NEW ZEALAND BUSINESS ROUNDTABLE

# Submission on the Taxation of Non-controlled Offshore Investment in Equity

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# Taxation of Offshore Investment

> An inquisition into every man's private circumstances, and an inquisition which, in order to accommodate the tax to them, watched over all the fluctuations of his fortunes, would be a source of such continual and endless vexation as no people could support.
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> Secondly, land is a subject which cannot be removed; whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour would necessarily be more or less diminished by its removal.
>
> Adam Smith (1776)[1]

## 1. Introduction

1.1 This submission on the officials' issues paper, *Taxation of Non-controlled Offshore Investment in Equity* (the issues paper), is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The taxation of outward and inward foreign investment is an important public policy issue. It has been the subject of several reviews since the 1980s. More efficient policies have generally been adopted but an optimal tax regime that fully reflects sound economic principles and provides appropriate certainty has yet to be put in place.

1.3 The international tax regime seeks to advance national welfare by reducing the extent to which New Zealand tax distorts resource use, particularly the allocation of resources between domestic and offshore investment. New Zealand residents are generally taxed on

[1] Smith, Adam (1776), *An Inquiry into the Nature and Causes of the Wealth of Nations*, book 5, chapter 2, paragraphs 90-91, see www.econlib.org.

their worldwide income (the residence principle) for this reason. However, the level of New Zealand tax imposed on different categories of outward investment varies widely and is not necessarily comparable to that payable on domestic investment.

1.4 The level of tax on outward investment was increased by the adoption of the foreign investment fund (FIF) and controlled foreign company (CFC) regimes. Under those regimes outward foreign investment is taxed on an accrual rather than a realisation basis. This reduces the scope for New Zealand tax to be deferred permanently by accumulating income in offshore entities. Investment in grey list countries is, however, exempted from the provisions of the CFC and FIF regimes.

1.5 The taxation of international investment is constrained by international agreements and conventions, limited jurisdiction over non-resident entities and information constraints. Policy trade-offs are unavoidable and feasible solutions are unlikely to conform to textbook models. The key objective, as the issues paper acknowledges, is to advance national welfare. This can be achieved by introducing changes that move the international tax regime in the right direction.

1.6 The issues paper focuses on outward equity investment where the investor does not control the entity in which the interest is made. While much of that investment comprises portfolio investment by individuals (where the investor's interest is less than 10 percent of the equity in the entity), it also includes direct investment in a range of businesses, for instance in joint ventures and associated companies, that does not confer control on the investor.

1.7 The most promising options for taxing offshore equity investment where the investor does not control the offshore investment vehicle (and therefore cannot obtain the information necessary to apply tax bases that are information-intensive such as the branch-equivalent basis) are likely to involve either a standard rate of return (or imputed return) or a comparative value approach. These tax bases are

similar but the level of tax that would be levied differs. The proposals also differ in the extent of their coverage.

1.8 The officials' issues paper is a step toward developing a possible alternative regime. The efficacy of any alternative regime will largely depend on the detailed rules that are proposed. We have not commented in detail on the rules proposed in the issues paper but we suspect that additional rules to those discussed in it would be necessary to implement either option.

1.9 An underlying problem is that the level of government spending – the overall tax burden – is too high. It is implausible that government spending at the margin yields an adequate return from an overall community perspective. Such a return would take account of deadweight costs. A substantial reduction in the level of government spending is required to retain successful New Zealanders and to attract wealthy immigrants and, more generally, to raise the rate of economic growth. Such a policy would be consistent with the government's statement in the Speech from the Throne at the opening of the current parliament that it:

> ... sees its most important task as building the conditions for increasing New Zealand's long term sustainable rate of economic growth.[2]

1.10 In the absence of a lower overall tax burden, a reduction in the operating surplus, or both, tax policy changes redistribute the tax burden among different classes of taxpayers. Thus both options contained in the issues paper broadly propose a reduction in tax on investments in FIFs resident in a non-grey list country and higher taxes on at least some such investment in grey list countries.

1.11 The proposals are unlikely to significantly change the incentive for wealthy New Zealanders to migrate and for wealthy potential immigrants to become New Zealand tax residents. The Tax Review 2001 (Tax Review) proposed a two-step personal income tax scale (18% up to $29,500 and then 33 percent), a company and trust rate

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[2] Dame Silvia Cartwright, Speech from the Throne, 27 August 2002.

of 33 percent and the introduction of a tax cap.[3] Those proposals, particularly the tax cap, might be better measures to encourage New Zealanders to remain resident for tax purposes.

