

# Taxing Offshore Investment Income

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## 2 David White:<sup>1</sup> Definition of Foreign Investment Funds and Taxpayers' Interests, Boundary Issues and Losses

### 2.1 Introduction

This chapter considers two jurisdictional questions: what interests are typically taxed under foreign investment fund regimes and how are boundaries usually drawn around these regimes? Because foreign investment fund regimes are often designed to support controlled foreign company rules that portfolio investors can easily circumvent and that direct investors can sometimes avoid, the coverage of foreign investment fund regimes can be wide. The broader a tax regime is, the greater the chance that it will overlap with other tax regimes and the more important the drawing of regime boundaries becomes. And, ironically, the broader a tax regime is, the more important the treatment of losses becomes, particularly when artificial losses can be generated offshore in secretive tax jurisdictions.

This chapter deals with the following issues:

- What kinds of foreign entities are considered to be foreign investment funds for tax purposes?
- What interests in a foreign investment fund require a taxpayer to calculate income in relation to that foreign entity under the foreign investment fund rules?
- Where are boundaries drawn between foreign investment fund regimes and:
  - controlled foreign company regimes;
  - settlor or grantor trust regimes; and,
  - other income tax regimes?
- To what extent are foreign investment fund losses quarantined?

### 2.2 Policy issues

The policy problem for residence-taxing countries exists because their residents can often obtain a tax benefit from offshore investment structures that they do not control. The underlying income arising from the investment is not subject to current domestic tax at home. The income is also more lightly taxed than investment through comparable structures at home. Buy shares in a *domestic* company that owns apartments offshore in its name and the rent will be taxed in the residence country as it is earned (by the domestic company). Buy shares in a *foreign* company that owns

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apartments offshore, and, in the absence of special rules, the rent will not be taxed in the residence country as it is earned (by the foreign company).

Worse still for a residence country, the real investment may be “local”, not “foreign”, as well as being virtually tax-free. An officials’ issues paper published in New Zealand in 2003 gave an example of an investment in New Zealand government bonds made through certain Australian unit trusts that claims to remove most tax on the bond income when the same investment made through a New Zealand vehicle would be subject to comprehensive New Zealand income tax as it was earned.<sup>2</sup>

### **2.3 Terminology**

Considering the large number of legal vehicles that residents in different countries can use to ensure that the underlying income is not subject to current domestic tax in their country of residence, it is necessary to settle on common terminology to refer to them all. National rules and guides sometimes use the term “entities”, with the implication that the general law treats the investor and the investment structure as separate legal persons and, in the absence of special rules, that tax law does so too. Often that will be the case, for instance with the distinction that most countries draw between companies and their shareholders, so that foreign companies owned by domestic shareholders will not be treated as a conduit for domestic tax purposes.

In other instances, however, the investment structure may not be a separate legal entity. The resident may simply invest in a life insurance policy issued by a foreign insurer, which is both free from domestic life insurance tax rules and lightly taxed offshore, and thereby gain a tax advantage. Although it is not strictly correct to use the word “entity” to describe all means by which residents may ensure that the underlying income from an investment is not subject to current domestic tax, this chapter will adopt common practice and use “entity”, interchangeably with “vehicle” and “structure”, to do so.

### **2.4 Defining foreign investment funds**

Foreign investment fund regimes come in different shapes and sizes. Many regimes modestly attempt to stop residents avoiding tax on investment made through foreign entities, particularly in tax havens. For countries that exempt much domestic saving from domestic income tax, the types of entity and investment vehicle that need to be caught by these rules may be more limited.

A few regimes, however, ambitiously attempt to prevent residents from deferring current tax at home on investment made through foreign entities. For countries with a relatively comprehensive income tax, especially in relation to savings, many entities offer a tax advantage over investment in local entities, in the absence of special rules. They include interests in entities in the foreign company grouping that are not caught by the controlled foreign company rules, as well as investment in foreign life insurance and superannuation.

Whether a foreign investment fund regime has a narrow or a broad tax policy objective, it should apply to all foreign entities that offer tax advantages and that are close investment substitutes for domestic investment. Alternatively, it may be accompanied by other regimes that, together with the foreign investment fund regime, extend to all close investment substitutes for domestic investment. If it does not, the

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<sup>2</sup> Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury, *Taxation of Non-Controlled Offshore Investment in Equity: An Officials’ Issues Paper on Suggested Legislative Amendments* (Policy Advice Division of the Inland Revenue Department, Wellington, 2003), 1-2 and 14-15.

main effect of the regime will be to encourage residents to switch their foreign investment from “residence-taxed” foreign entities to “non-residence-taxed” foreign entities. Residents would have incurred additional transaction costs to remain untaxed by their country of residence. The country of residence would not have protected its revenue base or have collected much additional revenue.

## **2.5 Investment vehicles**

The target for most (narrow) foreign investment fund regimes is passive savings or investment by investors who do not control the entity or investment. There are many types of vehicle that can be used by investors to house their passive savings or investment offshore, including:

- companies;
- trusts;
- unit trusts;
- life insurance policies;
- superannuation policies and schemes; and,
- foreign hybrid vehicles such as Liechtenstein anstalts, which are part trust and part company, and limited partnerships, which are part company and part partnership.

Another problem is that low-tax countries that seek to attract foreign portfolio investment have a huge incentive to develop new legal vehicles that are not caught by the foreign investment fund regimes of the major country providers of portfolio investment. Residence countries need a robust set of entity rules to ensure that they can tax their residents’ foreign portfolio investment that is more lightly taxed than investment through comparable structures at home.

The problem is a complex one that many residence-taxing countries struggle with and that none have satisfactorily resolved.<sup>3</sup> How does a national tax system define for its residents the investments in foreign entities that are subject to its tax laws? In around 190 countries that currently exist in the world, there are many tens of foreign entities with exotic foreign names, many of which combine some rights, obligations, or liabilities associated with different theoretical-entity types. Even mainstream entities in many countries do not always conform to the pure theoretical-entity type. In some national laws, for example, the separate legal personality of a company is not always respected. The hard issues, however, lie in the murky middle where hybrid entities have been developed that combine essential characteristics of several theoretical-entity types.

## **2.6 Four approaches**

Residence-taxing countries, in general, use four approaches to define the domestic tax status of foreign entities so that their residents may know what foreign portfolio investment is taxable at home. It is possible for a country to use a combination of these four approaches and, as will be discussed below, some countries, like Australia, New Zealand and the United States, do so. First, legislation or administrative rules may specify how a particular foreign entity in a particular country will be categorised for domestic tax purposes. Secondly, resident taxpayers may be required to categorise

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<sup>3</sup> See the analysis and conclusions drawn by the general reporter, Kees van Raad, from the national reports on this topic in, International Fiscal Association, “Recognition of Foreign Enterprises As Taxable Entities”, *Cahiers de Droit Fiscal International*, vol LXXIIIa (Deventer: Kluwer, 1988), 19-66, especially at 29-30 and 56-59.

the foreign-entity investment vehicle into local-entity types using a national definition or list of entity characteristics (a form or substance approach, in other words). Thirdly, resident taxpayers may be able to elect how their investment in a foreign entity is to be treated for domestic tax purposes. Fourthly, some investment by resident taxpayers in *all* types of foreign entities or structures may be taxed by the foreign investment fund regime.

