



Interest deductions for companies

A Government discussion document

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Interest deductions for companies; a Government discussion document
(Tax improvements for business 2)

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PREFACE

This discussion document proposes helping companies by completely removing the significant uncertainty surrounding the claiming of interest deductions. It also removes the major compliance costs companies sometimes incur to ensure their interest is deductible. The real beneficiaries are likely to be medium-sized companies, who are often surprised by the detail of present law.

This measure will encourage companies to focus their energies on more productive activities that benefit New Zealand, rather than on the minutiae of the tax laws and the need to structure their affairs.

The package presented here is an appropriate balancing of increasing certainty, reducing compliance costs and protecting the tax base. Accordingly, some foreign controlled companies may find they are affected by the stronger thin capitalisation cross-border rules proposed. Although this will increase their compliance costs, overall there will still be a significant reduction.

We believe this package of proposals will be met with enthusiasm, and we look forward to receiving submissions.

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CHAPTER 1

INTRODUCTION

- 1.1 A significant number of New Zealand companies pay interest on money they borrow to further their activities. But how much of that interest expenditure can be deducted for tax purposes has long been an area of uncertainty for them, since the law itself often lacks clarity. As a result, companies frequently structure their dealings in such a way as to ensure that the interest expense they incur can be deducted, which leads to increased compliance costs and economic inefficiencies.
- 1.2 This discussion document sets out proposals for clarifying and simplifying the rules for companies on interest deductibility. These proposals are consistent with the '5 steps ahead' package and with the proposals set out in the companion to this discussion document, *Less taxing tax*.
- 1.3 We seek submissions on these proposals as part of the normal policy development process.

Background

- 1.4 This is one of two Government discussion documents dealing with aspects of tax simplification, whether it is a matter of simplifying tax administration, or the law relating to specific areas of taxation.
- 1.5 The issue of interest deductibility has also arisen in the course of the rewrite of the Income Tax Act, itself a simplification measure. The rewrite process began in 1994 with the reordering and renumbering of the Act. Since then, new core provisions have been inserted into the Act, and the rewrite of Parts C, D and E is under way. The aim of the rewrite is to make the legislation more accessible through better structuring, clearer expression, and the use of a 'plain language' drafting style as far as possible.
- 1.6 A necessary part of rewriting the Act is to remove ambiguities of expression and meaning. To do this it is necessary to establish exactly what is intended in certain areas of the law. Interest deductibility is one such area.

The proposals

- 1.7 The discussion document sets out a package of proposals designed to simplify the interest deductibility rules and thus reduce compliance costs for companies, while tightening the thin capitalisation rules to increase their effectiveness.

Summary of proposals

Interest incurred by companies is to be fully deductible unless the thin capitalisation or conduit allocation rules apply, in which case they take precedence. This rule is to apply to all companies except qualifying companies and companies that derive exempt income other than exempt dividends.

As a complementary measure, the threshold for the thin capitalisation ‘safe harbour’, the debt-to-asset ratio that determines whether companies may be affected by the thin capitalisation rules, is to be lowered from 75 percent to 66 percent. The core rule – that the New Zealand ratio is acceptable if it is less than 110 percent of the worldwide ratio – is unchanged.

Foreign investments of New Zealand branches of non-resident companies that do not yield gross income will not be regarded as New Zealand assets for thin capitalisation purposes.

- 1.8 The Government is examining interest deductibility rules for other taxpayers (qualifying companies, companies that derive exempt income other than exempt dividends, individuals and trusts). There is concern about the proper application of the private and domestic boundary and about the apportionment of expenses incurred to derive exempt income. These concerns may take some time to resolve.
- 1.9 The private and domestic boundary for companies other than qualifying companies is at present effectively buttressed by the dividend rules. These rules do not apply to the same extent to qualifying companies.
- 1.10 In the meantime, the advantages of progressing with company interest deductibility rules are such that they should proceed. The eventual rules for other taxpayers should not cause the company rules to be changed.
- 1.11 The Government invites submissions on the merits of these proposals and on the detailed discussion that led to them. Issues on which submissions are particularly sought are highlighted at the end of each chapter, although this is not intended to limit the scope of the consultation.

SUBMISSIONS

The closing date for submissions is 26 November 1999. Submissions should contain a brief summary of their main points and recommendations and be addressed to:

General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

CHAPTER 2

CURRENT LAW

- 2.1 This chapter briefly sets out the current law in relation to interest deductions, highlighting the various tests taxpayers must pass in order to obtain a deduction, and the major boundaries within the rules.

The three limbs

- 2.2 Excluding specific rules,¹ three general rules govern interest deductibility. According to section DD 1(b) of the Income Tax Act 1994, for interest expense to be deductible it must be:
- payable in deriving gross income, or
 - necessarily payable in carrying on a business for the purpose of deriving gross income, or
 - payable by a group company to acquire shares in another group² company.
- 2.3 Essentially, these rules require borrowings to be traced to associated assets or a business or an investment in a group company, so the interest on those borrowings can then be tested for deductibility. Further, amounts that are expenditure under the accrual rules are generally deductible only under these interest deduction rules.

The first limb

- 2.4 Until 1985 the predecessor of the ‘payable in deriving gross income test’ was essentially the test for interest deductibility (excepting group companies – see below). A number of New Zealand and overseas cases have interpreted this test. The key New Zealand cases are set out below.

Pacific Rendezvous

- 2.5 In *Pacific Rendezvous*³ the taxpayer, a motel owner, wanted to increase the value of the motel before selling it. The taxpayer borrowed money to finance the expansion of the motel. The new units were rented out, producing gross income. Inland Revenue allowed only 25 percent of the interest expenditure to be deducted for tax purposes.

¹ Such as the forestry interest deductibility rule, section DL 1(3)(c).

² At least 66% owned.

³ (1986) 8 NZTC 5,146(CA).

- 2.6 On appeal, the court held that because all the capital was used to produce gross income, all of the interest expenditure was deductible. The court found that the use of the borrowed funds determines the deductibility of the interest expenditure. The fact that the underlying dominant purpose in borrowing the money was to make capital gains was not material. If all the money has been used to earn gross income, the interest is deductible without further inquiry as to whether any capital gains may also be made.

Brierley

- 2.7 The case *Brierley v CIR*⁴ involved a similar issue. The taxpayer sought an interest deduction for money borrowed to purchase shares in a publicly listed company. The taxpayer received from the company gross income of \$15,000, and ‘capital’ (but not exempt) dividends of \$451,000. The Commissioner apportioned the interest expenditure between the gross income and the other income.⁵
- 2.8 The Taxation Review Authority confirmed the Commissioner’s assessment. The Court of Appeal held that all the interest expenditure was deductible. All the borrowed funds had been used to derive gross income. The fact that the underlying purpose may have also been to derive ‘capital’ income was not relevant.
- 2.9 The Commissioner has accepted the decisions of cases like *Pacific Rendezvous* and *Brierley* in developing the underlying principles for determining the deductibility of interest expenditure. In *Tax Information Bulletin* Vol. 3 No. 9, June 1992, the Commissioner stated that the deductibility of interest will depend on whether the borrowed money is used in gaining or producing gross income in the period in which the deduction is claimed, or in the future.

