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New Zealand's Experience with Territorial Taxation

By
William McBride, PhD

Introduction

The U.S. is one of the few remaining developed countries that taxes the foreign profits of its multinational corporations on a worldwide basis. As of 2012, 28 of 34 OECD countries have moved to a territorial tax system, also known as participation exemption, which exempts to a large degree these foreign profits.[1] About half of these countries have transitioned to territorial taxation since 2000.

To understand the motivation behind this international trend, and the experience both before and after the reforms in each country, the Tax Foundation has published a series of case studies.[2] The following report on New Zealand represents the sixth such case study.

New Zealand's Current System and History

In 2009, New Zealand implemented a territorial tax system much like that found in other developed countries.[3] This system first distinguishes between the active and passive income of controlled foreign corporations (CFCs), where passive income is basically investment income such as dividends, interests, royalties, and rents, and active income is everything else.[4] Second, it exempts active foreign income entirely from New Zealand tax while continuing to tax passive foreign income as it is earned.

To prevent corporate base erosion, New Zealand limits interest deductibility against domestic income. These so-called thin-capitalization rules are common in countries with territorial tax systems. In New Zealand, the limit applies if a New Zealand-based multinational corporation's debt percentage is more than 60 percent of its assets.

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[1] PWC, *Evolution of Territorial Tax Systems in the OECD*, prepared for the Technology CEO Council (Apr. 2, 2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf.
[2] Philip Dittmer, *A Global Perspective on Territorial Taxation*, TAX FOUNDATION SPECIAL REPORT NO. 202 (Aug. 10, 2012), http://taxfoundation.org/article/global-perspective-territorial-taxation.
[3] The new rules went into force July 1, 2009.
[4] A Controlled Foreign Corporation is defined here as a foreign corporation with at least 10 percent of its shares owned by a New Zealand investor. *See* New Zealand Inland Revenue Department, *Taxation (International Investment and Remedial Matters) Act 2012: Overview*, http://www.ird.govt.nz/technical-tax/legislation/2012/2012-34/2012-34-overview/.

In 2012, New Zealand extended the exemption system to controlling investments in all foreign companies, not just CFCs.

What is interesting about this policy change is not just that New Zealand became one of the latest countries to move to a territorial tax system but also that it was essentially a return to the territorial system that existed in New Zealand from 1891 to 1988. Indeed, New Zealand was the first developed country to have a territorial tax system.[5] In 1988, New Zealand moved to a worldwide tax system without deferral, meaning all foreign income of CFCs was subject to New Zealand tax as it was earned, regardless of whether it was repatriated or remained abroad. From 1993 to 2009, New Zealand reinstated exemption but only for CFCs based in one of eight "grey list" countries: Australia, Canada, Germany, Japan, Norway, Spain, the U.K., and U.S.[6]

Reasons for Reform

New Zealand moved to reform their worldwide tax system in 2009 out of an awareness that it was exceedingly burdensome to New Zealand businesses and put them at an unfair disadvantage relative to businesses based in other countries. According to New Zealand's Inland Revenue Department:

> The purpose of these reforms is to bring New Zealand's tax rules into line with the practice in other countries and help New Zealand-based business to compete more effectively in foreign markets by freeing them from a tax cost that similar companies in other countries do not face. The changes will improve the competitiveness of New Zealand's tax system and encourage businesses with international operations to remain, establish and expand.[7]

Leading up to the reforms, in 2006 the New Zealand Ministers of Finance and Revenue issued a major review of their international tax system, stating:

> New Zealand's current system of international taxation is to tax offshore income as it accrues, with credits given for foreign taxes that have been paid. No other OECD country has adopted this approach. All other OECD countries either defer taxing offshore active income or exempt it altogether. Since New Zealand taxes the income of its CFCs more heavily than other countries, it can be attractive for innovative and dynamic firms to migrate from New Zealand, establish themselves in other countries or simply stay small and local.
>
> Since New Zealand's rules applying to CFCs were introduced in 1988, other countries, including Australia, have liberalised their tax rules for the active income of their CFCs. Moreover, it has become easier for both firms and workers to shift across international borders.

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[5] PWC, *Evolution of Territorial Tax Systems in the OECD*, prepared for the Technology CEO Council (Apr. 2, 2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf.

[6] New Zealand Inland Revenue Department, *New rules for taxing controlled foreign corporations and foreign dividends* (Apr. 15, 2010), http://www.ird.govt.nz/technical-tax/legislation/2009/2009-34/2009-34-taxation-act-2009/2009-34-rules/2009-34-nr-newrules/.