1.12 The aim should be to go much further in cutting spending and taxes over the next few years. Lower and more uniform rates of tax would also assist in reducing distortions in the taxation of domestic and foreign investment, especially as it is not feasible to address some biases (for instance, the exemption from tax of owner-occupied houses). The business community is exceedingly disappointed that the government has shown so little interest in acting on the recommendations of its expert tax review.

1.13 The balance of this submission is presented in 4 sections. The next section (section 2) discusses the framework. Sections 3 and 4 outline the proposals contained in the issues paper and comment on them. Section 5 sets out our conclusions.

## 2. Framework

2.1 Outward foreign investment is consistent with the advancement of national welfare if the economic return on such investment, after all foreign taxes, is at least equal to the return before tax that can be earned on domestic investment (other things being equal), and if that return equals the cost of capital. In these circumstances, national welfare cannot be increased by reallocating a dollar of foreign investment to domestic investment, or *vice versa*. Firms can be induced to act in the national interest when making decisions about outward foreign investment by allowing a deduction rather than a credit for foreign taxes, although international practice commonly allows a credit for such tax.

2.2 The contrasting treatment of foreign and domestic taxes arises because they have different economic effects. Tax paid to a foreign jurisdiction is a resource cost, just like the payment for labour

[3] McLeod, Robert *et al* (2001) *Tax Review 2001 – Final Paper*, The Treasury, Wellington, pp viii-xi.

services, because it reduces the level of resources available to New Zealand residents. Conversely, tax paid in New Zealand by a non-resident taxpayer increases the level of resources available to residents. Tax paid in New Zealand by residents simply transfers command over resources from one resident to another and does not reduce the level of resources available to New Zealanders (leaving aside compliance and administration costs which are resource costs).

2.3 A misunderstanding of this vital difference between tax paid by residents to foreign and New Zealand tax authorities leads to considerable confusion. Businesses usually view both classes of tax as equivalent because, from their perspective, they are a cost of doing business. However, if the government were to treat foreign tax as equivalent to domestic tax, the tax system would encourage foreign investment relative to domestic investment, and national income would be lower than otherwise.

2.4 A related concern sometimes expressed by businesses is that a resident firm may not be able to compete with firms resident in other jurisdictions where the rate of tax is significantly lower than that payable in New Zealand. This is not, however, a persuasive ground to tax outward investment at a lower rate than domestic investment. If New Zealand firms cannot compete for this reason, it implies that New Zealand resources (notably capital) would be better invested elsewhere, including at home. For a similar reason, the European Union's subsidisation of agriculture does not justify the provision of a subsidy for our dairy exports. From a national welfare perspective, the relevant issue is the relative rates of return on investment in New Zealand and offshore.

2.5 Most outward foreign investment is made in grey list countries. Income is not included in the taxable income of New Zealanders who invest in grey list countries on capital account until it is distributed. Where such investment is on revenue account, realised gains (broadly, the difference between the cost of the investment and the

amount obtained on its disposal) are also taxed. Under the CFC and FIF regimes those gains would generally be taxed as they accrue.

2.6 The grey list exemption, which is a focus of the issues paper, reflects an emphasis on tax avoidance rather than the advancement of national welfare. It was introduced largely for political reasons and, to a lesser extent, to reduce compliance costs. The grey list comprises countries that broadly tax income sourced in their countries relatively comprehensively at a significant rate of tax. The grey list thus excluded tax havens.

2.7 If income from investment in grey list countries had been included in taxable income and if credit had been given for tax paid by the foreign entity in the host country, as presently permitted under the CFC regime (not the FIF regime unless the branch equivalent method of income calculation is used), little additional tax would have accrued to New Zealand. However, compliance costs would have been substantial. Although a deduction for foreign taxes (rather than a credit) would have been desirable on economic grounds, that treatment was unlikely to be adopted, at least initially, because of political pressures to adopt international tax arrangements that reflected the practices of other comparable countries and to lessen the effect of the change introduced by the CFC and FIF regimes.

2.8 Consistent with the residence principle, the level of tax on inward foreign investment has been reduced. The tax discourages capital imports just as a tariff deters imports of goods and services. This is not the case, however, where foreign investors are able to credit such taxes against their tax liabilities in their home countries or where the tax applies to pure rents. Another concern is to prevent domestic investment being characterised as outward foreign investment. The avoidance issue relating to New Zealanders investing in New Zealand debt instruments through Australian unit trusts, which is discussed in the issues paper, illustrates this concern. These factors point to the retention of some tax on inward foreign investment

whereas exemption from tax is indicated by the pure residence principle.