Public Trustee

- 2.10 The *Public Trustee v C of T*⁶ case involved an estate that had assets that produced gross income. The estate was required to pay death duties but did not have sufficient cash to meet the payment. To avoid selling any assets, the trustee borrowed money to fund the payment.
- 2.11 The court held that the interest expenditure relating to the preservation of the income-earning assets was an allowable deduction. The court found there was a sufficient nexus between the interest expenditure and the income-earning process because the borrowed money was used for the purpose of preserving the income earning capacity of the estate.

⁴ (1990) 12 NZTC 7,184.

⁵ Capital gains are neither gross income nor exempt income, even though they are income in an economic sense.

⁶ [1938] NZLR 436.

The second limb

- 2.12 The business test was added in 1987, with effect from 1985. It provides that interest is deductible if it is necessarily payable in carrying on a business for the purpose of deriving gross income. It was added to the interest deductibility tests to coincide with the introduction of the accrual rules. Most expenditure deemed to be incurred in respect of a financial arrangement was deemed to be interest expenditure. Without the addition of the business limb, it was perceived there could be problems in obtaining deductions for expenditure from financial arrangements in some circumstances.
- 2.13 Discussion continues as to whether and, if so, by how much the second limb extends the ambit of the first limb.

The third limb

- 2.14 Interest incurred by a group company to acquire shares in another group company is deductible. This rule supposedly applies despite the fact that any resultant dividends may be exempt income.
- 2.15 Groups of companies frequently structure their transactions to utilise this rule to ensure the interest they incur is deductible. For example, assume a New Zealand company borrowed funds for a construction project which had a long lead time. Given the historical doubts that have been raised concerning interest deductibility (see the next chapter) and in order to obtain certainty, the company frequently applied the borrowed funds to subscribe for shares in a wholly owned subsidiary which in turn carried out the project.⁷
- 2.16 Subject to the limits to interest deductibility imposed by the thin capitalisation and conduit rules, corporate taxpayers can and almost always do structure their affairs to ensure that all interest expense that they incur is deductible, albeit while suffering compliance and structuring costs.

Boundaries to the current law

- 2.17 A number of boundaries apply or could apply to interest deductions. With interest deductions, like most areas of income tax law, these boundaries can create both uncertainty and the opportunity for tax avoidance. These uncertainties are discussed in the next chapter.

⁷ There is now a considerable body of opinion which holds there is no question that in this example, interest on direct borrowings is deductible.

Capital gains

- 2.18 Capital gains are neither gross income nor exempt income, even though they are income in an economic sense. New Zealand case law makes it clear that interest which is associated with the derivation of gross income is fully deductible even if a capital gain is also made. (See, for example, the *Brierley* case.)

Capital expenditure

- 2.19 The question as to whether interest can constitute capital expenditure and, if so, what are the consequences, has frequently been debated. Under current law this question is clearly not an issue because, even if it is capital expenditure, it is still deductible. This is because the section BD 2(2) capital expenditure prohibition does not apply when the expense is explicitly deductible.

The exempt income boundary

- 2.20 Some company receipts, which are income in an economic sense, are not subject to tax because they are exempt income. Frequently such receipts will constitute gross income of the ultimate shareholders (as will distributed capital gains) when they are passed on to those shareholders.
- 2.21 In particular, dividends received by a company from wholly owned New Zealand resident subsidiaries and from non-resident companies⁸ are generally exempt income as is most income derived by local and regional authorities. Exempt dividends are addressed in this document, but consideration of interest expense and its relationship to other exempt income has been deferred.
- 2.22 The exempt income expenditure apportionment rule in section BD 2(2)(b) applies to the interest deductibility rules. Thus, at least for interest deductions under the first two limbs of section DD 1(b), apportionment for exempt income may be required depending on the circumstances.
- 2.23 However, this apportionment rule must be read in context. Given the explicit and unilateral nature of the third limb of the interest deductibility rule, a nonsense would be created if the exempt income rule applied to overturn third limb deductions. There is no doubt as to the intended interpretation – the exempt income apportionment rule is not intended to override third limb deductions.

⁸ Although these latter dividends are generally subject to a withholding regime known as ‘foreign dividend withholding payments’.

The international boundary

- 2.24 The thin capitalisation rules and conduit interest allocation rules both deal with inbound investment.⁹ These rules are intended to have the effect of limiting interest deductions against the New Zealand tax base in circumstances where excess interest expense is being incurred in New Zealand.
- 2.25 These rules and further cross-border issues are discussed in detail in chapter 6.

The private and domestic boundary

- 2.26 Interest expense incurred on money borrowed to fund private and domestic expenditure, such as a private mortgage, is not deductible under New Zealand law. Concern as to the strength of the boundary between what is and what is not private is the main reason for not proposing more general reform of the interest deductibility rules until this issue has been fully analysed.
- 2.27 This matter is dealt with in more detail in chapter 8.

⁹ Investment by non-residents into New Zealand.

CHAPTER 3

NEED FOR CLARIFICATION OF THE PRESENT LAW

- 3.1 This chapter overviews the main problems with the existing law, especially as it relates to business taxpayers. It highlights the compliance costs, uncertainty and economic inefficiencies that can arise as a result of firms structuring their affairs to ensure the interest expense they incur is deductible.

Compliance costs and economic inefficiencies

- 3.2 One of the objectives of taxation is to raise revenue in the most efficient manner possible. An efficient tax system is one that minimises the distortions to economic decision-making, thus minimising the costs to the nation as a whole. Taxation causes businesses, for example, to adopt a less efficient pattern of production than would otherwise exist in the absence of taxation. This re-allocation of resources away from the preferred pattern of production is referred to as a 'deadweight cost' of taxation.
- 3.3 In relation to the interest deductibility rules for business taxpayers, deadweight costs arise because companies allocate resources to restructuring transactions and business operations to obtain a deduction for interest expense. For example, it is common practice to use the group company interest deductibility test to ensure that interest is deductible. The costs for companies of such structuring are not only the costs of complying with the law, but also the move away from a more efficient pattern of production that would exist in the absence of the need to so structure their affairs. The result is a loss of outputs to the taxpayer and to the economy as a whole.

Uncertainty

- 3.4 There is a degree of uncertainty concerning the current tax treatment of interest deductions. It is an area that affects, to some extent, every business in New Zealand. Recent overseas court cases and domestic commentaries on the issue have highlighted this uncertainty. These commentaries include:
- the Valabh Committee's¹⁰ *Final Report*.
 - *Rewriting the Income Tax Act – Parts C, D and E, a Discussion Document* (published in September 1997).
 - Inland Revenue Rulings Unit's *Interest Deductibility*, issues paper no 3 (released in September 1998).

¹⁰ The Committee on the Taxation of Income from Capital, appointed in 1989 and chaired by Mr Arthur Valabh. The *Final Report* was issued in 1992.

The Valabh Committee's Final Report

- 3.5 This report questioned whether it is possible to restrict company interest deductibility effectively. It also suggested that the tracing rules on which the present interest deductibility rules are based are fundamentally flawed because of the fungibility of debt and equity. This is further discussed in chapter 5.
- 3.6 The Valabh Committee's report predates the thin capitalisation and conduit taxation rules as well as the interest deductibility issues paper. The subsequent introduction of the thin capitalisation and conduit rules (which are based on pro rata apportionment) is consistent with the Valabh Committee's views.

