THE RESIDENT/NON-RESIDENT DICHOTOMY IN NEW
ZEALAND’S TAX REGIME: PROPOSALS FOR SOME
INTERMEDIATE STEPS?

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I INTRODUCTION

A key feature of New Zealand’s international tax regime is the comprehensive taxation
of New Zealand residents’ worldwide income. This is largely due to the broad
controlled foreign company (CFC) and foreign investment fund (FIF) regimes found in
the New Zealand tax regime.

Because of this comprehensive residence-based taxation, it is believed that highly
skilled migrants are deterred from relocating to New Zealand in favour of other
countries. Recognising that tax considerations may be undermining the objectives
sought from the government’s migration policies to attract highly skilled migrants, the
government has released a discussion document, Reducing Barriers to International
Recruitment to New Zealand (Discussion Document), proposing a limited exemption
for some new migrants from the full application of New Zealand’s international tax
regime.2

The objective of this paper is to review and analyse the proposals outlined in the
Discussion Document with respect to the proposed limited exemption for new
migrants.

II NEW ZEALAND’S TAX REGIME APPLYING TO RESIDENTS

A The CFC and FIF Rules

In the period 1987–96 New Zealand’s international tax regime was radically changed.
Extremely comprehensive CFC and FIF regimes were initially introduced in 1988 and
substantially reformed in 1992, giving New Zealand one of the broadest resident-based

1 A later version of this paper has been published. See Smith, Andrew M. C., "New Zealand's
International Tax Rules: Proposals For a Temporary Exemption For New Migrants", Bulletin For

2 Policy Advice Division of the Inland Revenue Department, Wellington, Reducing Barriers to
tax regimes in the world. While New Zealand’s CFC and FIF regimes are very complex, for the purposes of this paper the salient features of each regime will be outlined.

The New Zealand CFC regime applies if a CFC exists for New Zealand tax purposes. A CFC is a foreign company that either has:

- Five or fewer New Zealand residents whose aggregate control interests are greater than 50 per cent in the company; or
- One New Zealand resident where their control interest is 40 per cent or greater; or
- Five or fewer New Zealand residents where they have the power as a group to control the exercise of shareholder decision-making rights in the CFC.

Once a foreign company is deemed to be a CFC, the New Zealand resident shareholders are required to attribute their share of the CFC’s income (as determined using New Zealand tax accounting rules) if their income interest is 10 per cent or greater in the CFC on a ‘branch-equivalent’ (BE) basis. A credit is allowed against New Zealand tax for the taxpayer’s share of foreign tax paid by the CFC. If the CFC subsequently declares a dividend to its New Zealand shareholders (including companies), that dividend is taxable with a credit for taxes already paid on the attributed CFC income. In attributing income to the CFC’s shareholders no exemption is made for ‘active income’ earned by the CFC. New Zealand’s CFC regime is unusual in this respect—no active income exemption is offered.

The New Zealand CFC regime contains only one exemption. It is for CFCs located in certain approved countries (known as the ‘grey-list’) that have been deemed by the New Zealand authorities as having a comprehensive tax regime with effective tax rates similar to New Zealand’s. The grey-list currently comprises Australia, Canada, the United States, the United Kingdom, Germany, Norway and Japan.

If the CFC is resident in a ‘grey-list’ country New Zealand residents are not required to attribute any income in respect of their interests in those CFCs. Instead the income of ‘grey-list’ CFCs is taxed on a deferred basis when (or if) the CFC pays a dividend to its New Zealand resident shareholders. However, if the shareholder is a New Zealand resident company, a deemed credit is given against any tax payable, so the New Zealand tax is effectively deferred until when the New Zealand company declares a dividend to its shareholders. Therefore, there is a significant difference in the manner

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4 The CFC and FIF regimes are found in subpart CG of the Income Tax Act 1994 (ITA94). All statutory references are to this Act unless otherwise stated. For a detailed summary of the New Zealand CFC and FIF rules refer to New Zealand Master Tax Guide 2003, CCH New Zealand Limited, Auckland, New Zealand 908–35.

5 Control interests are determined under s CG 4 of ITA94.

6 Income interests are determined under s CG 5 of ITA94.

7 If their income interest is below 10 per cent, any income attributable to them from their CFC interest is determined under the FIF rules. (To be covered later in this paper.)