The following sections of this chapter elaborate and give examples of these four broad approaches. They also explain how foreign investment fund rules work with each approach. Finally, they evaluate the costs and benefits of each approach.

## **2.7 Foreign entity classification by listing**

The listing approach may be implemented two ways. First, particular foreign entities in particular countries may be listed as foreign investment funds. An example of a foreign investment fund listing mechanism is provided in the New Zealand income tax legislation.<sup>4</sup> Interestingly, the mechanism has not been used to date.

The second way the listing approach may be implemented is for named foreign entities in particular countries to be classified into local entity types. Foreign investment fund rules, or associated rules, may apply to foreign entities in local entity-type groupings that cause a tax policy problem for a national tax system. In other words, there are two steps. National legislation, for example, first specifies that a particular foreign entity from a particular country is classified as a “company” and, secondly, defines a “foreign investment fund” to include a foreign “company”.

## **2.8 Measures to simplify compliance**

An example of foreign entity listing is provided in the United States “check-the-box” regulations.<sup>5</sup> These regulations include a limited list of foreign entities that are automatically classified as “corporations” for United States federal tax purposes.<sup>6</sup> The organisations listed are limited liability entities such as the public limited company in Australia and the United Kingdom, the aktiengesellschaft in Austria, Germany and Switzerland and the sociedad anomina in Brazil, Spain and Mexico. That is step one. The second step is to state that a particular tax regime applies to a foreign “corporation”. The United States passive foreign investment company regime, for example, applies to foreign “corporations” that satisfy either a passive income or a passive asset test for the income year.<sup>7</sup>

Some countries provide resident taxpayers with useful guidance on the difficult question of categorising and reporting foreign investment fund income from foreign hybrid entities. In Australia, some retail investors with relatively small holdings in some foreign hybrids, such as United States limited liability companies, may make an irrevocable election for partnership tax treatment rather than being subject to the Australian foreign investment fund rules.<sup>8</sup> A ministerial statement indicates that this

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<sup>4</sup> The definition of ‘foreign investment fund’ provides that the term includes an entity described in one of the schedules to the Act. Income Tax Act 2004 s EX 29, NZ.

<sup>5</sup> See chapter 2.15, “Foreign entity classification by election.”

<sup>6</sup> Reg. §301.7701-2, US.

<sup>7</sup> Internal Revenue Code § 1297, US.

<sup>8</sup> Australian income tax law specifically provides that the partnership treatment requirements are satisfied for certain limited liability companies formed in the United States of America. Income Tax Assessment Act 1997 s 830-15(2), Aust.

partnership tax election will not be available for foreign hybrid entities such as anstalts and stiftungs. The statement characterises them as “trust-like entities”.<sup>9</sup>

## 2.9 Policy considerations in listing approaches

Legislative naming of entities greatly reduces the compliance costs for taxpayers and their advisers. All they have to do is to check the legislation to see whether a particular entity in a particular country is a foreign investment fund or how the particular foreign entity or vehicle that they have invested in is categorised for domestic tax purposes and whether the foreign investment fund rules apply to that entity type.

Establishing and maintaining comprehensive lists, whether of foreign investment fund entities or of classifications of each entity or investment vehicle-type in 190 or so countries, however, imposes high administrative costs for a tax authority.<sup>10</sup> To the extent that a list is not up-to-date, or lists a foreign entity inappropriately, it imposes high economic and revenue costs as well. Undoubtedly, these potential drawbacks explain why legislative lists that classify foreign entities into “foreign investment funds” or local-entity types do not purport to be comprehensive but merely prescribe how some listed foreign entities will be treated for domestic tax purposes.

## 2.10 Foreign entity classification by legislative criteria

Under the second approach, which is very widely used, legislation requires resident taxpayers to categorise the foreign entity into a local entity type: company, partnership, trust, unincorporated joint venture and so on. The legislative criteria may relate to the legal form used to create the foreign entity (a formal approach). Alternatively, the legislative criteria may test whether, in fact, listed characteristics of an entity form are present or absent in the foreign entity (a substantive approach). Resident taxpayers must apply that definition or characteristics test to determine how their foreign investment vehicle is characterised for domestic tax purposes.

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<sup>9</sup> “New Tax Treatment for Foreign Hybrids”, Attachment relating to the Australian Minister for Revenue & Assistant Treasurer’s media release CO26/03, 2, available at <<http://www.treasury.gov.au/documents/588/RTF/hybrid.rtf>>. For a full consideration of the issues that the anstalt poses for the Australian income tax system, see Matt Selig, “Half Trust, Half Company, All Anstalt: The History and Possible Tax Consequences of the Liechtenstein Anstalt Down Under,” (1999) 53 *Bulletin for International Fiscal Documentation* 375-397. To illustrate the divergence of views on classifying some foreign hybrid entities and how the entity classification for domestic tax law purposes can turn on several factors, including the domestic tax context in which the view is being expressed, contrast this Australian ministerial statement with the Canadian tax authorities’ view that the Anstalt is a ‘corporation’ for the purposes of the Canadian control foreign company rules, as it has separate legal personality and existence from the personality and existence of those who created or own it. See also the general view of the United Kingdom Inland Revenue, expressed in 1987, that the Liechtenstein anstalt is fiscally opaque (meaning the member generally is taxed only on the distributions made by the entity). United Kingdom Inland Revenue, “Entity Classification”, *Tax Bulletin Issue* 50 (2000), 809 at 811.

<sup>10</sup> An example of how even illustrative foreign entity lists can become dated is provided in the context of another foreign entity tax regime: the controlled foreign company regime of Canada. Interpretation Bulletin IT-343R issued by the then Canadian Department of National Revenue in September 1977 lists certain foreign entities that the Department considers are included in the term ‘corporation’ for the purposes of the Canadian controlled foreign company rules, even though the foreign entities are not joint stock companies or limited liability companies. Since 1977, many more entities have been developed in many countries, yet the list has not been expanded and updated. In relation to tax havens, for example, see generally, Walter H Diamond, Dorothy B Diamond, *Tax Havens of the World* (loose-leaf, Matthew Bender, NY).