Rewriting the Income Tax Act – Parts C, D and E, a Discussion Document

- 3.7 This discussion document raised questions on whether interest is deductible in relation to funds borrowed to finance capital expenditure. The Income Tax Act contains a rule that generally prohibits the deduction of expenditure of a capital nature. The discussion document suggested that making interest deductions subject to this rule would not have any practical impact. This suggestion caused a significant taxpayer reaction.
- 3.8 After analysing the submissions, and given recent overseas developments, the Government believes the law should be clarified so as to provide further certainty to taxpayers.

Interest Deductibility, Issues Paper no 3

- 3.9 This paper is a precursor to a proposed draft Inland Revenue public ruling. It analysed, under current law, relevant (and sometimes conflicting) scenarios in an attempt to find a consistent set of rules for interest deductibility. It considered:

the deductibility of interest in relation to money borrowed and used:

- *By a company to repurchase shares.*
- *By a company to pay dividends.*
- *By a partnership to return capital contributions.*
- *By a partnership to pay profits to partners.*
- *By any taxpayer to pay income tax and use-of-money interest.*
- *By a company to make a payment to share in a company's losses (a 'subvention payment').¹¹*

¹¹ At page 3.

- 3.10 The paper calls these borrowings ‘indirect borrowings’ because ‘*the funds are not used directly in deriving the taxpayer’s gross income or not used directly in the taxpayer’s business which is carried on for the purpose of deriving the taxpayer’s income.*’¹² It concluded that so long as the taxpayer had net assets, interest incurred on these indirect borrowings is deductible, subject to an apportionment based on asset value when the taxpayer also holds assets that produce exempt income, or are private or domestic in nature.
- 3.11 The paper also raised the issue of refinancing of debt but did not deal with it in detail. It suggested that interest on any refinanced debt should be dealt with in the same way as indirect borrowings, regardless of the original purpose of the original debt.
- 3.12 The paper’s interpretation of the current law, and in particular the suggestion on refinanced debt, differs from the interpretation of many practitioners on what the law is and from what past practice has been. The interpretation has no authority until (and unless) Inland Revenue formalises it by issuing a ruling.

Overseas cases

- 3.13 Recent overseas court cases have not helped to clarify the law in New Zealand. Following the decisions in *Steele v FC of T*¹³ (the Federal Court decision, which has now been overturned by the High Court) *Wharf Properties Ltd v Commr of Inland Revenue of Hong Kong*,¹⁴ it was unclear whether there is a new principle that interest deductions are not available until income is derived, or whether the cases were simply decisions on the facts.
- 3.14 In the Australian case of *Steele* the Federal Court found that a business had not commenced. Given the explicit language of the decision, however, it may have been difficult to accept that the result would have been different had the business commenced. Since the taxpayer won the appeal, this problem does not arise. *Steele*, as eventually decided, now supports the argument that, for Australian tax purposes and in appropriate circumstances, interest expense that relates to capital projects is deductible.
- 3.15 The Hong Kong legislation under which *Wharf Properties* was decided differs from New Zealand’s in that its capital prohibition explicitly overrides its interest deduction provision. Consequently, it is not likely that this decision would be followed by our courts.

Submission point

- 3.16 Is reform of the interest deductibility rules for companies necessary?

¹² At page 3.

¹³ (1997) 35 ATR (1997) and [1999] ITCA 7.

¹⁴ [1997] BTC 173.

CHAPTER 4

CONCEPTS UNDERLYING INTEREST DEDUCTIBILITY

- 4.1 How should interest expense incurred by taxpayers be treated in principle? Should all interest expense be deductible for income tax purposes, or should deductions be restricted to certain types of interest expense? This chapter discusses these fundamental issues for the purpose of determining whether there is an 'in principle' case for restricting deductions to certain types of interest expense.
- 4.2 In reforming the rules governing the deductibility of interest expenditure, the Government aims to improve both the efficiency and the equity of the tax system.

Interest deductibility under a comprehensive income tax

- 4.3 Under a comprehensive taxation system, taxpayers should be allowed to deduct all interest expenditure as it accrues, without needing to establish their purpose in incurring the debt. This was illustrated by the Valabh Committee in its *Final Report*.¹⁵

Assume that a taxpayer's only wealth is the right to a payment of \$121 payable in two years' time and that the market rate of interest is 10%. This implies that the payment is worth \$100 at the beginning of year 1 and \$110 at the end of that year.

To finance, say, \$10 of consumption in year 1, the taxpayer borrows that sum at the beginning of year 1 at an interest rate of 10%. Assuming that actual consumption in year 1 is \$10, the taxpayer's Haig-Simons income in that year is \$10 plus the change in the taxpayer's wealth. Wealth at the beginning of year 1 was \$100. At the end of the year it is the value of the asset of \$110 less the value of the debt outstanding of \$11 (i.e. principal of \$10 plus interest of \$1), giving wealth of \$99. Hence, the change in wealth over the year is -\$1. Haig-Simons income in year 1 is therefore consumption of \$10 less the wealth change of \$1, giving income of \$9.

Now consider how income for tax purposes would need to be defined to achieve the same result. The taxpayer's only source of income is the income accruing on the payment due. In year 1, this is \$10. To match the taxpayer's Haig-Simons income of \$9, a deduction would need to be allowed for the taxpayer's interest expense of \$1.

¹⁵ At page 61.

- 4.4 This conceptual analysis suggests that where all accretions in wealth are taxed (that is, Haig-Simons income), all interest, including private and domestic interest, should be deductible. For various practical and policy reasons, however, it is unlikely that all accretions in wealth will ever be subject to income tax.

Interest deductibility given current New Zealand law

- 4.5 New Zealand's income tax rules are not comprehensive. Assets that generate a mixture of 'non-taxable gains'¹⁶ and gross income are taxed more lightly than assets that generate only gross income.¹⁷ Other assets, such as private dwellings, are outside the tax base altogether. Accordingly, it does not automatically follow that the 'first best' tax treatment of interest expenditure is the best approach in practice.

Over-investment in tax-preferred assets as a result of uneven taxation

- 4.6 Uneven taxation of returns to different investments encourages over-investment in more lightly taxed assets. For example, suppose there are two equally risky assets in the economy. Returns to asset A are taxed at 50 percent and returns to asset B are taxed at 30 percent. The opportunity cost of capital – the after-tax amount that would otherwise be earned by investing in a bank account – is, say, 5 percent. As long as investors have sufficient capital, they will acquire assets A and B and, therefore, at least conceptually, increase the price of both A and B, to the point where the after-tax return to both assets is 5 percent. At this point the pre-tax rate of return to asset A is 10 percent and the pre-tax rate of return to asset B is 7 percent.
- 4.7 National income – to which both the tax paid return and the tax contribute – would be higher if the last dollar invested in asset B was instead invested in asset A. This shortfall in national income would not have occurred if all gains were taxed at the same rate or in the absence of tax, since in either case investors seeking to equalise after-tax rates of return to alternative investments would, in the process, have automatically equated before-tax rates of return.

Offsetting over-investment by denying interest deductions

- 4.8 It is often argued that restrictions on the deductibility of interest expenditure may mute the incentive provided by the differing effective tax rates, by making it less attractive to borrow to invest in tax-preferred assets. For instance, to the extent that investment in rental housing might be viewed as being tax-preferred because 'capital gains' are not gross income, limits on the deductibility of interest expenditure may restrict over-investment in rental housing.

¹⁶ For example, capital gains.

¹⁷ For example, a bank deposit.

- 4.9 In practice, however, restricting deductions for interest expenditure will only reduce investment in tax-preferred assets if investors do not have enough of their own money to buy these assets.