8 Part A, Schedule 3 ITA94.
in which New Zealand residents’ interests in CFCs are taxed in New Zealand, depending upon where the CFC is located.

The FIF regime is complementary to the CFC regime and was introduced at the same time for that reason, although its operation was delayed until 1992. The FIF regime has been more controversial than the CFC regime, partly because it is more likely to apply to individual taxpayers who have interests in FIFs, such as offshore managed funds, foreign life insurance policies and foreign superannuation schemes. The manner in which income is attributed to New Zealand taxpayers with FIF interests under the FIF regime can be penal in many circumstances and is sometimes interpreted by taxpayers as an effective prohibition upon foreign portfolio equity investment outside ‘grey-list’ countries.

The FIF regime applies to:

- Interests in CFCs (including unit trusts) where the New Zealand shareholder’s income interest is below 10 per cent;
- An entitlement to benefit from foreign life insurance policies where the policy was not offered or entered into in New Zealand by a non-resident life insurer; and
- Membership or the right to benefit under a foreign superannuation scheme.

Certain FIF interests are exempt. They include:

- Interests in CFCs required to be accounted for under the CFC rules.
- Interests in foreign entities that are resident in ‘grey-list’ countries. This exemption does not apply to foreign life insurance policies or superannuation schemes in ‘grey-list’ countries.
- Certain interests held by natural persons. This applies where the aggregate cost of all CFC interests held by the natural person are below NZ$50 000. (*De minimis* exemption.)
- Interests in an employment-related foreign superannuation scheme. This is a superannuation scheme entered into by virtue of the taxpayer’s employment outside of New Zealand when they were non-resident for tax purposes.
- Interests in foreign entities held by natural persons (where those interests were acquired before they became a New Zealand tax resident), where exchange controls offshore prevents the taxpayer from deriving any income interest or realising the interest for New Zealand currency.
- Interests in foreign life insurance policies and foreign superannuation schemes where these were acquired by natural persons before they became resident in New Zealand for the first four years after they become resident in New Zealand.
- Interests in a ‘qualifying foreign private annuity’ in respect of benefits derived by a New Zealand resident from a pension or annuity where the consideration provided by the taxpayer for that pension or annuity was provided when the taxpayer was a non-resident.

Where a FIF interest is deemed to arise (taking into account the above exclusions) the taxpayer is required to account for them for New Zealand tax purposes using one of four different methods. These methods are:
• Comparative Value Method. (Income for the income year is determined by aggregating dividends received plus the change in the market value of the interest over the income year. That is, an unrealised capital gains tax.)
• Deemed Rate-of-Return Method. (The income of the taxpayer is determined by applying a deemed rate-of-return to the aggregate cost of the investment.)
• Accounting Profits Method or Earnings Per Share (EPS) Method. (Taxpayers are taxed according to the earnings per share of the company attributable to their interest.)
• Branch Equivalent Method. (This is the same method used to account for interests in CFCs under the CFC regime.)

While it initially appears that taxpayers have an unfettered choice as to what method they can apply to an FIF interest, this is not so. For example, the Branch Equivalent Method can only be applied where there is an income interest in a CFC below 10 per cent and the taxpayer has access to sufficient information for the CFC’s income to be determined using the Branch Equivalent Method. This is likely to occur only if there are other New Zealand shareholders in the CFC with income interests of 10 per cent or greater that are required to apply the Branch Equivalent Method under the CFC regime.

The Accounting Profits Method can only be used where the CFC is a publicly listed entity offshore and the accounts distributed to shareholders meet certain standards. Both the Branch Equivalent Method and the Accounting Profits Method can only be used where the interest is a company, and not to life insurance policies or superannuation schemes.

The Comparative Value Method can only be applied where it is practicable to obtain market values for an FIF. The remaining Deemed Rate-of-Return Method is available only as a last resort mainly for interests in foreign life insurance policies and foreign superannuation schemes although it could be applied to portfolio interests in companies. The problem with this method is that the deemed rate-of-return for most income years since 1992 has been set around 10 per cent, based on the long-term New Zealand Government stock rate plus 4.0 per cent. If the interest has been recently acquired, the deemed rate is likely to be penal while if the interest has been held for a long period of time, the deemed rate could be concessional.