In many countries, in line with their private international law principles, the foreign law of the country under which the entity was created would determine its legal attributes but local law would determine its characterisation as a company, partnership, trust, or other local-entity type for local tax purposes.<sup>11</sup> That is step one. The second step is to specify the entity types to which the foreign investment fund rules apply.

Take New Zealand as an example. As the first step, New Zealand resident taxpayers must apply a mix of tax and general law definitions to determine the domestic tax status of a particular foreign entity that, for instance, has some characteristics of both a company and a partnership. For New Zealand income tax purposes, a “company” is defined in the Income Tax Act as meaning, “a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere.”<sup>12</sup> As there is no relevant definition of the term “partnership” in the New Zealand Income Tax Act that applies for foreign investment fund purposes, however, it is necessary to go to general law<sup>13</sup> and to apply the definition of partnership found there to determine whether a foreign entity is a partnership for New Zealand income tax purposes.

Once a New Zealand resident taxpayer has determined the tax status of a particular foreign entity for New Zealand income tax purposes, the second step is to check whether the New Zealand foreign investment fund rules apply to that entity. Currently, New Zealand casts a wide net in defining the type of foreign entity that can be a foreign investment fund and then greatly reduces its reach by means of a much narrower definition of what constitutes an “attributing interest” in a foreign investment fund. In June 2005, a government discussion document proposed greatly expanding the reach of the New Zealand foreign investment fund regime by repealing the most significant exemption, the comparable tax system exemption.<sup>14</sup>

## 2.11 Categories of investment vehicle: the New Zealand approach

New Zealand’s wide net identifies four very broad categories of investment vehicle that constitute a foreign investment fund:

- A foreign company, including any foreign entity that is treated as a company by New Zealand tax law, such as a unit trust;
- A foreign insurer that issues life insurance policies that are not subject to New Zealand’s domestic life insurance tax rules;
- A foreign superannuation scheme constituted outside New Zealand; and,
- An entity described in the legislation (no entity is currently listed).<sup>15</sup>

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<sup>11</sup> To illustrate how the local characterisation of a foreign entity can change as the foreign rules relating to that entity change, see the short discussion of the decision in the United Kingdom case of *Dreyfus v IRC* 14 TC 560 and how subsequent changes to the French code applying to the société en nom collectif resulted in a change of view by the United Kingdom Revenue: PN Hobbs, National Reporter, United Kingdom, in International Fiscal Association, “Recognition of Foreign Enterprises As Taxable Entities”, *Cahiers de Droit Fiscal International*, vol LXXIIIa (Deventer: Kluwer, 1988), 565, at 568.

<sup>12</sup> Income Tax Act 2004 s OB 1, NZ. This definition includes eight entities that are treated as companies. For the purposes of calculating direct income interests in foreign investment funds under section EX 31, “company” includes an entity described in a schedule to the Act (see s EX 31(7)).

<sup>13</sup> The ‘general law relating to partners’ in Part I of the Partnership Act 1908 contains a definition of ‘partnership’. See Partnership Act 1908 s 4, NZ.

<sup>14</sup> The New Zealand Minister of Finance, *Taxation of Investment Income: The Treatment of Collective Investment Vehicles and Offshore Portfolio Investments in Shares* (Policy Advice Division of the Inland Revenue Department, Wellington, 2005), 55.

<sup>15</sup> See the definition of ‘foreign investment fund’ in the Income Tax Act 2004 s OB 1, NZ.

In each case, general New Zealand tax law does not treat the investment vehicle as a conduit for domestic tax purposes, which would mean that New Zealand resident investors are automatically subject to current New Zealand tax on the underlying income of the foreign investment vehicle. To achieve that objective, special rules were necessary.

## **2.12 Life assurance and superannuation**

The inclusion of life insurance policies and superannuation schemes is particularly important for a country that offers little or no tax concessions for comparable domestic investment vehicles. New Zealand is one such country. A New Zealand resident buying life insurance or superannuation from almost anyone not subject to New Zealand income tax rules will be gaining a tax advantage. In many cases, they will effectively be investing in a tax haven.

The Australian foreign investment fund measures also extend to certain foreign life assurance policies. Instead of using the one concept of “foreign investment fund”, as New Zealand does, Australia uses two concepts of “foreign investment fund” and “foreign life assurance policy”. A “foreign investment fund” is defined as any foreign company or foreign trust, and the latter two terms are further defined.<sup>16</sup> “Foreign life assurance policies” are certain policies with an investment component that are issued by an entity that was a non-resident of Australia at any time in the income year.<sup>17</sup>

## **2.13 In substance definitions**

The long-standing United States entity classification rules that applied before 1 January 1997 are a good example of entity classification using a substance, or “facts and circumstances”, test. Under these former regulations, associations were classified as a corporation or a partnership for federal tax purposes by analysing whether six corporate characteristics were present or absent.<sup>18</sup>

This second approach does not provide the same certainty and reduced compliance costs for resident taxpayers and their advisers as the first “legislative list” approach does, especially when a resident is investing in a foreign hybrid. While it may be possible in some countries to obtain an advance ruling on entity classification, this may be expensive, time-consuming and, if the ruling is not made public, of little general use.

The second approach, however, does not impose high administrative costs for tax authorities in establishing a legislative list and then maintaining it. It is difficult to assess the likely level of economic or revenue costs resulting from either the form or substance variant of this approach. Some relatively novel hybrid entities, however, do seem to have been developed in tax havens that have taken into account the legislative rules for classifying foreign entities of major country providers of foreign investment such as the United States and some Western European countries.<sup>19</sup>

## **2.14 Foreign entity classification by election**

A third approach, classification by election, admits defeat on foreign entity classification. It allows taxpayers to choose how the foreign entity that they have

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<sup>16</sup> Income Tax Assessment Act 1936 s 481, Aust.

<sup>17</sup> Income Tax Assessment Act 1936 s 482, Aust.

<sup>18</sup> Former Reg. §301.7701-2, US, usually referred to as the Kintner regulations.

<sup>19</sup> See the types of legal entity now available in each tax haven, discussed in, Walter H. Diamond, Dorothy B. Diamond, *Tax Havens of the World* (loose-leaf, Matthew Bender, NY).

invested in will be treated for domestic tax purposes. That is step one. The second step is to specify the entity types to which the foreign investment fund rules apply.

The United States “check-the-box” regulations, for example, allow taxpayers to elect whether certain business entities that are not classified as a corporation per se (see section 2.8 above) receive corporate or partnership tax treatment. Broadly speaking, a business entity is any entity recognized for federal tax purposes that is not classified as a trust or otherwise subject to special treatment. A business entity that is not a trust or an entity classified as a corporation per se and that has two or more members may elect to be classified as either a corporation or a partnership. If such an entity has a single owner, it is classified as a corporation or is disregarded as an entity separate from its owner. To reduce compliance costs, the United States regulations contain a number of default classifications depending on the entity’s characteristics.<sup>20</sup> If an investor elects corporate tax treatment, the United States passive foreign investment company regime, which applies to foreign “corporations”, is one regime that may apply to the investment.