2.9 The see-saw principle recognises that the appropriate level of aggregate tax on outward foreign investment might be achieved by taxing outward investment at a lower rate than domestic investment and also taxing inward foreign investment. Because inward foreign investment is mobile, New Zealand tax on such investment increases the required rate of return on domestic investment projects. As a consequence, the return on domestic investment is raised above the world rate of return and this may offset the bias toward offshore investment from imposing a lower level of New Zealand tax on outward investment than on domestic investment.

2.10 Another reason for departing from a pure residence principle is that an excessive tax on outward foreign investment may unduly encourage some businesses and investors to cease to be resident in New Zealand for tax purposes. As the quotation cited above indicates, Adam Smith identified this risk over 200 years ago when tax rates were much lower than they are today. An excessive level of tax on outward foreign investment may also discourage wealthy individuals who could make a valuable contribution to New Zealand from immigrating because their offshore investment would become subject to New Zealand tax on outward foreign investment. Investment which can easily be directed to other countries (for instance, multinational companies may have scope to channel investment in third countries through New Zealand or another country) and residents who could relocate are likely to be sensitive to relatively small changes in the expected level of tax. This concern has arguably become more important as tax rates have increased and as countries have sought to attract wealthy immigrants and investment by introducing special tax regimes. As Adam Smith observed, a flight of capital and taxpayers is likely to be detrimental to prosperity generally.

## 3. Proposals

3.1 The issues paper identifies three key problems with the present FIF regime for taxing outward investment:

- The grey list distinction. Investment in a FIF in a grey list country is generally subject to taxation on the basis of dividends that are distributed to resident investors. This regime applies to investment that is on capital account. Where the investment is on revenue account, realised changes in the value of investments are also taxed. In contrast, investment in a FIF resident in a non-grey list country is taxed comprehensively on an accrual basis.

- Tax avoidance associated with investment by New Zealand residents in Australian unit trusts that invest in New Zealand debt instruments. New Zealand interest paid to a non-resident taxpayer is subject to the approved issuer levy (AIL) or non-resident withholding tax (NRWT). This income is then returned to New Zealand unit holders in the form of non-taxable bonus issues. The effective rate of New Zealand tax is lower than that which would be payable if the investment were made directly rather than through an offshore entity.

- The level of tax imposed on investment in a FIF in a non-grey list country is said to be unfair.

3.2 As a consequence of the first two problems, the following investment choices are distorted and efficiency is thereby impaired:

- the choice between domestic and offshore investment;

- the choice between investment in a grey list country and in a non-grey list country;

- the choice between direct investment offshore or indirect investment offshore via a resident institution; and

- the choice between equity and debt investment.

The focus should be on efficiency issues rather then perceived fairness. A higher effective rate of tax on investment in non-grey list countries than in grey list countries can, for example, be expected to bias the destination of investment flows.

3.3 The main features of the options advanced to address the problems identified in the issues paper are listed below:

- *The standard rate of return option*. Non-controlled offshore equity investment in a non-business context would generally be subject to tax computed by applying a deemed rate of return to the market value of the investment at the start of the tax year (with adjustment for additional investment, disinvestment and dividends during the year).

  The longstanding distinction between investment on revenue and capital account, which generally applies to domestic and offshore investment, would be replaced by a business test. If income were derived from foreign investment undertaken as part of the investor's business, it would not be subject to the standard return option. In that case, the present FIF rules and grey list would apply. A business is defined in the Income Tax Act 1994 as "any profession, trade, manufacture, or undertaking carried on for pecuniary profit."

  The grey list distinction would be abolished for non-business and non-controlled offshore investment but would be retained for investment in a business context.

  The standard rate of return option is based on the risk-free rate of return method (RFRM) proposed by the Tax Review. The initial standard rate of return is put at 4 percent. This is a real rate of return, before New Zealand tax, as it is computed on the market value of the investment at the start of each year. It is equivalent to comprehensive accrual taxation of real economic income with the exception that the rate of return is a deemed return rather than the actual return. The actual economic return

would reflect the change in the value of the investment, net capital contributions and dividend distributions during the year. The standard rate of return may be higher or lower than the actual return in any given year.

Investors who have sufficient information would be able to use the branch equivalent method. Under that method foreign taxable income is computed on a similar basis to domestic income. Investment that is subject to the CFC rules can be taxed on this basis but the NZBR understands that the comparative value basis is commonly adopted.