Further distortions caused by progressive tax rates

- 4.10 In a system with progressive tax rates we would expect to see high-rate taxpayers preferring lightly taxed (or un-taxed) assets, since the tax preference gives a greater tax saving to them than to low-rate taxpayers. They will continue to invest in these assets until the return from them is driven down to be equal to the return available on fully taxed assets. This can be illustrated using an example adapted from the Valabh Committee's *Final Report*.¹⁸

Assume that

- *fully-taxed assets produce a pre-tax rate of return of 10% and that this is also the pre-tax rate of interest;*
- *there are two tax rates – 30% and 20%; and*
- *returns from a particular asset are unexpectedly made tax exempt.*

Once the exemption is introduced, all investors but particularly the high-rate taxpayers will be induced to invest in the exempt asset. By forcing up the price of the asset, the cost of inputs, etc and therefore forcing down returns, the rate of return on the exempt asset will fall.

If the high-rate taxpayers are the marginal investors, the rate of return on the exempt asset will fall to 7%. At that point, there is no incentive for high-rate taxpayers to invest further in the asset, whether or not they obtain a deduction for interest on borrowings to invest in the asset. Similarly, there is no incentive for low-rate taxpayers to invest in the asset since they can obtain an 8% post-tax rate of return on the fully-taxed asset. Hence, restrictions on interest deductibility would not achieve anything, and would not reduce the investment in the exempt asset.

Where, however, equity-financed investment by high-rate taxpayers is insufficient to drive the rate of return down to 7%, the low-rate taxpayers will be the marginal investors and the rate of return on the exempt asset will settle at 8%. If there are no restrictions on interest deductibility, then high-rate taxpayers will have an incentive to borrow to invest in the exempt asset since their post-tax cost of borrowing is 7% and the rate of return on the exempt asset is 8%. The rate of return on the exempt asset will then be driven down to 7% because of the additional debt-financed investment by high-rate taxpayers. In the process, the low-rate taxpayers will be induced to dispose of their exempt assets because they can obtain a higher rate of return (8%) on the full-taxed asset. Overall, the aggregate investment in the exempt asset will be increased, since this is what caused the rate of return to fall from 8% to 7%. In this case, therefore, allowing an interest deduction for investment in the exempt asset will increase aggregate investment in the asset.

¹⁸ Pages 64-65.

Non-monetary benefits

- 4.11 Personal assets such as owner-occupied housing differ from business assets in that they generate both monetary returns (capital gains) and non-monetary returns (for example, the benefits of home ownership), neither of which is taxed. Indeed, with many personal assets there is usually no prospect of a monetary return. For example, most cars are sold at a loss.
- 4.12 Because none of the returns on these personal assets are taxed, the size of the tax preference on these assets is larger than on those assets that return a mix of taxed and untaxed income. Not only is the preference received larger, but because there is no taxable element, there is no need to apportion interest between the taxed and untaxed amounts in the event of interest deductibility restrictions. These factors combine to make interest deduction restrictions an effective and low-cost mechanism for reducing over-investment in these assets.

Submission points

- 4.13 This chapter suggests that, conceptually, an argument can be made that all interest should be deductible under a comprehensive tax system. However, because New Zealand does not have a comprehensive tax system, the situation is far less clear.
- 4.14 For example, the argument that denying interest deductibility can ameliorate any incentive to over-invest in tax-preferred assets depends on the market impact of substitutable equity financed investment. In practice this will be difficult to determine.
- 4.15 However, it seems that for assets where no part of the return constitutes gross income (such as private house or car ownership) the case for denying interest deductibility is stronger.
- 4.16 Therefore the approach to interest deductibility rests on various practical aspects that impinge on efficiency and equity, in particular:
- the implications of money being fungible;
 - the compliance costs of trying to limit interest deductions; and
 - the effects of uncertainty when the law is unclear.

CHAPTER 5

METHODS OF RESTRICTING INTEREST DEDUCTIBILITY

- 5.1 Interest deductibility restrictions could be imposed in a number of ways. This chapter examines three possible methods of doing so and the next chapter considers the reasons such restrictions might be appropriate.

Tracing rules

- 5.2 The current rules dealing with interest deductions can be described as adopting a tracing approach. This involves identifying what money has been borrowed by a taxpayer and determining how that money has been applied. Interest expense is deductible to the extent funds have been used to produce gross income or in carrying on a business, but is not deductible otherwise.¹⁹

- 5.3 There are two problems with the tracing approach:

- Particularly with larger taxpayers (and especially for corporate groups with layers of companies), it is just not possible to trace the use to which borrowed funds are put.
- When it is possible to trace the use to which borrowed funds are put, the rule is often arbitrary and may produce entirely different results for taxpayers with identical portfolios and financing arrangements. The practical outcome is that the tracing approach ‘bites’ only with respect to taxpayers who do not know how to, or cannot, plan around it. For those taxpayers who can plan around the tracing rules, the present legislation merely creates greater compliance costs.

The difficulty of tracing how money has been spent

- 5.4 The Tax Education Office offered the following observations on the practicality of tracing rules:²⁰

As a practical matter, there are of course real difficulties in ‘tracing’ borrowed funds for many taxpayers. This is because many taxpayers (particularly companies) operate bank accounts in which on any given day funds come in from a number of sources and go out to a number of sources. As an operational matter accounts of this type are frequently operated on the basis that money is fungible, i.e. it does not matter which money is used for what, the key is that the overall balance is in line with the taxpayer’s commercial guidelines. If borrowed money is placed in an account of this type, it may be difficult or impossible to ‘trace’ how the borrowed money is applied.

¹⁹ Except under the group company interest deductibility test, which arguably still requires tracing.

²⁰ *TEO Newsletter* No 103, 23 June 1995.

- 5.5 Suppose, for instance, that on the same day that borrowed funds of \$100 are deposited in a bank account, \$400 from other sources is also deposited. The next day, five amounts of \$100 are withdrawn, four of which are applied to purposes that would enable an interest deduction, and one of which would not. It is just not possible to trace the use of the borrowed funds in this example.²¹ It seems to be just as difficult to trace the use of funds through a large group of companies.

Inequitable results

- 5.6 When tracing is possible, it may have inequitable results, at least to the extent that taxpayers do not take advantage of the usually straightforward opportunities that are available to plan around tracing rules (albeit at a cost).
- 5.7 Consider, for example, a couple who entered into a loan of \$100,000 to buy their residence, which is valued at \$100,000. Interest paid on the mortgage would not, of course, satisfy any of the deductibility tests. Now suppose they win \$100,000 in Lotto and take either of two courses of action:
- a they repay \$50,000 of their loan and buy \$50,000 worth of shares in a listed company; or
 - b they repay the loan in full, then borrow (using their house as security) \$50,000 with which they purchase shares in a listed company.
- 5.8 Under either approach the couple ends up with a 'portfolio' worth \$150,000, comprising a house worth \$100,000 and shares worth \$50,000, which is financed with \$100,000 'equity'²² and \$50,000 debt. However, the two approaches have different tax consequences:
- Under approach (a), none of the interest expenditure on the remaining loan balance of \$50,000 is tax-deductible: the purpose for which the money was borrowed was to acquire the house, which does not produce gross income.²³
 - But under approach (b), all of the interest on the new loan of \$50,000 is tax-deductible: the purpose for which the money was borrowed was to acquire the shares, which does produce gross income.