This third approach imposes low to moderate compliance costs for resident taxpayers and their advisers, depending on the extent to which default classifications are chosen that are likely to match the preferences of most taxpayers in a particular position. The administrative costs for tax authorities will depend on the extent to which they must keep track of taxpayer elections. Economic and revenue costs from tax planning by election may rise as taxpayers can more easily choose the foreign entity classification that helps them minimise the tax that they pay, either at home or abroad. Indeed, the United States check-the-box regulations initially provided a formidable international tax planning device for United States taxpayers, enabling them to elect to end deferral on the foreign active income of some foreign entities and not of others.<sup>21</sup> Since 1997, however, the United States has progressively adopted more measures to limit the use of foreign single member entities that, under the check-the-box regulations, were disregarded and treated as mere extensions of their owners for United States federal income tax purposes, while being respected as corporate entities for foreign tax and corporate law purposes.<sup>22</sup>

### **2.15 Foreign entity taxation by facts and circumstances**

Like the third approach, which offers taxpayers an election, the fourth approach also admits defeat on entity classification. This approach crafts a foreign investment fund rule that applies to most foreign investment in almost any type of foreign entity that itself makes investments, and then limits its target by tests, like a tax motive or little-tax-paid test, or by exemptions.

The existing Canadian foreign investment fund rules, soon to be amended, are of this type.<sup>23</sup> The rules embody an all-embracing definition of foreign entities and limit their application by mention of the facts and circumstances of the investment. Canadian resident taxpayers who hold “offshore investment fund property” and who acquired or hold the interest with a tax deferral motive among their main motives

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<sup>20</sup> Regs. §301.7701-1 to §301.7701-3, US.

<sup>21</sup> Michael Schler, "Initial Thoughts on the Proposed 'Check the Box' Regulations," (1996) *Tax Notes* 1679.

<sup>22</sup> David S Miller, “The Strange Materialization of the Tax Nothing,” (2000) 87 *Tax Notes* 685.

<sup>23</sup> Income Tax Act 1985, s 94.1, Can. It is not yet clear whether the fourth, and most recent, draft of the Canadian proposed foreign investment entity rules will be approved as drafted. David Wentzell and Michael Friedman, “New FIE Rules Address Accounting, Technical Issues” (2004) 33 *Tax Notes International* 239-40, at 240.

must include in their income each year the greater of the actual distributions from the foreign investment fund and a notional amount computed by multiplying a prescribed rate of interest by the cost of the property. “Offshore investment fund property” is defined very broadly to include shares, debt, or other interest, including rights or options to acquire such interests, in a “non-resident entity”. “Non-resident entity” is then defined extremely broadly to mean “a corporation that is not resident in Canada, a partnership, organisation, fund or entity that is not resident or is not situated in Canada” or certain foreign trusts.<sup>24</sup> To trigger the rule, the investment in the non-resident entity should derive its value, directly or indirectly, primarily from portfolio investments by the entity in shares, debt, commodities, real estate, Canadian or foreign resource properties, or foreign currencies.

## **2.16 The Canadian experience**

The 1999 Canadian federal budget proposed new measures to make the Canadian foreign investment fund and non-resident trust taxation rules more effective but amendments have still not been enacted. In the 1999 budget papers, the Canadian authorities said that they have found it difficult to enforce the existing rules because of the requirement to establish a tax motive and the lack of information.<sup>25</sup> In addition, as a senior Canadian tax practitioner has pointed out,<sup>26</sup>

in recent years, as prescribed interest rates have plummeted, the differential between the actual yield on the investment and the notional amount included each year in the investor’s income has grown to a point where investment in an offshore fund has become quite advantageous. Taxation of the excess of the actual yield over the notional amount has been deferred until the investment is redeemed, at which time it is subject to taxation as a capital gain.

This fourth approach may impose moderate to high compliance costs for resident taxpayers determining whether the facts and circumstances of their offshore investments mean that the rules apply to them. It would seem, from the Canadian experience, that the administrative costs for tax authorities are likely to be high as they seek the information necessary to enforce the rules. Economic and revenue costs arising from tax planning by high-income earners may also be high under this approach.

## **2.17 Defining attributable interests in foreign investment funds**

Clearly, national definitions of an interest in a foreign investment fund relate to the types of entity that are included in the national definition of a foreign investment fund. In particular, the way in which an attributable interest is defined, can be used to narrow the target of the regime or to keep it broad. The current New Zealand definition of an attributable interest in a foreign investment fund, for example, substantially narrows the scope of the New Zealand regime.<sup>27</sup> Indeed, most of the jurisdictional action in narrowing the net of the New Zealand foreign investment fund

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<sup>24</sup> Income Tax Act 1985, s 94.1(2)(b), Can.

<sup>25</sup> Alan Lanthier, “Foreign Investment Chill” 7(3) *Canadian Tax Highlights* 16 March 1999 (published by the Canadian Tax Foundation).

<sup>26</sup> Wolfe D Goodman, “Canadian Income Tax - Offshore Investment Funds” in Robert Milroy ed, *Standard & Poor’s Guide to Offshore Investment Funds 2000-2001 edition* (Guernsey, International Offshore Publications, 2000), 514.

<sup>27</sup> As noted above, a 2005 government discussion document proposed greatly expanding the reach of the New Zealand foreign investment fund regime by repealing the comparable tax system exemption. *Supra* note 14.

regime takes place as an “attributing interest” in a foreign investment fund is defined. The current exemptions are extensive. If an exemption applies, the interest in question is not an attributing interest in a foreign investment fund,<sup>28</sup> it does not have to be disclosed to the Commissioner,<sup>29</sup> and it does not give rise to foreign investment fund income or loss.<sup>30</sup> By contrast, the United States definition of an interest in a passive foreign investment corporation, for example, being shares in a foreign company, does not limit the target of that regime.<sup>31</sup>

## 2.18 Some national rules

The New Zealand “attributing interest” determination is a two-step exercise: first, check whether one of the positive items applies to establish the person holds rights of a certain kind in a foreign investment fund; second, check whether one of the exemptions applies. In New Zealand, residents must test whether they have an attributable interest in a foreign investment fund at any time in the year, not just at the end of their income year. For persons resident for only part of a year, the question is whether they held an attributable interest in a foreign investment fund on any day when they were resident.