Although not currently proposed, work has been undertaken with a view to applying the standard rate of return option to domestic saving and investment. This would have the advantage of treating domestic and foreign investment on a similar basis.

- *The offshore portfolio investment rules*. Non-controlled offshore equity investment would be taxed according to a series of rules that are similar to those that apply under the FIF regime.

  Non-controlled offshore equity investment would be subject to the same rules whether the investment were on revenue or capital account. Thus the capital revenue distinction would be replaced.

  The grey list distinction would be abolished for all non-controlled offshore investment. It would remain for investment that confers control.

  Investors who hold a non-controlling interest of 10 percent or more would be taxed on a branch equivalent, foreign account (the amount of reported after-tax foreign income of the entity attributable to the investor), revised comparative value basis (70 percent of the change in the value of the investor's investment plus dividend distributions), or an imputed return basis (broadly the same as the standard return option except that a nominal rather than real rate of return would be set).

Investors who hold a non-controlling interest of less than 10 percent in a foreign company and those who hold a non-controlling interest in an entity other than a company would be taxed on a revised comparative value basis or an imputed return basis.

## 4. Comment

4.1 The framework outlined in paragraphs 3.1 to 3.9 of the issues paper is endorsed. The grey list distinction is inconsistent with that framework because it effectively treats foreign tax as a substitute for New Zealand tax rather than as a cost of doing business in a foreign jurisdiction.

4.2 The NZBR's submission on the issues paper prepared by the Tax Review gave qualified support to the proposed repeal of the grey list:

> We agree with the Review's conclusion that it would be desirable to repeal the grey list provided that it is possible to develop a suitable regime for the taxation of the foreign-sourced income that residents derive from their investments in grey list jurisdictions.[4]

The NZBR also noted that the RFRM proposed by the Tax Review required detailed and careful investigation against recognised criteria.[5] Our view has not changed.

4.3 The NZBR submission to the Tax Review opposed the introduction of an active/passive distinction:

> … we see very little merit in replacing the grey list with an 'active/passive' distinction for income from investments in jurisdictions currently on the grey list (ie non-black list investments) as a means of reducing compliance costs.[6]

The omission of consideration of an active/passive distinction in the issues paper is endorsed. Such an approach is not consistent with the national welfare criterion.

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[4] New Zealand Business Roundtable (2001), 'Submission on the Tax Review 2001 'Issues Paper", New Zealand Business Roundtable, Wellington, p 26.

[5] *Ibid*, p vii.

[6] *Ibid,* p 26.

4.4 A key difference between the two options discussed in the issues paper relates to the classes of outward foreign investment that would be taxed under new rules. The standard rate of return option would apply to non-controlling offshore equity investment other than where such investment constitutes a business activity under existing tax rules (ie where the investment is undertaken in a business context.)

4.5 The practical effect of adopting this business test is that portfolio investment by individuals (ie where the equity interest amounts to less than 10 percent of the entity) and some investment by firms that does not satisfy the business test would no longer be taxed under the FIF rules. Instead taxable income would be computed by applying the standard rate of return to the value of the investment at the start of the year. The grey list exemption would be removed. However, existing rules, including the grey list exemption, would apply where the investment is undertaken in a business context. Thus managed funds that are actively managed, minority holdings in associated companies and interests in joint ventures (up to a 50 percent interest) would generally be unaffected.

4.6 The apparent behaviour of investment funds (among other things) was investigated in developing the current proposal. It seems that most managed funds (other than passive funds) that invest in grey list countries turn over their investments regularly, thereby realising gains. There is little indication that only losses are realised or that realised gains are offset by realising losses although such behaviour is expected when realised gains are taxed. If such funds had been taxed according to the standard rate of return method over the past few years, tax collections would generally have been lower. Moreover, certain spokespeople for the funds management industry have advocated retention of the existing grey list rules. In those circumstances, the standard rate of return option apparently sought to leave managed funds unaffected. The business test has this effect.

4.7 The offshore portfolio investment rules option would apply to all non-controlling offshore equity investment. It would therefore apply to non-controlling offshore equity investment in a business context. Such investment would generally be more heavily taxed than under the standard return option because the grey list exemption would be removed. There would be greater consistency among the tax treatments of different classes of investment. On the other hand, the level of tax imposed on outward business investment may unduly discourage such investment, as discussed above. The proposal to tax 70 percent of the change in the value of certain investments may be an acknowledgement of this risk.