The four options available for accounting for interests in FIFs have attracted much controversy, especially when compared to how domestic equity investments and

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9 Section CG 17(1) ITA94.
10 Section CG 17(5) ITA94.
11 Section CG 17(6) ITA94.
12 Section CG 17(4) ITA94.
13 Section CG 17(3) ITA94.
14 It should be noted that the New Zealand Government has recently released a discussion document titled Taxation of Non-Controlled Offshore Investment in Equity: An Officials’ Issues Paper on Suggested Legislative Amendments, Policy Advice Division of the Inland Revenue Department/New Zealand Treasury, Wellington (December 2003) [hereafter Issues Paper]. It is proposed to tax all offshore portfolio equity interests held by New Zealand residents (including ‘grey-list’ ones) on a ‘risk-free’ rate of return basis—being approximately 4.0 per cent pa. Unlike the Deemed Rate-of-Return method in the current FIF rules, it would be applied to the market value of the investment rather than its aggregate cost.
interests in ‘grey-list’ companies are taxed. As New Zealand does not have a comprehensive capital gains tax, many gains derived from the sale of interests in New Zealand and ‘grey-list’ companies may not necessarily be subject to tax at all.  

The FIF rules have given rise to distortions in investment patterns, as the difference in the way interests in ‘grey-list’ and ‘non grey-list’ companies are taxed is significant. The FIF rules have encouraged New Zealand investors to invest in ‘non grey-list countries’ through managed funds located in ‘grey-list’ countries (some of whom have significantly concessional tax rules for some types of managed funds), placing New Zealand managed funds at a disadvantage.

B The Implications of the New Zealand Tax Regime for Migrants

While New Zealand tax rates on individual incomes are not low, they are more moderate than the effective rates prevailing in many Western European countries. New Zealand does not tax capital gains on a comprehensive basis (as is done in Australia), which may be attractive to potential migrants with investments. No estate duty is imposed in New Zealand either. Apart from the top marginal tax rate of 39 per cent applying from NZ$60 000 (US$40 000 approx), New Zealand’s tax regime would not necessarily be a huge deterrent for most migrants from OECD countries locating to this country.

Where problems arise, however, is with the CFC and FIF rules. Any interests migrants have in foreign companies will be subject to the CFC regime unless it is located in a ‘grey-list’ country. Many prospective migrants are likely to have interests in foreign superannuation schemes and foreign life insurance policies that will potentially be caught under the FIF rules. This is especially so given that such investments are sometimes mandatory and/or subject to tax incentives (or preferences) in other countries.

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15 In the case of interests in ‘grey-list’ and New Zealand companies, whether or not gains upon sale are taxable depends upon whether the transaction falls within the scope of s CD 4 ITA94.
16 Above n 14. Furthermore, under the proposals in the Issues Paper, the ‘grey-list’ distinction will be removed and all portfolio interests in foreign companies will be taxed on the same basis.
17 To some extent these more moderate rates are tempered by: the absence of any tax-free threshold for individuals, minimal deductions available for individual taxpayers, and a comprehensive, single-rate GST without any substantial exemptions.
18 In this respect it is also important to note that New Zealand has a superannuation policy (and tax regime) that is not consistent with those found in most other OECD countries. It is not mandatory for New Zealand employees to contribute to a private superannuation scheme nor is there any requirement for New Zealand employers to offer a superannuation scheme to employees. The taxation of superannuation schemes and employers’ contributions to such schemes are not subject to any preferential tax treatment in New Zealand although consideration is being given to changes in this area. Refer to A Future for Work-Based Savings in New Zealand—Final Report of the Savings Product Working Group, Wellington, August 2004.
III PROPOSED EXEMPTION

A Background

As part of an agreement signed in 1999 between the Labour and Alliance Parties to form a coalition government, it was agreed that an inquiry would be held into the New Zealand tax regime. Prior to the 1999 election the Alliance Party alleged there were major deficiencies in the New Zealand tax regime that were resulting in major inequities, although no evidence nor details of any kind were given to support this assertion.