²¹ An old case in England, *Clayton's Case* [(1816) 1 Mer 572] provides authority that for accounts such as in this example a FIFO basis of applying receipts against withdrawals is appropriate. The New Zealand courts have accepted this rule (*Bank of New Zealand v Development Finance Corporation of New Zealand* [1988] 1 NZLR 495 (CA) and *Hotdip Galvanisers (Christchurch) Ltd (in liq) & ANOR v CIR* (1996) 17 NZTC 12,679). This is clearly an arbitrary rule.

²² That is, the individual's own money.

²³ See TRA case H10 (1986) 8 NZTC 160 for this fact situation.

- 5.9 Another example is that of a couple who live in an equity-financed house worth \$100,000 and own a fully debt-financed rental property, also worth \$100,000. Interest on the loan is fully tax deductible. They decide to move into the rental property and instead rent out their former residence. As a consequence, the interest on the loan is no longer tax-deductible.
- 5.10 Both before and after the move, the couple have a portfolio worth \$200,000, half of which generates gross income. This is financed with \$100,000 debt and \$100,000 equity. Before moving, they are able to deduct all their interest expenditure; after moving, none of their interest expenditure would be deductible.²⁴

Stacking rules

- 5.11 The idea behind stacking rules is quite simple – they ‘order’ income and expenditure so as to provide a deduction for interest only where there is sufficient income or assets to satisfy the test. Stacking rules can follow two broad approaches:
- Under the first type of stacking rule, interest expenditure would be deductible only to the extent it exceeded deemed ‘income’ from assets outside the taxation base (for example, notional rent or the non-monetary benefit from the owner-occupied house), or the debt outstanding exceeded the value of assets outside the tax base (for example, the value of the owner-occupied house).
 - Under the second type of stacking rule, all interest expenditure would be deductible to the extent it did not exceed gross income, or the debt did not exceed the value of assets inside the tax base.
- 5.12 The problem with the first type of stacking rule is that it too can create perverse results. Consider a taxpayer who owns a fully equity-financed exempt asset (for example, a private house) worth \$200,000 and who wishes to borrow money at a 5 percent interest rate to acquire a debenture which costs \$50,000 and generates a rate of return of 6 percent. The tax rate is 33 percent. Under the first type of stacking rule, interest will not be deductible on the borrowed funds (because the notional rent would exceed the interest expense, or the debt would be less than the value of the house).
- 5.13 The second type of stacking rule also has problems in practice. In particular, it may lead to inequitable outcomes when some sources of income, such as income from life insurance and superannuation products, are not attributed to taxpayers even though tax has been paid. Taxpayers earning income from these sources will be disadvantaged compared with taxpayers who save through equities and financial arrangements if the value of, or the income from, the life insurance and superannuation products is not included in the interest deductibility calculation.

²⁴ See TRA cases N63 (1991) 13 NZTC 3,483 and R8 (1994) 16 NZTC 6,049 for similar fact situations.

5.14 Further, to the extent a taxpayer's debt is less than the value of that taxpayer's assets that are inside the tax base (or the interest expense is less than gross income), the taxpayer receives an incentive (the tax deduction) to borrow, even if the funds are used to acquire or enhance non-taxable assets (for example, to trade up the dwelling). This could result in a misallocation of assets.

Pro rata allocation rules

5.15 Two types of 'pro rata' allocation rules appear to be possible:

- Under the first type of pro rata rule, taxpayers would be permitted to deduct a percentage of their interest expense equal to the ratio of gross income to total income.²⁵
- Under the second type of pro rata rule, taxpayers would be permitted to deduct a percentage of their interest expenditure equal to the ratio of assets within the tax base to total assets.

5.16 Pro rata rules avoid some of the problems associated with tracing rules by explicitly dealing with the issue related to the fungibility of money – taxpayers cannot avoid the pro rata rules by judiciously ensuring borrowed funds are matched against assets that produce gross income. These rules also present problems, however, when it comes to implementation since:

- The appropriate measure of 'total income' is economic income. However, there are obvious difficulties associated with accurately measuring economic income from all assets and, in particular, the benefits derived from the ownership of private assets (which is a key factor in not taxing economic income).
- A similar problem arises in determining asset values.
- Most assets return a mixture of gross and non-taxable income.
- Complex consolidation rules would be required to counter taxpayers' incentives to segregate in separate entities assets which do not produce gross income from assets which do.

²⁵ In this context, total income could include capital gains, exempt income and notional income (for example, the benefits from owning your own house).

- 5.17 Pro rata rules are in many ways similar to stacking rules and can create similar inequitable results.
- 5.18 Both the thin capitalisation and conduit interest allocation rules use the pro rata method despite these problems. The Government has accepted that in these circumstances the disadvantages are not sufficient to rule out the use of the pro rata rule. Taxpayers seem to have accepted this.

Submission points

- 5.19 None of these possible allocation rules for restricting interest deductions is problem-free. This means a trade-off must be made between the benefits arising from denying interest deductions and the potential problems arising from restrictions on interest deductions. In the end, however, any restrictions the Government places on interest deductions are likely to be by way of one or a combination of the rules discussed above.
- 5.20 In the New Zealand corporate environment, where there are frequently layers of companies, any apportionment rule will have to use consolidation to be effective. This eliminates tracing as a viable option and leaves stacking or pro rata allocation. Of these choices, pro rata allocation seems to be generally the more appropriate because, although it is still arbitrary, it better reflects the economic reality of the position of the company or group of companies.
- 5.21 This leaves the question of interest deductibility to be decided on a case-by-case basis, taking into account the strength of the reason for non-deductibility, the question of whether an appropriate rule can be devised, and the compliance costs of imposing such a rule.

CHAPTER 6

THE DESIRABILITY OF APPORTIONING COMPANY INTEREST EXPENSE

- 6.1 It might be perceived in a variety of circumstances that it could be appropriate to subject companies' interest expense to apportionment or allocation rules. These include cases where:
- Capital gains are derived that are not taxed.
 - The interest is arguably capital expenditure.
 - Exempt dividends are derived.
 - Non-residents invest into or through New Zealand companies (to ensure the interest expense borne by the New Zealand tax base is appropriate to the circumstances).

Capital gains

- 6.2 As illustrated in chapter 2, New Zealand does not require apportionment of interest expense when a capital gain is derived, so long as gross income is also derived. Chapter 4 indicates that it is sometimes argued that because capital gains are not gross income, the overall cost of the tax system (that is, economic distortions) may be reduced if expenses incurred in deriving them were not deductible. However, it then goes on to suggest that this depends on the impact of equity financed investment, which will be difficult, if not impossible, to determine.
- 6.3 If it were decided, however, that it is desirable to deny interest deductions on money borrowed which is used to generate capital gains, doing so would not be easy to achieve. The associated problems include:
- Some form of apportionment based on income would be required.
 - The compliance cost of annual valuation to ascertain unrealised holding gains would be large.
 - If annual unrealised gains did not form the basis of apportionment, it would have to be on realisation (possibly with retrospective adjustment to prior years' interest expense).
 - Consolidation would be required to prevent interest expense being distanced from the assets that could yield the gain.
 - Capital losses would have to be dealt with.

- 6.4 The hurdles imposed by the technical problems and the associated compliance costs suggest it will be impracticable to develop a rule. Further, there is no evidence that any rule is likely to lead to more efficient and equitable outcomes.

