rather than 20 percent). Considering that NZ Co 1 and NZ Co 2 would both make the investment as part of a strategic initiative to grow an active New Zealand business, and would, given their joint venture arrangement, have the same access to information, it would seem inappropriate for NZ Co 2 to be taxed under the fair dividend rate methodology, while NZ Co 1 may qualify for the active income exemption.

A provision should be introduced to address this scenario and to allow for the aggregation of income interests for the purposes of applying the active income threshold. A rule drawing on the formulation contained in sYB 18 of the Income Tax Act 2007 (prior to its repeal by the Taxation (International Taxation, Life Insurance and Remedial Matters Act 2009)) may be appropriate. So investors would be permitted to aggregate income interests in circumstances where there are two or more persons who "habitually act in concert" with respect to the holding or exercise of the things in sEX 5(1) (ie shares, shareholder decision-making rights, rights to income distributions and rights to asset distributions). This would ensure that unincorporated joint venture or co-investment arrangements such as those discussed above are not disadvantaged. If the "habitually acting in concert" formulation were considered too broad, the suggested rule could be confined to "joint ventures or other arrangements between two or more parties for co-investment in the foreign company" (or a similar phrase) to provide a narrower definition.

### ***Recommendation***

That a new rule be introduced for the purposes of allowing the aggregation of income interests held by investors through a joint venture or some other form of co-investment arrangement.

### ***Submission: interest allocation rules should not be enacted to apply to New Zealand residents with FIF interests (see Chapter 5 of the Issues Paper)***

The Issues Paper suggests that interest allocation rules should apply to New Zealand residents with FIF interests of 20 percent or greater in the same way that they apply to New Zealand residents with CFC interests. The Society submits that it would be inappropriate to extend the interest allocation rules to apply to persons with FIF interests, because the concern that led to these rules being enacted for the purposes of the CFC rules does not exist with respect to the FIF rules.

### ***Explanation***

Specific interest allocation rules for CFCs were enacted as part of the recent overhaul of New Zealand's CFC regime involving the move to an active/passive attribution test.

One consequence of the move to active/passive CFC rules is that income of active CFC's will cease to be taxable in New Zealand. Because of this, the Government was concerned that an incentive could be created for firms to fund their CFCs from New Zealand to maximise the interest deductions they were able to claim against their other New Zealand income (potentially eroding the New Zealand tax base). The concern was explained as follows in the 2006 discussion document, *New Zealand's International Tax Review: A Direction For Change*:

*Under the proposed active/passive rules, the active income of CFCs would no longer be taxable in New Zealand. To the extent that New Zealand has a higher tax rate than the jurisdiction in which the CFC is located, the revised rules would also create an incentive for firms to allocate their interest costs against New Zealand income as opposed to the tax-exempt foreign income. This can be done by the parent company financing investments in active CFCs in the form of equity, as opposed to debt.*

To prevent this outcome, specific CFC interest allocation rules have been enacted to guard against New Zealand residents overcapitalising their CFCs and retaining the debt (and hence claiming the interest deductions) in New Zealand. If, applying the legislative tests, a CFC is deemed to be overcapitalised, the interest deductions available to a New Zealand investor in that CFC will be limited.

The concern that led to the enactment of CFC interest allocation rules can only arise where the New Zealand shareholder (or shareholders) of an overseas company has sufficient control over the company to determine how it is financed. A CFC, by definition, is a company that is **controlled by** a New Zealand resident shareholder (or shareholders) and there would accordingly be scope for its shareholders to control the manner in which it is financed.

By contrast, a FIF is **not controlled** by New Zealand residents. An entity will automatically be a FIF where it is an overseas company (being a company that is non-resident for tax purposes and not treated as a New Zealand resident under an applicable double tax agreement) irrespective of the level of New Zealand resident shareholders. Any New Zealand investors in a FIF do not control the FIF.

Because a FIF is not controlled by New Zealand residents, the ability to substitute borrowings at a New Zealand shareholder level for borrowings that would otherwise be undertaken at a foreign entity level is much diminished because the New Zealand resident shareholders will not have any ability to dictate the financing policies of the FIF.

The Discussion Document nevertheless suggests that the interest allocation rules should apply to a FIF if New Zealand residents have a "substantial stake" in that FIF:

*The principle underlying the extension of the active income exemption to FIFs is that it should apply to investments where there is a substantial stake in an active foreign company. If there is a substantial stake, there will sometimes be scope to manipulate how a FIF is funded. For example, in the case of a joint venture or a closely held FIF, the New Zealand shareholder could easily have tax incentives that are aligned with those of foreign shareholders, in which case they could negotiate financing arrangements which produce a mutual tax benefit.*

The Discussion Document equates a "substantial stake" in a FIF with a 20 percent shareholding in the overseas entity. However, even if a New Zealand shareholder did have a 20 percent FIF shareholding, it does not follow that they would have any ability to influence the manner in which

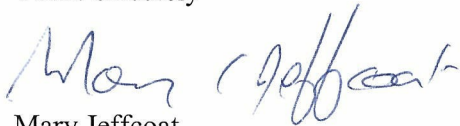
the FIF was financed. In addition, the fact the FIF may be a joint venture that is not controlled by any one shareholder may mean that financiers are not prepared to lend to the FIF, meaning that borrowing is only available at shareholder level in any event.

***Recommendation***

That it is unnecessary to enact interest allocation rules for FIFs because the concern that led to such rules being enacted for the CFCs (i.e. that persons with control of the overseas entity might seek to locate group interest expenditure in New Zealand) does not exist with respect to investors in FIFs. FIF investors are unlikely to have any ability to control or manipulate the manner in which the relevant FIF is financed.

The Society trusts these comments are helpful. If you require further assistance please do not hesitate to contact Kim Oelofse by phone (04) 463-2991 or email [kim.oelofse@lawsociety.org.nz](mailto:kim.oelofse@lawsociety.org.nz).

Yours sincerely



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