The Labour Party (having been responsible for a large part of the reforms to New Zealand’s tax regime in the 1980s) did not hold the same view and the agreement to convene an inquiry into the tax system was a compromise between the two parties. In 2000 a committee of review (known as the ‘McLeod Committee’) was convened with terms of reference to ‘review the tax system and advise the government of an appropriate framework for policy’.19 The McLeod Committee delivered Tax Review 2001: Final Report (Final Report) in October 2001.20 The McLeod Committee was of the view that ‘radical restructuring is not required’ and that the ‘broad architecture of the tax system is sound’.21

The Final Report contained numerous recommendations for minor changes, a number of which were dismissed by the government.22 One of the McLeod Committee’s other recommendations was:

An individual with no previous connection to New Zealand who becomes a resident of New Zealand for tax purposes should only be taxed on their New Zealand-sourced income for the first seven years after they first become resident.23

In respect of this recommendation the government requested officials in the Inland Revenue Department (IRD) and Treasury to undertake further work on this matter. As a consequence of this work, a discussion document titled Reducing Barriers to International Recruitment to New Zealand: A Government Discussion Document24 (Discussion Document) was released for public consultation in November 2003.

20 Ibid.
21 Ibid, Overview i.
22 A recommendation to tax owner-occupied homes was rejected very quickly due to the likely adverse public reaction. Also rejected was a recommendation to reduce the top individual tax rate and the company tax rate so that they were aligned, and to reduce/eliminate excise taxes with a rise in GST to compensate. Another recommendation to tax NZ companies at a reduced tax rate of 15 per cent if they were non-resident owned was subsequently rejected after a report from officials.
23 Above n 18, Overview xi.
24 Policy Advice Division of the Inland Revenue Department, Wellington, Reducing Barriers to International Recruitment to New Zealand: A Government Discussion Document (November 2003). (Referred to in this paper as the Discussion Document.)
The concept of providing certain new residents with some temporary relief from New Zealand’s international tax rules is couched in terms of the impact of those rules on the ability of New Zealand employers to hire skilled employees from outside New Zealand. It is argued that New Zealand businesses may have to offer higher salaries to potential employees from overseas to compensate them for the effects of New Zealand’s comprehensive international tax rules25 or that highly skilled persons may be dissuaded from working in New Zealand because of New Zealand’s international tax rules. The main benefit of ‘the proposed exemption would be to make it cheaper for New Zealand businesses to recruit and retain skilled employees’.26 Because of this objective, the government does not propose to offer a similar exemption to wealthy migrants bringing capital to New Zealand nor to entrepreneurial migrants.27

The decision to offer relief against New Zealand’s international tax rules to certain new migrants is briefly discussed in terms of general tax policy such as the need to balance the costs of taxation against the need for tax revenue. The Discussion Document mentions the need of other taxpayers for a perceived fairness in the exemption, which may explain the somewhat tortuous logic to attempt to justify the proposal in terms of existing tax policy settings.

C Proposals in the Discussion Document

The Discussion Document contains a proposal to exempt certain persons, who are recruited to work in New Zealand, from some of New Zealand’s international tax rules. The exemption would be offered to persons who have not been resident in New Zealand for tax purposes for 10 years prior to becoming resident. It would be available to both New Zealand and foreign citizens. The Discussion Document does not make it clear whether the 10-year period of non-residency must be determined from a certain age or whether a period of non-residence as a minor will be taken into account when determining eligibility for the exemption.

As well as meeting the above non-residence test for a 10-year period, the persons would also have to meet a ‘work test’. This work test would be met if the person earned a certain amount of income from employment in New Zealand or worked full-time in employment in any income year the exemption was claimed. Income earned from a non-family partnership in capacity of a partner would be treated as employment income to enable such partners to qualify for the exemption. If the work test was satisfied by one household member, the resulting exemption would apply to the whole household although the remaining spouse would still have to meet the requirement of not being resident for the previous 10 years. If only one spouse meets the 10-year non-residency test the benefits of the exemption would be limited to that spouse only. That

25 Ibid, para 2.3.
26 Ibid, para 1.10.
27 In order for the exemption to have an anti-avoidance provision, it is proposed that migrants who are employed by a company in which they have a substantial interest will be ineligible for the exemption.
same spouse would also have to meet the work test.\textsuperscript{28} It is proposed that the exemption would be available to a person only once in their lifetime.