Unsurprisingly, the positive list of what constitutes a prima facie attributable interest in a foreign investment fund has three main elements, each of which connects to one of the three main types of foreign entities that constitute a foreign investment fund:

- for a foreign company, it is necessary to have a “direct income interest”, with a minor exception for one calculation method;<sup>32</sup>
- for a foreign life insurance policy, it is necessary to have a right to benefit from the policy, including contingent or discretionary rights;<sup>33</sup>
- for a foreign superannuation scheme, it is necessary to have rights to benefit from the scheme as a beneficiary or member, including contingent or discretionary rights.<sup>34</sup>

The direct income interest test is the same test that is used for New Zealand’s controlled foreign company regime. For the foreign investment fund regime, it is the highest percentage of the following things that a resident holds in a foreign company at any time:

- shares;
- shareholder decision-making rights to vote or participate in decision-making about: (a) distributions, (b) the company’s constitution, (c) variations in the company’s capital, (d) the appointment or election of directors;
- the right to receive or apply any of the company’s income for its accounting period that the taxpayer would be entitled to if the income were distributed on

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<sup>28</sup> Income Tax Act 2004 s EX 30(1), NZ.

<sup>29</sup> Tax Administration Act 1994 s 61(1), NZ.

<sup>30</sup> Income Tax Act 2004 ss CQ 5(1), DN 6(1), NZ.

<sup>31</sup> Internal Revenue Code, § 1291, 1293 and 1297, US.

<sup>32</sup> The general “direct income interest” requirement is in s EX 30(2). The minor exception is in s EX 43(6) and (7). *Indirect* income interests in a foreign investment fund underlying the first foreign investment fund may be treated as attributing interests in a foreign investment fund in one circumstance only. Whenever a taxpayer elects to use the ‘New Zealand tax rule’ method for calculating foreign investment fund income or loss in a foreign investment fund, they must look through that FIF and apply the *direct* and *indirect* income interest rules from the controlled foreign company regime for any income interest in another foreign company that the first tier foreign investment fund has.

<sup>33</sup> Income Tax Act 2004 s EX 30(4) and (5), NZ.

<sup>34</sup> Income Tax Act 2004 s s EX 30(3) and (5), NZ.

the last day of the accounting period and the entitlement were the same at all other times in that period;

- the right to receive or apply any of the value of the company's net assets, if they were to be distributed.<sup>35</sup>

## **2.19 Exemptions and limitations**

There are seven important exemptions that currently exclude much New Zealand portfolio investment in foreign entities from the foreign investment fund regime.<sup>36</sup> The three most important are the controlled foreign company exemption, the comparable tax system exemption and the \$50,000 de minimis exemption. These exemptions are analysed in chapter three of this book.

The drafting of the current Canadian definition of an interest in a foreign investment fund also serves to narrow the scope of the regime.<sup>37</sup> In brief, the existing Canadian rules define an interest in a foreign investment fund as shares, debt, or other interest, including rights or options to acquire such interests, in a non-resident entity, whose value is derived primarily from portfolio investments in passive assets that were acquired or are held with a major motive of tax deferral.<sup>38</sup>

Australia, which has two key concepts of a "foreign investment fund" and a "foreign life assurance policy", must have two matching "interest" concepts. Broadly, an interest in a "foreign investment fund" is defined as a share in the company or an instrument to acquire such a share, like an option or a convertible note. For a trust, it is defined as an interest in the corpus or income of the trust (including an interest in a unit trust) or an instrument to acquire such an interest, like an option or a convertible note. Secondly, a person has an interest in a "foreign life assurance policy" if he or she has legal title to it.<sup>39</sup>

## **2.20 Boundary issues**

Most countries that seek to tax their residents on some or all of their investments made through foreign entities at the time when the foreign entity earns its income have developed more than one tax regime for the purpose. Using multiple regimes to achieve a single anti-deferral objective creates boundaries. Boundaries drawn around legal constructs, like entities, need to be thought through very carefully or they will produce confusion, or multiple taxation or no taxation at all. The following sections briefly illustrate the ways in which some countries have drawn the line between their foreign investment fund regimes and other tax regimes that apply to investments made by their residents in foreign entities.

## **2.21 Boundary with controlled foreign company regimes**

As foreign investment fund and controlled foreign company regimes often apply to residents' interests in the same type of foreign entity, they may overlap. Take the New Zealand and Australian anti-deferral regimes, for example. The New Zealand foreign investment fund and controlled foreign company regimes both apply to interests in foreign companies and foreign unit trusts. The Australian foreign

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<sup>35</sup> Income Tax Act 2004 s EX 31, NZ.

<sup>36</sup> Income Tax Act 2004 s CQ 5(1)(d), EX 32 TO EX 37, NZ. On becoming resident in New Zealand, there may also be a limited exclusion for life policy death benefits provided by section EX 39.

<sup>37</sup> See chapter 2.15, "Foreign entity taxation by facts and circumstances."

<sup>38</sup> Income Tax Act 1985, s 94.1(a), Can.

<sup>39</sup> All of these definitions are in section 483 of the Income Tax Assessment Act 1936, Aust.

investment fund and controlled foreign company regimes both apply to interests in foreign companies.

To the extent that they overlap, controlled foreign company regimes normally take priority over foreign investment fund regimes. The policy reason is simple. Whether broad or narrow in objective, both regimes seek to tax income earned by residents through foreign entities in much the same way as that income would be taxed if it were earned onshore. One regime assumes that its investors have access to the detailed accounting records of the foreign entity and can restate much of the entity's income as if it were earned onshore. The other assumes that its investors often do not have the information and so must use cruder proxy methods of calculating the entity's income. The controlled foreign company regime rules approach more closely to the policy objective and for that reason should have priority. Foreign investment fund regimes, which at times can be rough and ready, should not be used when the sharp and sophisticated rules of controlled foreign company regimes are available.

## 2.22 **Omnium gatherum followed by exemption**

The New Zealand rules drive everything in and then back a good deal out. The first rule states that *all* direct income interests in a foreign company (including a unit trust) are interests in a foreign investment fund.<sup>40</sup> It matters not whether the interest is a fraction of a per cent or one hundred per cent. The second rule states that an income interest of ten per cent or more in a controlled foreign company is exempt from the foreign investment fund regime.<sup>41</sup> The net result is that for any period when the regimes overlap in relation to a resident's interest in a foreign company the controlled foreign company regime applies and the foreign investment fund regime does not.

The Australian rules operate in the same way. The first rule states that a share, or an instrument to acquire a share, in a foreign company is an interest in a foreign investment company.<sup>42</sup> A second rule prevents double taxation by providing that where the controlled foreign company and foreign investment fund regimes overlap the foreign investment fund regime will not apply.<sup>43</sup> As a contribution to the recent review of Australian business taxation, a leading Australian expert on international taxation has argued that the current control and substantial shareholder rules in Australia do not draw this boundary appropriately. His main proposal is that the controlled foreign company rules should apply to Australian residents with substantial interests in non-resident companies or *any* interests in closely-held non-resident private companies, with the foreign investment fund rules applying in other cases.<sup>44</sup>

## 2.23 **Conceptually simpler overlap rules**

Under the current Canadian offshore investment fund property rules, a Canadian taxpayer with at least a ten per cent interest in a non-resident entity that is both a foreign investment fund and a controlled foreign company is subject to the controlled foreign company rules, not the foreign investment fund rules.<sup>45</sup> Although the

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<sup>40</sup> Income Tax Act 2004 ss EX 30(1)(a), EX 31, NZ.