4.8 For similar reasons to those discussed in relation to the standard return option, the offshore investment rules option would impose similar or more favourable tax treatment on managed funds invested in grey list countries. However, passive funds would generally be subject to increased taxation.

4.9 The standard rate of return is reported to be equivalent to the nominal risk-free rate of return proposed by the Tax Review 2001, after adjustment for inflation. The rate also appears to have been set to reflect a 'reasonable' dividend yield on an equivalent domestic investment held on capital account. The issues paper argues that a higher rate would apply (6 percent) if the approach were extended to non-controlled equity investment held in a business context. That proposition seems to be inconsistent with the concept of a risk-free rate and indicates that the standard rate of return option is conceptually different from the RFRM proposed by the Tax Review. It is apparently intended to establish a rate of return broadly comparable to that earned on domestic investment. Without a firm and clearly articulated conceptual basis for setting the level of return, the standard rate could easily be increased over time to reflect factors other than any change in the risk-free rate of return.

4.10 By taxing the risk-free return only, the RFRM would not bias risk taking. Returns to risk-taking were not to be taxed and similarly

losses from such activities were not deductible. In contrast, the standard rate of return option and at least some bases included under the offshore portfolio rules option (eg imputed return basis) would seem to entail a tax bias against risk taking. This arises because the government would share in *ex ante* rewards to risk taking but would not share commensurately in actual losses. While it might be argued that an equity investment would on average return at least 4 percent before tax over the long run, that would not necessarily be true for particular taxpayers.

4.11 Under the RFRM the risk free rate of return was to be applied to the investment, net of debt, and consequently interest would not be deductible. Under the standard rate of return option, the deemed rate of return would be applied to the gross investment in equity and interest would be deductible in the usual way. We think that this is an improvement as it would avoid a troublesome allocation of debt between investment that is taxed on a standard rate of return basis and that which is taxed on the normal basis.

4.12 The distinction between investment on revenue and capital account is viewed as a significant problem in the issues paper. The distinction, however, pervades much of the present tax system and is likely to remain. The land on which a manufacturer's factory sits, for instance, is on capital account while that held by a property developer for resale is on revenue account. There is substantial case law on the distinction.

4.13 While there are economic grounds for taxing all economic income on an accrual basis, such an approach is not feasible for all asset classes because many classes cannot be stated at their current market value at the end of each tax year. An alternative would be to tax so-called capital gains on a realisation basis. However, this is undesirable as the Tax Review reported:

> New Zealand's income tax base is broad by international standards but falls short of being fully comprehensive in two notable respects: (i) the absence of a comprehensive tax on capital gains and (ii) the non-taxation of owner occupied housing.

> We do not consider that New Zealand should adopt a general realisations-based capital gains tax. We do not believe that such a tax would make our tax system fairer and more efficient, nor do we believe that it would lower tax avoidance or raise substantial revenue that could be used to reduce rates. Instead, such a tax would increase the complexity and costs of our system.[7]

The Tax Review recommended "a continuation of the past approach of dealing with the capital gains issue as specific problems are identified."[8] The NZBR broadly agrees with that approach. The Tax Review viewed the RFRM as consistent with it.

4.14 The Tax Review initially proposed that the RFRM should be applied to owner-occupied housing, consistent with the proposition that income should be taxed comprehensively on an accrual basis. The NZBR accepts that it may be desirable to shift the boundary between capital and revenue in some circumstances but it counselled against that proposal. We saw serious administrative problems with it and we did not think that the public and political support necessary to allow such a proposal to be implemented on a satisfactory basis would be forthcoming. We considered a better way of addressing the distortions was to adopt a lower and flatter tax scale.

4.15 If the appropriate benchmark were comprehensive taxation of economic income on an accrual basis, the FIF regime for taxing offshore equity investment in a non-grey list country would not be changed but investment in grey list countries would be moved on to a similar regime. This is not advocated under either option, however, for reasons such as those discussed in paragraphs 3.10 to 3.15 of the issues paper and in section 2 of this submission. Some of those concerns might be met, however, by taxing the income at a lower rate or by including a proportion of such income in taxable income rather than by altering the tax base.

4.16 The move away from viewing the comprehensive taxation of economic income on an accrual basis as the appropriate benchmark raises uncertainty about the appropriate benchmark. The abolition of

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7 McLeod, *et al* (2001), p iii.

8 *Ibid,* p 29.

the capital and revenue account distinction is not necessarily appropriate in such circumstances. Each situation should be examined on its merits.