The proposal in the Discussion Document is not final in relation to two key elements—the extent of the exemption and the period of the proposed exemption. The Discussion Document instead contains several options for these two key parts, on which the government is seeking feedback.

IV SCOPE OF THE PROPOSED EXEMPTION

From the government’s perspective the ideal exemption should cover only those taxes that are passed on to New Zealand employers of foreign staff who have sensitivity to New Zealand taxes. The proposed exemption would ideally be set to avoid adverse side effects such as the creation of incentives to invest outside New Zealand; making foreign recruits cheaper to employ than equivalent New Zealand residents; and undermining the perceived equity of the New Zealand tax system in the eyes of resident taxpayers.\textsuperscript{29}

Whatever the scope of the proposed exclusion will be, it would not apply to any foreign-sourced income arising from the taxpayer’s own services. This is to prevent diversion of employment income derived from services provided in New Zealand to offshore entities. It would also not apply to any income derived from the taxpayer’s own services where those services were provided offshore.

With respect to the scope of the exemption, two possible options are outlined in the Discussion Document. They are termed a ‘broad’ option and a ‘narrow’ option.

A The ‘Broad’ Option

Under this option, all eligible persons’ foreign-sourced income would be exempt from New Zealand tax. This would include: investments caught within the CFC and FIF rules, any income from other offshore investments (whether equity or debt), rental income derived from any property situated outside New Zealand, and any obligations to deduct Non-Resident Withholding Tax (NRWT), or Approved Issuer Levy (AIL)\textsuperscript{30} from interest paid to a non-resident lender.

In its favour, the government believes the broad option is more likely to reduce the tax-related costs to New Zealand employers. It would send a strong signal to New Zealand employers and potential foreign recruits and would be easier to understand and comply with. The broad option, however, is likely to create incentives to invest offshore rather than in New Zealand, and potentially into tax havens.\textsuperscript{31} The broader the exemption, the

\textsuperscript{28} Above n 23, paras 7.22–7.23.
\textsuperscript{29} Above n 23, para 3.2.
\textsuperscript{30} The Approved Issuer Levy (AIL) is a 2 per cent stamp duty imposed upon interest paid by New Zealand residents to non-associated, non-resident lenders. Interest payments subject to this AIL are effectively exempt from Non-Resident Withholding Tax (NRWT).
\textsuperscript{31} The incentives to invest in a tax haven for portfolio investment may be overstated. Many countries (other than tax havens) pay interest to arm’s length non-residents without any withholding taxes so tax
more likely the proposed exemption will be perceived as ‘unfair’ by other taxpayers, thus possibly undermining the voluntary compliance that underpins New Zealand’s tax administration. Such perceived ‘unfairness’ could also be politically controversial and may risk a public backlash.

B The ‘Narrow’ Option

Under this option the exemption would be centred on the part of New Zealand’s international tax rules that ‘are more comprehensive than the international norm’ such as New Zealand CFC and FIF rules. In addition, the person would be exempt from NRWT (or AIL) and certain share options and trust income.

A narrow option would reduce perceptions that the proposed exemption is ‘unfair’ by other New Zealand taxpayers especially since most New Zealanders’ understanding of the CFC and FIF rules is very poor. Incentives to invest offshore rather than New Zealand would be reduced because new employees would still be taxed on their foreign-source income under existing rules (apart from the CFC and FIF rules), but there would be increased incentives to invest in CFCs and FIFs over other types of investments (both foreign and New Zealand-based). The effects on the incentive to invest offshore under the ‘broad’ and ‘narrow’ options may therefore be similar.

One potential way of dealing with the incentive effects of the broad option would be to limit the exemption to sources of foreign income held at the time the person first settled in New Zealand. This, however, could be costly to administer and to comply with and, for that reason, the government does not propose to distinguish between pre- and post-migration assets except for financial arrangements.

V LENGTH OF THE EXEMPTION

Another key matter in which the government is uncertain is the length of the proposed exemption and again it seeks input from interested parties. In an early part of the Discussion Document the length of the exemption is discussed in terms of the estimated fiscal cost. It is estimated that the broad option, if offered to migrants for three years, would have a similar fiscal cost to the narrow option if it were offered for a seven-year period.