<sup>41</sup> Income Tax Act 2004 ss EX 30(1)(b), EX 32, NZ.

<sup>42</sup> Income Tax Assessment Act 1936 s 483, Aust.

<sup>43</sup> Income Tax Assessment Act 1936 s 494, Aust.

<sup>44</sup> L. Burns, "The Border Between the Controlled Foreign Companies and Foreign Investment Fund Regimes", (2000) 6 *UNSWLJ Forum* 51-3.

<sup>45</sup> Income Tax Act s 94.1(1)(a), Can.

proposed changes to the Canadian foreign investment fund rules have not yet been adopted, it seems that in most cases the proposed rules will also give priority to the Canadian controlled foreign company rules.<sup>46</sup> Indeed, the most recent proposals contain an option for some taxpayers to elect irrevocably to receive controlled foreign company treatment for their interest in a foreign affiliate.<sup>47</sup>

The boundary between the United States controlled foreign company regime and the passive foreign investment company rules has continued to be a source of concern, notwithstanding that Congress enacted an overlap rule in 1997.<sup>48</sup> Before that rule, a United States shareholder's ten per cent or larger investment in a foreign company could be subject to both regimes. To reduce uncertainty and complexity, the 1997 amendment provided that in respect of such a United States shareholder the controlled foreign company was generally not treated as a passive foreign investment company.<sup>49</sup> Neither tax lawmakers nor taxpayers are happy with the overlap rule. An official report into Enron Corporation's tax practices proposed that the overlap exemption should be tied more closely to the United States shareholder's potential tax liability under the controlled foreign company regime rather than being based on a person's status as a United States shareholder with 10 per cent or more voting power.<sup>50</sup> Tax advisors argue the overlap rule does not work well for taxpayers, taxpayers such as, for example, investors with tiered passive foreign investment companies or options to acquire shares in passive foreign investment companies.<sup>51</sup>

## 2.24 Boundary with settlor or grantor trust regime

To be fully effective, anti-deferral regimes must include measures that apply to trusts, because trusts can often substitute for companies, sheltering underlying income from a resident's investments from current domestic tax at home. Settlor (or grantor) trust regimes seek to ensure that trust income derived by non-resident trustees of trusts settled by residents is taxed each year as it is earned. These regimes achieve this objective by imposing a primary or secondary obligation on resident settlors to pay the tax.

Boundary issues often arise between foreign investment fund rules and settlor or grantor trust rules. Most foreign investment fund regimes also apply to some types of trusts, even where a separate regime for taxing foreign trusts exists.

Australia has three anti-deferral regimes that currently apply to foreign trusts. The regimes are inconsistent and overlapping, although these shortcomings may be remedied in the future.<sup>52</sup> The transferor trust regime applies to family trusts, particularly of the discretionary type.<sup>53</sup> Where Australian residents have transferred

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<sup>46</sup> Proposed paragraph (a) of the definition of "exempt interest" in proposed section 94.1(1).

<sup>47</sup> Proposed paragraphs 94.1(2)(h) and (i).

<sup>48</sup> C. Bowers, R Laudeman, S Fitzgerald, J Cowan, "PFIC/CFC Overlap: Not Out of the Woods Yet", (2003) 34 *The Tax Advisor* 328-330.

<sup>49</sup> Internal Revenue Code, § 1297(e), US.

<sup>50</sup> Joint Committee on Taxation, Report of Investigation of Enron Corporation And Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, JCS-3-03, February 2003, Vol 1, 31. Report available at <[www.house.gov/jct/s-3-03-vol1.pdf](http://www.house.gov/jct/s-3-03-vol1.pdf)>.

<sup>51</sup> C. Bowers, R Laudeman, S Fitzgerald, J Cowan, "PFIC/CFC Overlap: Not Out of the Woods Yet", (2003) 34 *The Tax Advisor* 328-330.

<sup>52</sup> This analysis draws on the commentary by Robert Deutsch, Richard Krever, Ann O'Connell, John Raneri, "Australia" in International Bureau of Fiscal Documentation, *Investment Funds: International Guide to the Taxation and Regulation of Mutual Investment Funds and Their Investors* (loose leaf: Suppl. No 7 June 2002) 73-77.

<sup>53</sup> Income Tax Assessment Act 1936 Part III of Division 6AAA, Aust.

value to a non-resident trust, this regime attributes trust income to them. Most investment trusts, even if they are closely held, are exempted from this regime. The second trust regime, which, in part, is aimed at collective investment funds, is the foreign investment fund regime itself. The regime applies to all foreign trusts other than to some deceased estates and bare trusts.<sup>54</sup> The third anti-deferral regime applies to all investments in all foreign investment funds and claws back all of the exemptions available under the foreign investment fund rules.<sup>55</sup>

The New Zealand rules draw the boundary between trusts that are collective investment funds (called “unit trusts”<sup>56</sup>) and other trusts. Interests in unit trusts are taxed in the same way as interests in companies and are either subject to the foreign investment fund rules or the controlled foreign company regime.<sup>57</sup> Interests in other trusts are governed by the settlor regime.<sup>58</sup>

## **2.25 Boundary rules in North America**

The United States rules draw the boundary between trusts that it classifies as “business entities” and other trusts. In general, arrangements are treated as trusts if their purpose is to vest in trustees responsibility for the protection of property for beneficiaries who cannot share in discharging this responsibility and, thus, are not associates in a joint enterprise for the conduct of business for profit.<sup>59</sup> There are also special rules for “investment” trusts. Whether they are classified as business entities or trusts turns, in part, on whether there is a power under the trust agreement to vary the investment of the certificate holders.<sup>60</sup> The controlled foreign company and passive foreign investment company rules, for instance, apply to business entities that are classified as foreign “corporations”. If the foreign entity is classified as a trust, it will be subject to the anti-deferral rules applicable to foreign trusts.

## **2.26 Boundaries with other tax regimes**

Some national rules draw an explicit boundary between foreign investment fund regimes and other taxing regimes. The boundary may be a rule that one regime has priority over another or a rule that allows taxpayers to elect which regime applies. In Australia, for example, non-passive investors who hold interests in a foreign investment fund as trading stock may elect to bring all of their interests in trading stock foreign investment funds to account at market value. Where taxpayers elect to do so, they are not subject to foreign investment fund taxation on income arising from the interest in question.<sup>61</sup>

## **2.27 Losses**

As noted in the introduction to this chapter, the broader the foreign investment fund tax regime, the more important the treatment of losses becomes. One possible risk is

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<sup>54</sup> Income Tax Assessment Act 1936 s 493, Aust.