[7] *Id.*

> For these reasons, the government supports a change to New Zealand's paradigm of comprehensive taxation of CFC income toward providing an exemption for offshore active income.[8]

The 2006 report also expressed a secondary concern that the worldwide system with foreign tax credits was causing New Zealand companies abroad to choose high-tax jurisdictions over low-tax jurisdictions, and the resulting large foreign tax credits were reducing New Zealand tax revenue. Lastly, the report cited compliance costs of the worldwide system, arguing that full exemption of active foreign income would be a significant simplification.

Results of New Zealand's Experiment with Ending Deferral under Worldwide Taxation

As mentioned, one of the major motivating factors behind New Zealand's reform was the sense that New Zealand businesses were hamstrung in their ability to expand abroad, and this was harming the vitality of these businesses at home. The following charts bear that out.

Figure 1 shows New Zealand's stock of outbound foreign direct investment (FDI) as a share of GDP, as it compares to Australia and the OECD simple average. In the early 1980s, most countries, including New Zealand, engaged in very little investment abroad. With the onset of modern globalization, however, FDI stock abroad grew to 30 percent of GDP in Australia and more in other developed countries. In contrast, FDI stalled in New Zealand soon after the transition to a worldwide tax system without deferral and remained at about 10 to 15 percent of GDP for more than twenty years. It is too early to say to what degree the 2009 reforms will lead to a rebound in FDI, especially due to the lingering effects of the financial crisis, but New Zealand's exemption of active foreign income should eventually lead to more foreign investment.

Figure 2 shows that throughout New Zealand's experience with worldwide taxation, from 1988 to 2009, the level and growth of real GDP per capita remained below Australia's as well as the average among developed countries. Real GDP per capita in New Zealand grew 31 percent from 1988 to 2009 versus 47 percent in Australia and 37 percent in the average OECD country.

New Zealand's poor economic performance under worldwide taxation is testament to the economic importance of foreign investment. New Zealand made other policy changes that improved growth prospects, particularly cutting the corporate tax rate from 48 to 28 percent in 1988, but this was insufficient to overcome the detrimental effects on foreign investment of worldwide taxation without deferral. Certainly in the case of New Zealand, most of the world's customers are outside the country. To reach those customers with operations abroad, New Zealand businesses had to pay foreign taxes plus New Zealand taxes on income as it was earned—an extra burden not faced by businesses based in other developed countries. This higher tax burden hindered the ability of New Zealand's businesses to grow abroad and therefore limited their hiring and investment in domestic support operations such as headquarters, supply chain and logistics, and

[8] New Zealand Inland Revenue Department, Policy Advice Division, Michael Cullen & Peter Dunne, *New Zealand's International Tax Review: A Direction for Change: A Government Discussion Document* (Dec. 2006), http://taxpolicy.ird.govt.nz/sites/default/files/2006-dd-international-tax-review.pdf.

R&D. Much empirical evidence supports this basic story that when firms increase foreign investment and wages, they also increase domestic investment and wages.[9]

Figure 1: Outbound FDI Stock as a Share of GDP
in New Zealand, Australia, and OECD