In a later part of the Discussion Document, the length of the exemption is couched in terms that a person’s sensitivity to New Zealand tax is likely to become less the longer they are resident in New Zealand. With respect to a seven-year exemption, it was felt that a shorter time period could be desirable because if a person has been resident in havens do not necessarily have an advantage in that area. With respect to portfolio equity investment, investments made in funds located in tax havens are likely to be ultimately invested in countries that are not tax havens.

\[32\] Above n 23, para 3.4. An interesting admission that New Zealand’s international tax rules are in effect not comparable to international tax norms found elsewhere.

\[33\] Ibid, para 5.8.

\[34\] Ibid, para 4.39.

\[35\] Ibid, para 3.18.
New Zealand for 6–7 years, their sensitivity to New Zealand tax will be considerably less than when they first arrived. Although not mentioned in the Discussion Document, the length of similar exemptions offered in other countries should be considered carefully as New Zealand is likely to be competing for the same type of migrant. The period of the exemption must also be related to the period of non-residency necessary to obtain the exemption.  

VI ELIGIBILITY

It is proposed that both foreign and New Zealand citizens will be eligible for the exemption, the key criteria being that the person was a non-resident for New Zealand tax purposes for 10 years immediately prior to seeking the exemption. It is intended that the period of non-residency to qualify for the exemption be substantially longer than the period of the exemption in order to prevent creating tax incentives for New Zealanders to leave in order to gain a tax advantage when they return. In addition, the government does not want to create incentives for New Zealand employers to hire foreigners over New Zealand citizens. In extending the proposed exemption to both foreigners and New Zealand citizens, it must be noted that a significant number of current New Zealand residents are not New Zealand citizens (around 25 per cent) and a significant number also hold dual nationality (believed to be around 20 per cent).

VII EMPLOYER-PROVIDED SHARE OPTIONS, FINANCIAL ARRANGEMENTS AND TRUSTS

A Employment Related Share Options

In many countries skilled and high-level employees are partly remunerated in the form of share options. It is not a common form of remuneration in New Zealand (apart from business executives), which may be due to the way in which share options are taxed in New Zealand.

The New Zealand rules for taxing employment-related share options are contained in s CH 2 of ITA94. As in most countries the amount of income to be taxed from the exercise of employment-related share options is the difference between the exercise price and the market price of the shares at the time when the option is exercised. In New Zealand income arising from such options does not attract any concessional tax treatment, nor is any distinction made between whether or not the taxpayer was a New Zealand resident at the time the options were acquired. In this respect New Zealand taxes options differently from other countries where the options granted prior to becoming resident are not taxed nor are subject to apportionment in respect of the prior period of non-residence.

36 Refer to the next section of the paper.
37 Section CH 2 only applies to share options obtained through employment, and not to share options acquired in the capacity of a shareholder or some other non-employment relationship; refer CIR v Hannigan; CIR v Levet (1980) 4 NZTC 61,573.
As a consequence migrants to New Zealand who bring unexercised employment-related share options are likely to find the share options taxable in the country where they acquired them as well as in New Zealand. This may render New Zealand an unattractive place to migrate to, especially if the exercise of the options will produce a major gain. It is likely to discourage highly skilled migrants of a type that New Zealand seeks to attract.

The Discussion Document proposes that this issue be dealt with by expanding the scope of the exemption to include gains derived from the exercise of share options acquired by persons prior to becoming resident in New Zealand. There is a risk that the gains from the share options may end up being not taxed in any jurisdiction, possibly creating incentives for persons to relocate to New Zealand for a short period of time. This, however, is perceived to be much less of a risk to the New Zealand revenue, given that prospective migrants can decide when their options are exercised and, in the absence of such an exemption, for share options there is no certainty New Zealand would be able to tax their gains on their share options anyway.

B Financial Arrangements

In New Zealand financial arrangements (being debt and similar types of securities) are comprehensively taxed under the accrual rules in Subpart EH of the ITA94. Under the rules:

1. Persons gaining New Zealand tax residency are deemed to have acquired any financial arrangements at the market value on that date and are deemed to have disposed of those arrangements on the day they cease to be resident in New Zealand; and

2. Persons with financial arrangements denominated in foreign currencies are required to account for foreign exchange variations arising from those arrangements on an unrealised basis annually.38

Many countries do not tax financial arrangements as comprehensively as New Zealand does. The accrual rules are likely to be of particular concern to migrants who have large deposits or owe money denominated in a foreign currency (for example, a house mortgage over offshore property).