Interest as capital expenditure

- 6.5 From an economic perspective it can be argued that interest incurred is not capital — it does not add to the value of whatever asset it finances. The frequently cited example is that of interest being incurred while a hotel is being built. The value of the hotel does not increase merely because it is debt funded rather than equity funded.

Exempt income

- 6.6 The group companies interest deductibility rule excepted, apportionment of interest expense is required under the Income Tax Act when it relates to the derivation of exempt income. There are two main sources of exempt income for companies:

- dividends from wholly owned group companies; and
- dividends from ownership interests in foreign companies.

- 6.7 Other income can also be exempt (for example, income derived by a charity or most income of a local authority). Consideration of interest expense that relates to these types of exempt income is beyond the scope of this discussion document.

- 6.8 Again, apportionment of interest is only relevant when taxpayers need to borrow. Taxpayers may have sufficient equity to undertake investments that yield exempt income without borrowing.

Dividends from wholly owned group companies

- 6.9 Under current New Zealand tax law, dividends from wholly owned group companies are exempt income. In the early 1990s the general inter-corporate dividend exemption was limited to dividends from wholly owned group companies.

- 6.10 This reduced the relevance of the group companies interest deductibility rule to the cost of financing shares in wholly owned subsidiaries (and to certain foreign companies – see the next page). However, its current importance to taxpayers should not be understated.

- 6.11 From an economic perspective, a group of wholly owned companies can be regarded as one economic entity. Under such an analysis, all intra-group transactions (such as the payment of intra-group dividends) can be ignored.²⁶ The presumption is then made that the group's third party expenditure is incurred to derive the group's income. If all this income is gross income (intra-group transactions, especially dividends, having been eliminated), all related expenditure should be deductible.
- 6.12 Therefore there is no reason to restrict interest deductibility to the extent it is incurred to derive exempt dividends from New Zealand-resident wholly owned group companies, so long as the income of those companies is gross income. This logic provides the rationale for the current group companies interest deductibility rule and confirms that in these circumstances apportionment is not required.

Dividends from foreign companies

- 6.13 The other significant source of exempt income is dividends received by a New Zealand company from a foreign company. In a number of cases the underlying income is brought into the New Zealand tax base through the controlled foreign company (CFC) and foreign investment fund rules. However, because any resultant impost on companies generally results in withholding payment account credits, it may loosely be regarded as also being exempt income.
- 6.14 The CFC rules and, so long as the investment is a non-portfolio investment, foreign dividend withholding payment rules generally allow credits for underlying tax. These credits cause an examination of associated interest expense to be relevant.
- 6.15 The complex interaction of the various groups of outbound investment rules and New Zealand's expense deductibility rules is best illustrated by example. The examples in the Appendix indicate that when foreign tax credits (actual or deemed) are being claimed and the overseas income is not being distributed to shareholders, there might be inappropriate incentives to locate interest expense in New Zealand.
- 6.16 In principle, New Zealand would be better off if an interest allocation rule discouraged overallocation of interest expense to the New Zealand tax base. A rule could be designed to ensure that New Zealand companies and their CFCs each incurred an 'appropriate' amount of the overall interest expense. Consolidation of all entities associated with each New Zealand company would be required to ensure any apportionment rule could not be readily circumvented.

²⁶ Obviously for tax purposes they are not ignored, except for the dividends (unless the consolidation rules are used).

- 6.17 The conduit interest allocation rules, which do rely on consolidation, could be modified to fill this role. It might be difficult, however, to target them to situations where foreign tax credits (actual or deemed) are being claimed and the overseas income is not being distributed to the shareholders.
- 6.18 The issue is whether such a rule would be in New Zealand's best interests, given the compliance costs involved and its possibly arbitrary nature. We have significant doubts that such a rule could reasonably be imposed on many New Zealand owned companies. Further, an interest allocation rule could be perceived as clawing back the advantages yielded by the underlying foreign tax credit rules. Considerable work would have to be undertaken before such a rule could be seriously considered and, at this stage, the Government has other priorities.

Non-residents investing into, or through, New Zealand companies

- 6.19 New Zealand has perceived that there is a need to ensure that entities at least partially owned by non-residents do not inappropriately load interest expense against the New Zealand tax base. There are two sets of rules that are intended to prevent this. These are the:
- thin capitalisation rules; and
 - conduit interest allocation rules.

- 6.20 These are detailed below.

Thin capitalisation rules

- 6.21 The thin capitalisation rules were enacted in December 1995, to complement the transfer pricing²⁷ and branch income and expense apportionment²⁸ rules. Their policy aim is to prevent non-resident controlled groups allocating excessive debt to their New Zealand operations, relative to their worldwide operations.
- 6.22 New Zealand's tax rules, in common with rules internationally, create a bias for non-residents to invest into New Zealand by way of debt rather than equity. The thin capitalisation rules, by placing a cap on the amount of interest deductions available in New Zealand, limit the extent to which the tax bias will determine a non-resident's form of investment into the country.

²⁷ Section GD 13.

²⁸ Section FB 2.

- 6.23 The thin capitalisation rules are based on ‘pro rata’ allocation rules and effectively require a consolidation of the New Zealand entities and of the worldwide entities controlled by a non-resident. They work by comparing the debt-to-asset ratio of the New Zealand entities to that of the ‘controller’s’ worldwide debt-to-asset ratio. If the New Zealand ratio is less than 110 percent of the worldwide ratio the apportionment rules are not triggered.
- 6.24 As a means of reducing compliance costs, taxpayers are not subject to the thin capitalisation rules if the New Zealand group’s debt is less than 75 percent of its assets. This is known as the ‘safe harbour’.
- 6.25 The effect of the rules has become a test of whether a taxpayer’s debt is below what is perceived by taxpayers to be the ‘acceptable’ (and arbitrary) 75 percent threshold, rather than the more appropriate question of whether an excessive amount of a worldwide group’s debt has been allocated to New Zealand.
- 6.26 If New Zealand is to move toward freer deductibility of interest expense, the thin capitalisation rules will play an important role in ensuring that non-residents cannot deduct interest expense that has no real connection with New Zealand.
- 6.27 The fungibility of debt and equity can make it difficult to trace whether particular debt has been applied to New Zealand operations. For this reason, the role of the thin capitalisation rules become more important, to prevent the misallocation of debt to New Zealand. Because the thin capitalisation rules are based on the pro rata allocation method they explicitly address fungibility of debt and equity.

The safe harbour

- 6.28 To ensure that the thin capitalisation rules are sufficiently robust in light of the interest deductibility proposals it is proposed that 66 percent be the thin capitalisation safe harbour.
- 6.29 The 75 percent safe harbour threshold was set conservatively. It was intended to eliminate most companies from the practical effect of the rules based on debt levels at that time. However, it was not intended to become the *de facto* thin capitalisation test, or to signal that the Government considered 75 percent to be the appropriate level of debt for New Zealand operations.
- 6.30 Decreasing the safe harbour to 66 percent would force more companies to meet the primary policy test of the thin capitalisation rules (the 110 percent test). Although this might increase compliance costs for some companies, however, 66 percent is a conservative threshold – it is higher than the commercially normal level of debt for non-finance sector companies operating in New Zealand.