4.17 The perceived problem concerning the capital and revenue account distinction is accentuated by IRD rulings which treat so-called passive investment by managed funds as being on capital account. Under common law, investment by superannuation, insurance and investment funds was on revenue account and the issue of whether the investment was managed passively or actively was irrelevant. This issue should be re-examined in any event.

4.18 Several criticisms of the standard rate of return option have been made. They include the following:

- It would smooth tax collections and thereby blunt the automatic stabilising influence of tax collections. The perceived concern is that the level of the standard rate of return, unlike the actual return, would be unaffected by the business cycle. While that is true, tax collections would fluctuate on a lagged basis because the base on which the return is computed would reflect market conditions at the start of the tax year. Moreover, the pattern of actual returns on offshore investment would tend to reflect business cycles in the host countries which would not necessarily be synchronised with the New Zealand business cycle. In any event, it seems unlikely that the volatility of the government's total tax collections would be greatly affected because most income and goods and services would continue to be taxed on the present rules (eg wages and company income from domestic investment) and would be subject to domestic conditions.

- Under the standard return option taxpayers would be liable for tax when their investment actually returned a loss. This has been perceived as unfair. On the other hand, under standard tax rules relating to investment on capital account, dividends are subject to tax even though the investment may have fallen in

value during the year such that the overall return to the investor is negative.

- A related concern that has been raised is that taxpayers may not have sufficient funds to meet their tax liability. Because tax is levied on income and not cash flow, there is scope for a divergence between cash flow and income, for instance when goods are sold on credit. In most instances this is not a serious issue and taxpayers are expected to manage their cash flows such that they can pay their tax when it falls due. The NZBR understands, however, that in particular cases significant liquidity problems have arisen under the existing international regime where substantial costs would be imposed if investors were required to liquidate their investment to meet their tax liability. An example is unrealised gains that arise from the movement in exchange rates that are taxable under the CIF rules where the investment is in a non-grey list country. Provision for relief may need to be provided in extreme cases.

- The standard return calculation becomes complicated where the level of investment changes during the year, necessitating a part-year adjustment. Changes in the level of investment may not be under the control of the investor, for instance when a firm returns capital. The adjustments proposed in the issues paper are unlikely to be easy for relatively unsophisticated investors and would add to compliance concerns. This problem does not arise under the comparative value approach because no account is taken of the timing of net capital contributions during the tax year.

4.19 The analysis of the problem that is said to arise from the activities of certain Australian unit trusts seems to depart, in some respects, from the framework. In paragraphs 1.7 and 4.18 of the issues paper, for instance, it is implied that the absence of Australian tax is a source of the problem. However, Australian taxes on New Zealand investment in an Australian unit trust are a cost of doing business, just like

wages. It is in New Zealand's interest that they be as low as possible. Thus the absence of Australian tax is not the real problem.

4.20 Interest income earned by non-residents is subject to the AIL or NRWT and taxed at a lower rate of tax than returns from equity investment. A relatively low rate of tax on genuine inward foreign investment is consistent with the residency principle. The fundamental problem is that such income effectively accrues to residents rather than non-residents. This arises because the Australian unit trusts distribute their income in the form of non-taxable bonus shares. This is somewhat similar to the zero coupon bond problem that arose some years ago. An avoidance rule that addresses the problem may warrant further examination if the broader options do not proceed.

4.21 It is doubtful, however, if major changes to the FIF rules relating to offshore equity investment generally could be justified solely because of the avoidance issue. They must rest on a broader analysis of the feasibility of any regime and an assessment of whether it would advance overall national welfare.

## 5. Conclusion

5.1 The NZBR's key conclusions are listed below:

- The taxation of outward and inward foreign investment is an important public policy issue. The deadweight costs of taxation of capital income are generally high and New Zealand should be striving to reduce them. More efficient policies have generally been adopted but an optimal tax regime that fully reflects sound economic principles and provides appropriate certainty has yet to be put in place.

- Lower and more uniform rates of tax would assist in reducing the inconsistencies in the taxation of domestic and foreign investment. The tax cap proposed by the Tax Review should also be adopted.

- The repeal of the grey list is supported provided that a suitable method of taxing affected offshore investment can be established.

- Both options proposed in the issues paper would move the taxation of non-controlled investment in foreign equity in the desired direction. They differ, however, in their scope and in the level of tax that would be applied.

- The government would need to establish that any proposed regime is feasible and would advance overall national welfare before adopting it. The issues paper is only a preliminary document in this respect and more detailed proposals need to be formulated. Any such proposals should be subject to full consultation.