<sup>55</sup> The ‘deemed present entitlement’ rules in section 96C Income Tax Assessment Act 1936.

<sup>56</sup> ‘Unit trust’ is defined as “a scheme or arrangement ... that is made for the purpose or has the effect of providing facilities for subscribers, purchasers or contributors to participate, as beneficiaries under a trust, in income and gains (whether in the nature of capital or income) arising from the money, investments, and other property that are for the time being subject to the trust;” excluding certain specified trusts. Income Tax Act 2004 s OB 1, NZ.

<sup>57</sup> Definition of a ‘company’ in Income Tax Act 2004 s OB 1, NZ.

<sup>58</sup> Income Tax Act 2004, ss HH 1-8 passim, NZ.

<sup>59</sup> Reg. section 301.7701-4, US.

<sup>60</sup> Reg. section 301.7701-4(c), US.

<sup>61</sup> Income Tax Assessment Act 1936 s 521, Aust.

that artificial losses may be generated offshore in secretive tax jurisdictions and used by residents to reduce the tax payable on their domestic income. A regime designed to extend the taxing power of a residence country over foreign source income may inadvertently sabotage a country's domestic income tax base. The act of stretching out overseas may result in a hollowing out at home.

Some rules that respond to this risk by limiting the deductibility of foreign investment fund losses can appear harsh. At the extreme, there may be no relief for foreign investment fund losses at all, wherever they arise. In other cases, income and losses are treated asymmetrically: income is immediately attributed to a resident but losses are not. Most commonly, foreign investment fund losses are deductible against residents' income to the extent that they have reported foreign investment fund income in previous years.

Foreign investment fund tax loss rules can be complex. They can vary according to the foreign investment fund calculation method used by the resident or according to the tax status of the resident. In the transition to a new foreign investment fund regime, the treatment of existing losses, which may be treated as an asset in the accounts of some savings vehicles, may be an important issue for resident investors.<sup>62</sup>

The following sections analyse a particular feature of foreign investment fund loss rules: the extent to which residents can offset these losses against other sources of income. The analysis starts with examples where losses are not quarantined, proceeds to instances of moderate quarantining, and ends with harsh no-loss-allowed rules.

## **2.28 Losses allowed without quarantining**

Foreign investment fund rules rarely allow residents to offset losses against their other sources of income without restriction. Where they do, they usually limit the categories of taxpayers who can take advantage of the exception. On close examination, however, some of these exceptions that appear very restrictive on paper may, in fact, be available much more widely. Indeed, in the case of New Zealand, under the current rules, a so-called "exception" that allows resident taxpayers unrestricted offsetting of losses is likely to be the general practice and loss quarantining is likely to apply only to taxpayers who, in the main, are badly advised.<sup>63</sup>

On the face of the current legislation<sup>64</sup> and according to the official guide to the foreign investment fund regime,<sup>65</sup> the general New Zealand rule for foreign investment fund losses is quarantining. Freedom to offset foreign investment fund losses against other income is the limited exception. Furthermore, the unrestricted loss-offset "exception" is limited both by the method that taxpayers use to calculate their foreign investment fund income or loss and by the activity of the taxpayer.<sup>66</sup>

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<sup>62</sup> *Supra* note 2, 86.

<sup>63</sup> The 2005 New Zealand government proposals would allow capped losses. *Supra* note 14, 59-60.

<sup>64</sup> Income Tax Act 2004 ss DN 5-DN 9, NZ.

<sup>65</sup> The official guide to the regime, as it was drafted in the 1994 legislation, starts by setting out "the general rules" for losses calculated under all four calculation methods and then sets out the exception for "offset of losses by dealers in foreign investment fund interests". New Zealand Inland Revenue Department, *Foreign Investment Funds, Booklet IR 275B*, (Inland Revenue Department, Wellington, October 1994), 34-5.

<sup>66</sup> Income Tax Act 2004 s DN 8(4), NZ.

## 2.29 Exception according to calculation method and taxpayer activity

The current New Zealand tax rules first limit the “exception” to taxpayers who incur foreign investment fund losses calculated under three of four permitted calculation methods (the deemed rate of return, accounting profits and comparative value methods).<sup>67</sup> In practice, this is no limitation. Almost all reporting of income from attributable interests in foreign investment funds under the New Zealand tax rules appears to use one or other of these three calculation methods.<sup>68</sup> Most taxpayers have insufficient information to use the fourth method, namely branch-equivalent. (The branch equivalent method is so called because it entails calculating the income of the foreign investment fund in question as if it were a foreign branch of the New Zealand taxpayer’s business. It is the method under the New Zealand controlled foreign company rules). In addition, even taxpayers who have sufficient information to use the more accurate branch-equivalent method may instead choose one of the first three calculation methods so that they have the freedom to offset foreign investment fund losses against other income.

Furthermore, the New Zealand tax rules also limit the “exception” by the activity of the taxpayer (being a “dealer” in foreign investment funds). Again, this is unlikely to be a real limitation for the well-advised taxpayer whose interests in foreign investment funds are not excluded by any relevant exemptions. It is relatively easy for taxpayers to set up portfolios of non-exempt interests in foreign investment funds in a way that enables them to argue that the loss arose from a foreign investment fund interest acquired:

- as part of a business that includes dealing in such interests; or
- for the purpose of deriving a gain on the disposal of the interest; or
- as part of an undertaking or scheme entered into or devised for the purpose of making a profit.<sup>69</sup>

## 2.30 Policy considerations

Foreign investment fund losses that meet both the calculation method and “dealer” activity tests are not subject to any foreign investment fund loss offset restrictions. They may be offset in the year incurred against any other net income. It seems likely that many, if not most, New Zealand taxpayers who report income under the foreign investment fund regime will have structured their portfolios so that the foreign investment fund loss quarantining rules do not apply to their attributable interests in foreign investment funds. New Zealand taxpayers reporting income under the regime are likely to be sophisticated and well advised. Small investors are currently excluded by the many exemptions, especially the comparable tax system exemption and the NZ\$50,000 threshold for natural persons.<sup>70</sup>

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<sup>67</sup> Income Tax Act 2004 s DN 8(4), NZ.

<sup>68</sup> “[F]rom a sample of 3008 [attributable foreign investment fund] interests for the 2001 income year, the methods used for calculating foreign investment fund income were as follows:

Comparative value method – 2972

Branch equivalent method – 19

Deemed rate of return method – 11

Accounting profits method – 6.” Letter to the author from Keith Taylor, Portfolio Manager, Policy Advice Division, Inland Revenue Department, dated 29 May 2003.