- 6.31 In other countries the trend has been towards lower safe harbour thresholds. For example, Australia has reduced its threshold from 75 percent to 66 percent with effect from the 1997-98 income year.²⁹ The recent Canadian business taxation review has recommended reducing Canada's safe harbour threshold from 75 percent to 66 percent. The threshold in the United States is 60 percent. A reduction in the New Zealand safe harbour threshold would, therefore, not be out of line with comparable overseas countries.
- 6.32 Reducing the safe harbour threshold to 66 percent would bring it into line with the threshold for the conduit interest allocation rules. This may allow some of the complexities in the conduit interest allocation rules to be removed.

New Zealand assets

- 6.33 A particular quirk of the present system is that it regards all assets of a New Zealand entity as being New Zealand assets, even though some of those assets might be outside the New Zealand tax base. For example, the New Zealand branch of a non-resident company might be 'allocated' investments in companies in other countries. Although this would increase the quantum of assets regarded by the thin capitalisation rules as being New Zealand assets, and therefore the borrowing capacity of the branch, no income from these investments would be subject to New Zealand tax under New Zealand and international tax rules.
- 6.34 An option would be to amend the thin capitalisation rules so that these branch assets are not regarded as New Zealand assets.

The conduit taxation rules

- 6.35 'Conduit' investment is investment by a non-resident into a foreign company with the investment being channelled through a New Zealand subsidiary.
- 6.36 New Zealand imposes tax on the worldwide income of the New Zealand subsidiary, which can include the income of the foreign subsidiary, even though the foreign subsidiary (and hence its income) is ultimately 'owned' by the foreign investor. The term 'conduit taxation' is used to refer to this taxation by New Zealand of the foreign income derived by a New Zealand company on behalf of its non-resident shareholders.
- 6.37 Key features of the conduit rules include:
- The taxation of a New Zealand company on income derived from certain foreign companies is relieved, to the extent the company is owned by non-resident shareholders.

²⁹ Albeit, at this stage, it only deals with debt from 'foreign controllers'.

- A pro rata based interest allocation rule allocates interest between the New Zealand company and the foreign companies on the basis of debt-to-asset ratios. This rule applies to the extent conduit relief does, or could, apply. Again, consolidation of the various entities is required.

6.38 With the exception of amendments that might be made to align the conduit interest allocation rules with the proposed reduced thin capitalisation threshold, the Government does not propose any changes to the conduit rules.

Compliance costs

6.39 These two sets of rules help to ensure that when non-residents are involved, an appropriate amount of New Zealand taxation is paid. They focus on the measurement of New Zealand source income and test its appropriateness. Although it is acknowledged that both sets of rules are compliance cost intensive, they are both targeted at entities which have some non-resident ownership. Therefore a certain level of skills and capability can be presumed.

6.40 Further, it must be remembered that the conduit rules offer taxpayers tax relief. The conduit interest allocation rule, although compliance cost intensive, is regarded as a necessary buttress to the conduit rules.

Submission points

6.41 The analysis above concludes that interest apportionment is not appropriate when:

- Capital gains are also derived.
- Interest could be regarded as capital expenditure.
- Or exempt dividends are derived from wholly owned New Zealand companies.

6.42 Although interest apportionment might conceptually be desirable where there is outbound investment³⁰ that attracts foreign tax credits, such rules would be difficult to design and cumbersome. It is possible that any benefit would be offset by the economic and other costs of such restrictions. Inevitably any rules would be arbitrary, with resultant adverse effects on patterns of investment, and would impose significant compliance costs.

6.43 It is appropriate, however, to maintain and enhance the interest apportionment and allocation rules (the thin capitalisation and conduit rules) that can apply when there is inbound investment.

³⁰ Investment out of New Zealand.

6.44 In particular, it is proposed to reduce the thin capitalisation safe harbour from 75 percent to 66 percent and to limit the investments that branches can regard as being New Zealand assets for thin capitalisation purposes.

6.45 The Government welcomes submissions on these points.

CHAPTER 7

PROPOSED TREATMENT OF COMPANY INTEREST EXPENSE

- 7.1 Because it is not possible for larger companies to trace the use to which borrowed funds are put, little can be achieved at the company level by imposing onerous tracing rules to govern interest expense. As can be seen from chapters 5 and 6, alternative methods of restricting interest deductions (stacking or pro rata) also present their own problems.
- 7.2 Given these problems, the Government believes that gains, if any, made from attempting to apportion New Zealand resident companies' interest expense for exempt dividend income or capital gains are more than offset by the economic and other costs of such restrictions. Inevitably any rules would be arbitrary, with resultant adverse effects on patterns of investment. Further, the compliance costs that effective apportionment rules would impose would be significant (if such rules could even be devised).
- 7.3 Accordingly, it is proposed that company interest be deductible, subject to the thin capitalisation and conduit allocation rules.³¹ In this context, interest includes 'use-of-money' interest payable in respect of taxation and accrual rules expenditure that is regarded as interest under section DD 1(b).
- 7.4 The Government believes it can and should move ahead on reform of the company interest deductibility rules because companies (other than qualifying companies) do not pose the same risk as other business entities of private expenditure being recharacterised as business expenditure. The deemed dividend rules in relation to company distributions mean that almost any transfer of wealth to shareholders will be gross income as a dividend. Avoidance concerns in relation to company structures revolve not around the private and domestic boundary, but the international boundary. These concerns were discussed in the preceding chapter.
- 7.5 Because of concerns over the private and domestic boundary, the Government is not yet in a position to consider what the rules should be for other taxpayers such as individuals, trusts and qualifying companies.
- 7.6 Further, there are a number of problems with allowing the interest deductibility proposal to apply to incorporated societies and the like, and to local authorities and other companies that derive exempt income (other than exempt dividends).

³¹ The general anti-avoidance rule will continue to apply.

7.7 For companies, the proposed reform outlined in this document will improve the efficiency and equity of the income tax system by:

- simplifying and clarifying the interest deductibility rules;
- increasing taxpayer certainty; and
- reducing compliance costs.

7.8 The Government is aware that concern may be expressed that this proposal may allow inappropriate interest deductions. We do not believe that the proposal will have this effect in practice, given that the general anti-avoidance, thin capitalisation and conduit interest allocation rules will apply, and considering the robustness of the dividend rules. However, the outcome will be regularly monitored.

Submission points

7.9 Do readers agree that the proposed rule will lead to simplified and more certain interest deduction rules, and therefore increased certainty and reduced compliance costs?

7.10 How significant are these advantages?

7.11 Do readers agree with the core interest deduction proposal?

7.12 Should the Government be concerned about inappropriate interest deductions being allowed under the proposal? Or should the Government consider other ways to increase certainty and reduce the compliance costs associated with interest deductibility?

CHAPTER 8

FUTURE INTEREST DEDUCTION ISSUES

- 8.1 A number of issues have not been addressed in this discussion document. Because of the size of the project, the Government has made the decision to do it in two parts. The Government is continuing to analyse a number of issues, which are briefly discussed below. Before any further changes are made there will be appropriate opportunities for consultation.