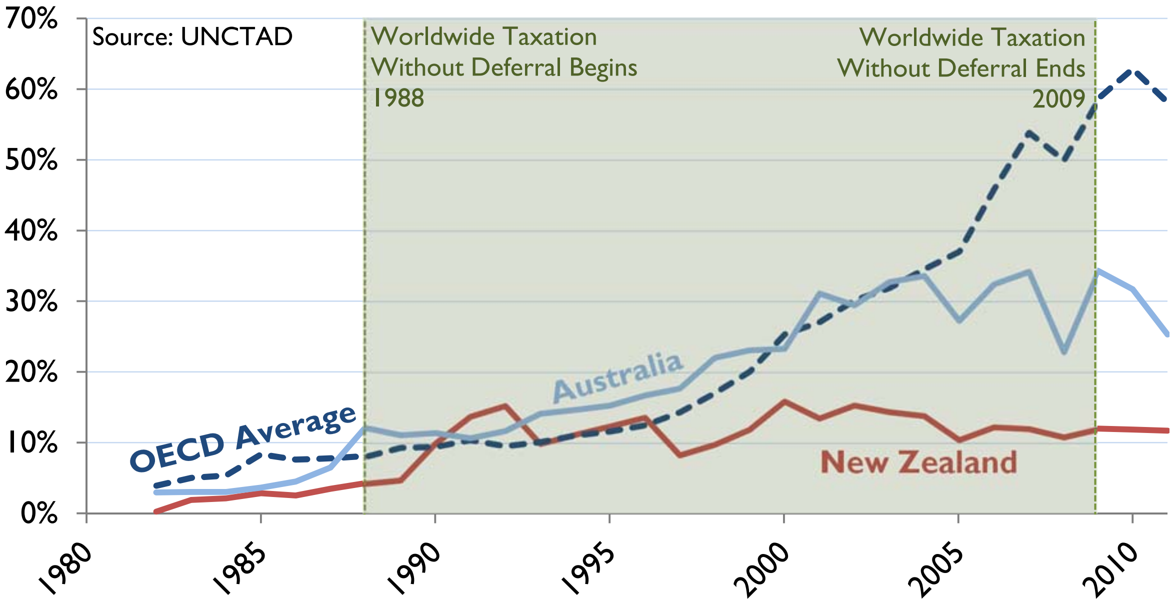
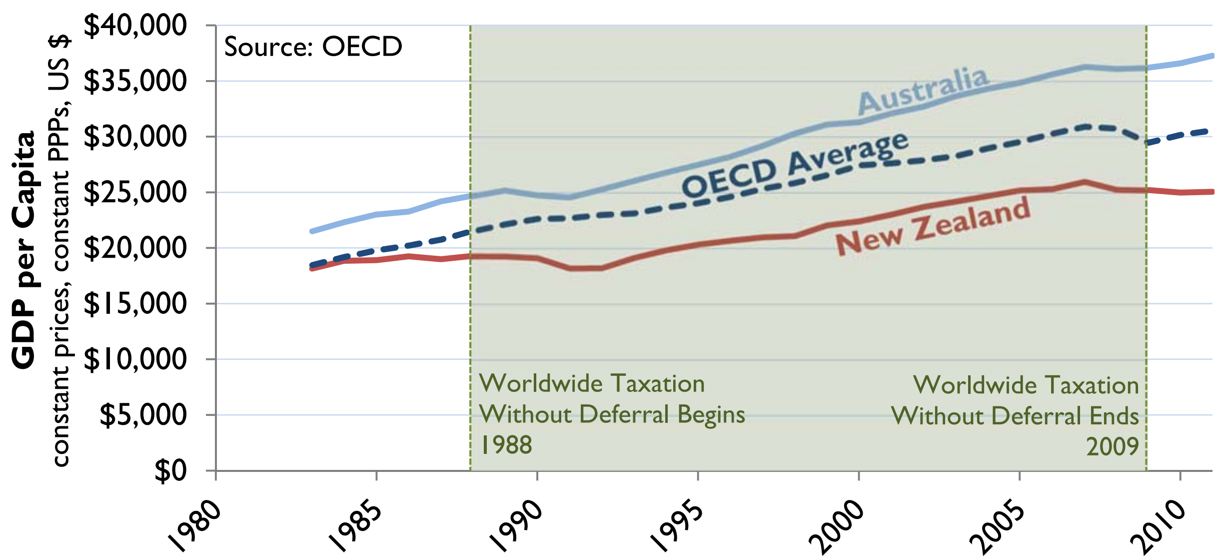


Figure 2: Real GDP Per Capita
in New Zealand, Australia, and OECD



[9] Mihir A. Desai, C. Fritz Foley, & James R. Hines, Jr., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 AMERICAN ECONOMIC JOURNAL: ECONOMIC POLICY 181 (2009). *See also* James Hines, *Treasure Islands*, 24 JOURNAL OF ECONOMIC PERSPECTIVES 103 (2010).

Conclusion

New Zealand is one of only two developed countries, the other being Finland, that switched from a territorial tax system to a worldwide system.[10] Both eventually returned to a territorial tax system for competitiveness reasons. New Zealand went one step further in their experiment with worldwide taxation by ending deferral. This resulted in a twenty year stagnation in foreign investment at a time when foreign investment was growing dramatically in the rest of the developed world. This coincided with an economic decline in New Zealand relative to Australia and the rest of the developed world. Because foreign investment is key to accessing the world's consumers, it is not surprising that less foreign investment translated to less economic prosperity at home.

The New Zealand experience shows that ending or limiting deferral in the United States, as President Obama[11] and others[12] have proposed, would likely have severe economic downsides. Instead, as New Zealand eventually did in 2009, the U.S. should implement a territorial system that exempts foreign earnings.

National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045

202.464.6200
www.TaxFoundation.org

[10] PWC, *Evolution of Territorial Tax Systems in the OECD*, prepared for the Technology CEO Council (Apr. 2, 2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf.
[11] The White House & Department of the Treasury, *The President's Framework for Business Tax Reform* (Feb. 2012), http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf.
[12] Center on Budget and Policy Priorities, Chye-Ching Huang, Chuck Marr, & Joel Friedman, *The Fiscal and Economic Risks of Territorial Taxation* (Jan. 31, 2013), http://www.cbpp.org/cms/index.cfm?fa=view&id=3895.