<sup>69</sup> Income Tax Act 2004 s DN 8(4), NZ.

<sup>70</sup> Income Tax Act 2004 sCQ 5(1)(c) and (d), NZ. It is estimated that around 80 per cent of New Zealand’s non-controlled equity investment offshore occurs in the 7 countries on New Zealand’s grey list. *Supra* note 2, para. 4.2 at 12.

A 2003 New Zealand officials' issues paper on suggested legislative amendments to the New Zealand foreign investment fund regime proposed liberalising the tax loss rules in respect of the more extensive of the two possible reform options put forward for discussion. Officials argued that taxpayers with losses calculated under the modified comparative value method on shares held in companies listed on recognised stock exchanges should be able to offset these losses against non-foreign investment fund income, whether the losses exceed foreign investment fund income from the current year and previous years or not. Relying, it would appear, on the audit and accounting listing requirements imposed by stock exchanges, officials argued that the risk of losses being manufactured for shares listed on a recognised stock exchange was low.<sup>71</sup> As has been pointed out here, it is highly likely that most New Zealand taxpayers, other than the badly advised, are already benefiting from unrestricted offsetting of foreign investment fund losses against non-foreign investment fund income.

A 2005 New Zealand government discussion document proposes allowing capped losses in relation to a simplified set of foreign investment fund rules, which for most investors would require the use of the comparative value method of taxation. Following a general election and the formation of a new coalition government, the future of these 2005 proposals is unclear.<sup>72</sup>

### **2.31 Losses allowed with quarantining**

Most foreign investment fund regimes allow for losses but quarantine them on a fund-by-fund, country-by-country, or prior foreign investment fund income basis.

In Australia, foreign investment fund losses may arise under two of the three available calculation methods: the market value and "calculation" methods. The quarantining of losses under both methods is fund-by-fund. Take the market value method first. Assume that the taxpayer holds the same interest in a fund throughout the income year. A foreign investment fund loss will arise in relation to the taxpayer's interest in that fund where the opening value of the taxpayer's interest is greater than the total of the closing value of that interest in the fund plus all fund distributions received during the income year. This foreign investment fund loss will be deductible against the taxpayer's assessable income only to the extent that income in respect of *that same fund* was previously included in the taxpayer's assessable income. To the extent that this loss is not deductible that year, it may be carried forward and offset against the taxpayer's foreign investment fund income from the *same foreign investment fund* in subsequent years.<sup>73</sup>

The second way a loss may arise under Australia's foreign investment fund rules is when a taxpayer elects to calculate the income of the foreign fund using abbreviated Australian tax rules: the so-called "calculation" method. A loss calculated under this method from a foreign investment fund interest may be carried forward and deducted in calculating foreign investment fund income arising for the taxpayer in the following year from the *same fund*.<sup>74</sup>

In contrast, the current New Zealand loss quarantining rules are generally less strict. Foreign investment fund losses calculated under the deemed rate of return, accounting profits or comparative value methods are merely quarantined by the amount of foreign investment fund income derived and returned by the taxpayer

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<sup>71</sup> *Supra* note 2, paras. 7.33-7.35 at 68 and the submission points at 70.

<sup>72</sup> *Supra* note 63.

<sup>73</sup> Income Tax Assessment Act 1936 s 532, Aust.

<sup>74</sup> Income Tax Assessment Act 1936 s 572, Aust.

using any of these three methods in the current and all previous income years.<sup>75</sup> Although foreign investment fund losses calculated under the New Zealand branch-equivalent method are treated more strictly, the quarantining occurs only on a country-by-country basis, not entity-by-entity.<sup>76</sup> As has been argued above, the small number of taxpayers choosing the branch-equivalent method may partly be explained by taxpayers choosing to circumvent this quarantining by choosing another tax method and then using the “dealer” exception (see section 2.29 above).

### 2.32 Complete disallowance of losses

A small number of regimes do not allow losses incurred by a foreign investment fund to be offset against a resident’s non-foreign investment fund income at all. Imputed return regimes generally fall into this category.

The existing Canadian foreign investment fund regime,<sup>77</sup> which is soon to be replaced, and the Australian deemed rate of return method<sup>78</sup> provide examples of imputed return regimes that do not provide a resident investor with any relief for losses incurred by the foreign investment fund.

The current New Zealand deemed rate of return regime is an example of imputed return regime that may produce a foreign investment fund loss but this will occur only when residents dispose of their attributable interests in foreign investment funds. The New Zealand deemed-rate-of-return rules allow for a balancing adjustment on disposal of an attributable interest in a foreign investment fund in some circumstances.<sup>79</sup>

No relief for foreign investment fund losses, however, was proposed under the 2003 New Zealand officials’ proposal for a standard (or deemed rate of) return rule. Officials argued that:<sup>80</sup>

“(u)nder a standard return rule an investor holding a qualifying asset would be subject to a standard return of 4%, each year, even if the asset declined in value. This could be perceived as unfair because the rule will have the effect of deeming the asset to have returned a gain of 4% to an investor when, in fact, the investor may have incurred an economic loss.

Although this argument has some merit, the same result can occur under the current tax rules that tax an investor on dividends derived. That is, a company whose share price declines during a year is still likely to pay a dividend that is currently taxed at the shareholder level. In addition, in most years investors would expect to derive a greater than 4% return from qualifying assets. Returns in excess of the 4% would not be subject to tax.

Finally, the United States foreign investment fund rules provide an unusual example of a very accurate regime that still does not allow United States taxpayers to deduct their share of net losses of the foreign fund from their non-foreign investment fund income. This is so even though the foreign fund provides its United States investor taxpayers with annual statements of each taxpayer’s pro rata share of fund ordinary earnings and net capital gain calculated according to United States tax rules and the foreign fund also allows United States investors to inspect and copy its books and

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<sup>75</sup> Income Tax Act 2004 s DN 8, NZ.

<sup>76</sup> Income Tax Act 2004 s DN 9, NZ.

<sup>77</sup> Income Tax Act 1985, s 94.1, Can.

<sup>78</sup> Australian Taxation Office, *Foreign Investment Funds Guide 1997-98* (Australian Taxation Office, Canberra, 1998), 16-18.

<sup>79</sup> Income Tax Act 2004 s EX 45(12) and (13), NZ.

<sup>80</sup> *Supra* note 2, paras. 6.141-6.142 at 60.

records to verify these calculations. This regime is the “qualified electing fund” regime.<sup>81</sup>

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<sup>81</sup> Internal Revenue Code, § 1295 election and the annual information statement requirement in Reg. § 1.1295-1(g)(1), US.