Since under New Zealand law foreign exchange variations on financial arrangements are deemed to be New Zealand-sourced, an exemption for foreign-sourced income would not be adequate to deal with this problem. To isolate new migrants from adverse effects of the accrual rules, it will be necessary to either exempt New Zealand-sourced income arising from financial arrangements if that arrangement was a loan made to the person before they became resident, or to give an exemption from the accrual rules as a whole in respect of arrangements acquired before becoming resident in New Zealand.

Surprisingly, the Discussion Document does not make mention of existing exemptions in the accrual rules for migrants in s EH 46(1) of the ITA94. This section removes the

38 Unless they are a ‘cash basis person’ where foreign exchange variations arising from a financial arrangement are taxed on a realised basis.
requirement for ‘cash basis persons’ from undertaking a ‘base price adjustment’ in respect of financial arrangements they held before becoming resident in New Zealand for up to four years after becoming resident in New Zealand. This existing exemption is more limited, however, than that being proposed in the Discussion Document.

C Trusts

New Zealand taxes trusts according to whether or not the settlor of the trust is a New Zealand resident. The trust tax regime is likely to create extra costs for persons with trusts settled while they were non-residents especially former residents returning to New Zealand. One option being considered is to include trusts within the proposed exemption.

VIII ANALYSIS

The first point to note from the Discussion Document is that the New Zealand Government has identified that the recruitment and retention of highly skilled labour is important to promote economic growth in New Zealand. New Zealand must compete for such labour in a global market and the government has finally recognised that a competitive tax regime will contribute to the country’s ability to attract such talent. It is also finally a recognition, after over a decade, that certain aspects of New Zealand’s international tax regime (that is, the CFC and FIF rules) are very tough, not consistent with international norms and could be harming New Zealand’s wider interests.

The need to offer new migrants tax concessions may instead be a ‘bandaid solution’ to more fundamental problems in New Zealand’s tax regime that render it uncompetitive by international standards. Apart from the very broad CFC and FIF regimes, the high average and marginal tax rates applying to individual taxpayers are particularly unattractive to new migrants. Despite a large budget surplus, the government is opposed on political grounds to reducing individual and corporate tax rates. Reform of the CFC and FIF regimes is particularly difficult unless government is strongly of the view that changes are necessary given a well organised resistance from certain public officials to more balanced CFC and FIF rules.

Ironically, one of the benefactors of the proposed exemption may be the New Zealand Government as an employer. The New Zealand Government is a major employer in

39 Defined in s EH 27 of the ITA94 as a natural person whose total value of financial arrangements on every day in a given income year is below NZ$1.0 million.
40 A ‘mop-up’ calculation required when a financial arrangement is sold, matures, disposed of or remitted as defined in s EH 47.
42 This issued was raised in A M C Smith, ‘New FIF and CFC Regime Introduced in New Zealand’ (1993) InterTax 371–379.
43 The top individual marginal tax rate is 39 per cent which applies above NZ$60 000 (US$40 000 approx).
the education and health sectors and both sectors continue to face severe shortages of skilled personnel. The ability of New Zealand to attract skilled migrants to work in these sectors will be improved if New Zealand is able to increase the after-tax incomes of new migrants working in New Zealand.44

The proposed exemption contains risks, only some of which are identified in the Discussion Document. There is uncertainty as to how other New Zealand taxpayers may react if it is widely known that some migrants are eligible for tax concessions even though the concessions may be limited to the CFC and FIF regimes. The government has expressed concerns that if other taxpayers perceive the exemption as inequitable the exemption may undermine the voluntary compliance that underpins the whole New Zealand income tax regime.45 Whether the proposed exemption will give rise to artificial distortions in investment decisions and labour markets is also uncertain and is likely to depend upon how many migrants are able to benefit from the proposed exemption. This problem is likely to be greater if a large number of migrants have large offshore investments while it could be minor if prospective migrants have only FIF interests, such as superannuation and life insurance policies. It is in this latter area that New Zealand’s tax rules are likely to create the greatest problems for migrants, and it may, perhaps, be more important to offer an extensive exemption in this area.

