

Taxation (International Investment and Remedial Matters) Bill

Commentary on the Bill

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

First published in October 2010 by the Policy Advice Division of Inland Revenue, PO Box 2198,
Wellington 6140.

Taxation (International Investment and Remedial Matters) Bill; Commentary on the Bill.
ISBN 978-0-478-27190-4

CONTENTS

Changes to FIF rules	1
Overview of proposed amendments	3
Extending the active income exemption to non-portfolio FIFs	4
Rationalising other FIF calculation methods	12
PIEs with non-portfolio interests in CFCs or FIFs	16
Replacing the grey list exemption with an Australian exemption	18
Branch equivalent tax accounts of companies and conduit tax relief accounts	19
Repeal of branch equivalent tax accounts of companies and conduit tax relief accounts	21
Remedial amendments: branch equivalent tax accounts of companies	28
Changes to the thin capitalisation regime	29
Applying the thin capitalisation rules to active FIFs	31
New thin capitalisation test for low-asset companies	32
State-owned banking groups	38
Application to non-residents with no fixed establishment	41
Exemption from the outbound rules	42
Zero rate of AIL on bonds	43
Zero rate of AIL on qualifying bonds	45
Miscellaneous remedial changes	51
Revaluing inherited former grey-list shares	53
Qualifying companies amendment	55
Amendment to non-resident exclusion from conduit anti-avoidance rule	56
Attributed foreign income – liability to tax	58
Active business test – clarifications and remedial amendments	62
Ability for Commissioner to impose conditions on an insurance CFC determination	65
Foreign dividend exemption – deductible dividends	66
Losses of controlled foreign companies – transition	68
Foreign tax credits of controlled foreign companies – transition	69
Other remedial changes	70

Changes to FIF rules

OVERVIEW OF PROPOSED AMENDMENTS

The Taxation (International Investment and Remedial Matters) Bill builds on and extends earlier international tax reforms. The main proposal is to extend the active income exemption that currently applies to offshore subsidiaries so that it also applies to joint ventures and other significant shareholdings in foreign companies. This will remove a barrier to offshore expansion by New Zealand businesses.

In 2009 an active income exemption was introduced for foreign companies that are controlled by New Zealand investors (controlled foreign companies (CFCs)). This reform was designed to ensure that New Zealand businesses that expand offshore by operating subsidiaries in foreign countries can compete on an even footing with foreign competitors operating in the same country. This means that a New Zealand-owned manufacturing plant in China would generally face the same tax rate as other manufacturers operating in China.

An “active business test” is used to reduce the tax and compliance costs associated with calculating and attributing small amounts of passive income. The test is passed and no income is attributed, if less than 5% of the gross income of the CFC is passive. If the test is failed, then only the passive income (i.e. highly mobile income such as interest, rent or royalties) is attributed to the shareholder.

In 2007 some new methods were introduced for calculating income from less than 10% shareholdings in foreign companies (portfolio foreign investor funds (FIFs)). As a consequence, such investors generally calculate income based on an assumed 5% rate of return (fair dividend rate method), although a natural person and trustees of family trusts can choose to be taxed on the actual returns of all of their foreign portfolio investments (although any losses are reduced to zero).

The 2007 and 2009 reforms did not apply to interests of between 10% and 50% in companies that are not controlled by New Zealanders (non-portfolio FIFs). Within this tranche some investors take an active role in managing the foreign company or invest in companies that are strategically aligned with their own business (akin to a CFC), while others will enter an investment based mainly on expected dividends and share gains (akin to a portfolio shareholding).

The Taxation (International Investment and Remedial Matters) Bill (“the Bill”) aims to provide consistency of tax treatment between similar types of foreign investment. It achieves this by extending the active income exemption and active business test (with some small modifications) to non-portfolio FIFs. It also extends and rationalises the portfolio FIF reforms so that those investors who are unable to use the active income exemption (due to having an insufficient shareholding or access to information) will generally be taxed on an assumed 5% rate of return (fair dividend rate method).

The main exception to these rules is for foreign companies that are located in Australia. The Bill replaces the grey list for non-portfolio FIFs with an exemption for non-portfolio FIFs that are resident and subject to tax in Australia. This is consistent with earlier reforms that replaced the eight-country “grey list” exemptions with an exemption for CFCs that are resident and subject to tax in Australia and with an exemption for ASX-listed companies.