Private and domestic boundary

- 8.2 Interest expense incurred on money borrowed to fund private and domestic expenditure, such as a private mortgage, is not deductible under New Zealand law. It is often difficult, however, to trace how borrowed money has been used. Because of this, some taxpayers, such as the self-employed, may be able to recharacterise private interest expenditure as deductible business expenditure. Any relaxation of the rules relating to interest expenditure could, therefore, increase opportunities for taxpayers to obtain a deduction for what is essentially private and domestic expenditure.
- 8.3 By way of a simple example, consider a self-employed person privately using a work vehicle financed by way of an increased business overdraft. It is almost impossible in this situation to determine accurately how much of the interest paid on the overdraft relates to business expenditure and how much relates to private consumption.
- 8.4 The boundary between companies and their shareholders is buttressed by comprehensive dividend rules. Thus almost any distribution of value to a shareholder is deemed to be a dividend, so is gross income of the shareholder. For this reason, we believe a relaxation of the rules relating to interest deductions for companies, as opposed to businesses in general, presents significantly fewer problems in relation to the private and domestic boundary.
- 8.5 The Government intends to undertake further work on the private and domestic boundary and consider the deductibility of interest expense for taxpayers other than companies (that is, qualifying companies, individuals and trusts) in light of that work.

Incorporated societies

- 8.6 From a tax perspective, incorporated societies and the like are companies. One important characteristic is that, typically, at least some, if not most or all, of their income is exempt (such as that of an amateur sports promoter).

- 8.7 Thus simply allowing interest deductibility seems to be inappropriate. The Government wishes to consider further what interest deductibility rules should apply to such entities.

Local authorities

- 8.8 A significant portion of the income of local authorities (which the Income Tax Act regards as companies) is exempt. Again, it seems to be inappropriate to allow unilateral interest deductibility.

Submission point

- 8.9 Submissions on these or any other issues are welcomed.

APPENDIX

APPENDIX

DIVIDENDS FROM FOREIGN COMPANIES

The following examples consider interest apportionment in respect of non-conduit outbound investment. The table provides calculations to support each of the examples.

Example 1 – Tax havens

New Zealand resident individuals (Shareholders) invest in a New Zealand company (Hold Co) which then acquires a controlled foreign company resident (CFC) in a tax haven. Borrowings are required. Presume that Shareholders, Hold Co and CFC derive sufficient net income to 'utilise' any interest they incur (that is, Shareholders and Hold Co have income other than what they receive by way of dividends from Hold Co and CFC respectively).

Given the assumptions, from a New Zealand taxation perspective it does not matter whether the interest is incurred in CFC, Hold Co or by Shareholders. The total amount of tax payable in New Zealand is the same. The income of Hold Co and CFC is consolidated for taxation purposes and there are no underlying tax credits to complicate the analysis.³²

CFC IN TAX HAVEN

All Income Distributed Interest Incurred	By CFC			By Hold Co			By Shareholders		
	CFC	Hold Co	Shareholders	CFC	Hold Co	Shareholders	CFC	Hold Co	Shareholders
Other Income	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
"Income" from CFC		50.00			100.00			100.00	
Dividend from Hold Co			100.50			100.50			134.00
	100.00	150.00	200.50	100.00	200.00	200.50	100.00	200.00	234.00
Interest Expense	50.00	0.00	0.00	0.00	50.00	0.00	0.00	0.00	50.00
Net Income	50.00	150.00	200.50	100.00	150.00	200.50	100.00	200.00	184.00
Net Tax Expense	0.00	49.50	33.00	0.00	49.50	33.00	0.00	66.00	16.50
Cash Available	50.00	100.50	167.50	100.00	100.50	167.50	100.00	134.00	167.50
Amount Distributed	50.00	100.50		100.00	100.50		100.00	134.00	

Note that it makes no difference whether the CFC income is distributed or not because Hold Co pays full tax on the income anyway.

³² This conclusion would be different if the shareholders were not New Zealand resident - the conduit rules would apply to appropriately locate the interest expense.

Example 2 – Underlying tax credits, but all income is distributed to Shareholders

Now presume that CFC is resident in a grey list country that has an effective tax rate of 33%, and that the income of CFC and Hold Co is all distributed to Shareholders. So long as CFC has sufficient income, Shareholders' return and the New Zealand tax take are maximised if CFC incurs the interest. This is because CFC's tax liability (which is effectively treated as an expense upon ultimate distribution of its income to Shareholders) is minimised by the interest deduction.

Put another way around, Hold Co maximises its imputation credits in relation to its and CFC's income by ensuring the interest is incurred by CFC.

CFC IN GREY LIST COUNTRY

All Income Distributed Interest Incurred	By CFC			By Hold Co			By Shareholders		
	CFC	Hold Co	Shareholders	CFC	Hold Co	Shareholders	CFC	Hold Co	Shareholders
Other Income	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
"Income" from CFC		33.50			67.00			67.00	
Dividend from Hold Co			100.50			100.50			134.00
	100.00	133.50	200.50	100.00	167.00	200.50	100.00	167.00	234.00
Interest Expense	50.00	0.00	0.00	0.00	50.00	0.00	0.00	0.00	50.00
Net Income	50.00	133.50	200.50	100.00	117.00	200.50	100.00	167.00	184.00
Net Tax Expense	16.50	33.00	44.06	33.00	16.50	55.11	33.00	33.00	38.61
Cash Available	33.50	100.50	156.45	67.00	100.50	145.39	67.00	134.00	145.39
Amount Distributed	33.50	100.50		67.00	100.50		67.00	134.00	
Net Cash Surplus			156.45			145.39			145.39

Example 3 – Income only distributed to extent imputation credits available

Now presume that CFC's income is either retained by CFC or distributed to Hold Co and retained by it. So long as there is sufficient income to utilise the interest expense it doesn't matter which party incurs it. This could cause the parties to be indifferent from a taxation perspective as to where the interest expense is located.

However, if CFC's income is then distributed to Shareholders in a subsequent year, their return and the New Zealand tax take are maximised if the interest was located in CFC (for the same reasons as in Example 2: if the interest is located in Hold Co its income is less and therefore it has less imputation credits)

All CFC Income Retained By Hold Co Interest Incurred	By CFC			By Hold Co			By Shareholders		
	CFC	Hold-Co	Shareholders	CFC	Hold-Co	Shareholders	CFC	Hold-Co	Shareholders
Other Income	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
"Income" from CFC		33.50			67.00			67.00	
Dividend from Hold Co			67.00			33.50			67.00
	100.00	133.50	167.00	100.00	167.00	133.50	100.00	167.00	167.00
Interest Expense	50.00	0.00	0.00	0.00	50.00	0.00	0.00	0.00	50.00
Net Income	50.00	133.50	167.00	100.00	117.00	133.50	100.00	167.00	117.00
Net Tax Expense	16.50	33.00	33.00	33.00	16.50	33.00	33.00	33.00	16.50
Cash Available	33.50	100.50	134.00	67.00	100.50	100.50	67.00	134.00	100.50
Amount Distributed	33.50	67.00		67.00	33.50		67.00	67.00	
Balance	0.00	33.50		0.00	67.00		0.00	67.00	
Net Cash Surplus			167.50			167.50			167.50

The analysis above considers only the CFC and dividend rules. In practice, the analysis is further complicated by other taxation factors such as the potential effect of the CFC loss ring fencing rules, thin capitalisation rules, overseas tax rates and by non-taxation factors such as currency exposure.

From a New Zealand taxation perspective it is the indifference as to the location of the interest expense in example 3 that potentially presents a problem

The nub of the issue is that, conceptually, New Zealand should not provide interest expense deductions related to income that is not subject to New Zealand taxation. To the extent there are underlying foreign tax credits (actual or deemed), the income of CFC does not enter the New Zealand tax base until it is distributed by Hold Co.