One risk the New Zealand Government has identified is the risk to tax revenue if entrepreneurs and migrants with extensive capital were eligible for the proposed exemption. As the proposed exemption is designed to reduce the overall costs of hiring skilled migrants to New Zealand businesses, the exemption is to be limited to employees. While this argument is correct, it ignores the wider issue of whether other aspects of New Zealand’s tax regime are also internationally competitive. Higher than necessary tax rates on capital, for example, may raise the cost of capital in New Zealand with an according reduction in investment in New Zealand. The argument about reducing taxes to reduce the cost of doing business in New Zealand (that is, hiring skilled employees) can also be applied to reducing taxes to reduce the cost of equity capital to New Zealand businesses.

One issue not considered in the Discussion Document is the effects upon trans-Tasman migration. As Australian citizens and permanent residents have full rights of residency in New Zealand, it would be easy for wealthy Australian citizens to relocate to New Zealand for the proposed exemption. As Australia has decided not to proceed with a similar exemption for new migrants,46 there is less risk of a ‘merry-go-round’ of skilled labour moving between the two countries driven by tax considerations.

The proposed exemption is modest by international standards and whether it is sufficient to attract more high-skilled migrants is questionable. It is, at least, a move in the right direction. It will improve New Zealand’s competitiveness vis-à-vis Australia in attracting migrants given that Australia has a higher marginal individual tax rate (48

44 Skilled staff in the public sector also bore the brunt of the increase in the top individual marginal tax rate from 33–39 per cent in 2000 as they have been unable to be compensated by their employers for the higher tax rate.
45 Above n 23, paras 3.9–10.
per cent) and does not offer (and is not likely to offer) similar concessions for migrants.\textsuperscript{47} It is probably too modest to improve New Zealand’s competitiveness sufficiently vis-a-vis Hong Kong, Singapore and the UK, being countries identified as competitors in the Discussion Document for skilled migrants.

The Discussion Document does not contain a comprehensive analysis of what concessions other countries offer skilled migrants (and expatriates).\textsuperscript{48} While Finland and Belgium warranted a brief mention, the more generous concessions offered elsewhere in Europe were not. As an example, the Netherlands offer foreign experts a 5-year exemption from Dutch tax on any foreign-sourced income along with 30 per cent of income derived from Dutch employment. The 5-year period can be extended for a maximum of 10 years. Similar regimes exist in Belgium and Luxembourg. While New Zealand’s proposed exemption is modest in comparison, it could be differentiated on grounds that New Zealand wants to attract skilled migrants to settle permanently. European countries, on the other hand, aim to make their countries attractive places for multinational enterprises to set up facilities, and concessional tax arrangements for inter-company transferees are necessary to meet that wider objective.\textsuperscript{49}

IX CONCLUSION

The proposed temporary exemption for new migrants to New Zealand is final recognition that aspects of New Zealand’s tax regime are uncompetitive and ultimately undermining New Zealand’s economic development. While the proposal is modest, the government is, at least, due credit for finally putting New Zealand’s wider economic interests ahead of tax considerations. The proposals will be a useful step towards enhancing New Zealand’s attractiveness as a destination for new migrants.

The proposals mask the more fundamental issue that New Zealand needs a more competitive individual and corporate tax regime. This would require a revision of the CFC and particularly the FIF rules along with revised tax scales, especially the 39 per cent individual top marginal tax rate.

\textsuperscript{47} Ibid. Note that Australia has a tax-free threshold for the first A$6000 of income for residents and a lower rate of GST (with some exemptions).

\textsuperscript{48} The European concessions are usually aimed at expatriates rather than new migrants. The difference is that expatriates are usually inter-company transferees of large multinational companies who may be posted to a foreign country for a limited period of time as opposed to migrants who move to have permanent residency in a new country. In practice the difference is not that significant—both are aimed at newly resident skilled individuals.

\textsuperscript{49} The Netherlands also offers their tax concession to ‘foreign experts’ being individuals with particular skills that cannot be found within the Netherlands. The objective is to strengthen the competitiveness of Dutch businesses, one very similar to the objective of New Zealand’s proposed exemption.