EXTENDING THE ACTIVE INCOME EXEMPTION TO NON-PORTFOLIO FIFS

(Clauses 7(2), 7(3), 8(2), 13, 14, 15(2), 16, 19(2), 25(3), 26(2), 29, 33, 35(2), 35(8), 35(9), 36 to 40, 42, 43, 69 70(3), 70(4), 72, 73, 97, subclauses 126(4), (9), (18), (20), (25), (27) and (30))

Summary of proposed amendments

In 2009 an active income exemption was introduced for foreign companies that are controlled by New Zealand investors (CFCs). The Bill extends the active income exemption to interests of between 10% and 50% in companies that are not controlled by New Zealanders (non-portfolio FIFs).

Application date

The changes apply to income years beginning on or after 1 July 2011.

Key features

Under the existing rules investors in FIFs are able to calculate their income based on how the income would be calculated if the FIF were a branch of a New Zealand company (the branch equivalent method). The branch equivalent method will be replaced by the attributable FIF income method. Investors will only be able to use the attributable FIF income method in respect of FIFs in which they have a 10% or greater interest. Such investors will generally calculate their FIF income as though the FIF were a CFC using the active income exemption, although two modifications are made to make the CFC rules more accommodating to FIF investors.

Firstly, the active business test is relaxed to enable FIF investors to use consolidated accounting information to apply the test to chains of FIFs (including FIFs that are in different jurisdictions). Secondly, the exemption that applies to payments of interest, rent and royalties from an active CFC to an associated CFC (e.g. 50% common ownership) is modified so that a similar exemption applies when a FIF holding company controls an active FIF. These modifications are explained in the detailed analysis below.

Background

New Zealand's international tax rules can impose higher tax or compliance costs on offshore operations than those faced by competing businesses operating in the same country. In many cases a New Zealand business which invests into a foreign country needs to not only comply with the tax rules of that country, but also attribute income (and potentially pay further tax in New Zealand) using New Zealand tax concepts. In contrast, many other countries reduce or eliminate the additional tax or compliance burden created by a second layer of tax by exempting offshore income that is earned by active businesses (e.g. manufacturing, services and sales income). This may create an incentive for New Zealand companies undertaking or considering active business ventures outside New Zealand to relocate their headquarters to countries with more favourable tax rules.

In 2009 an active income exemption was introduced for foreign companies that are controlled by New Zealand investors (CFCs). The reform was intended to ensure that New Zealand businesses that expand offshore by operating subsidiaries in foreign countries could compete on an even footing with foreign competitors operating in the same country. This means that a New Zealand-owned manufacturing plant in China would generally face the same tax rate as other manufacturers operating in China.

CFCs are a key vehicle for expanding New Zealand businesses beyond the domestic market. However, firms expand beyond New Zealand through a variety of structures, and New Zealand companies wanting to expand overseas may have good commercial reasons for not operating through a wholly or majority-owned subsidiary. For this reason the proposed Bill will allow investors with interests of between 10% and 50% in foreign companies that are not controlled by New Zealanders to apply the active income exemption to these FIF interests.

Detailed analysis

Attributable FIF income method (section EX 50)

The branch equivalent method is replaced with an attributable FIF income method. Under this method investors in the FIF generally calculate their FIF income as though the FIF were a CFC using the active income exemption. No income is attributed from FIFs that satisfy the active business test, either independently or as part of a consolidated group of FIFs.

Investors that do not satisfy the active business test attribute the portion of attributable income that corresponds with their income interest in the FIF (the investor's income interest is also worked out by applying the CFC rules).

The attributable FIF income method differs from the CFC rules in two key respects. Firstly, the active business test is relaxed to enable investors to use consolidated accounting information to apply the test to chains of FIFs (including FIFs that are in different jurisdictions). Secondly, the exemption that applies to payments of interest, rent and royalties from an active CFC to an associated CFC (e.g. 50% common ownership) is modified so that a similar exemption applies when a FIF holding company controls an active FIF.

The remainder of this commentary focuses on these differences. A detailed description on how the CFC rules operate can be found in the October/November 2009 *Tax Information Bulletin* (Part II, Vol. 21, No. 8).

Active business test (sections EX 21D, EX 21E and EX 50)

An "active business test" is used to reduce compliance costs in cases where there is a low risk to the tax base. The test is passed and no income is attributed, if less than 5% of the gross income of the foreign company is passive. If the test is failed, then only the passive income (i.e. highly mobile income such as interest, rent or royalties) is attributed to the shareholder.

Under the CFC rules, New Zealand investors that have more than one majority-owned CFC in a jurisdiction are allowed to use consolidated accounts for all their majority-owned CFCs in that jurisdiction for the purposes of the active business test. The purpose of this measure is to simplify the application of the test when accounting information is available at a consolidated level, such as when a group produces segmental reporting by country.

The Bill proposes a similar consolidation rule for investors in non-portfolio FIFs. This should enable more investors to use the active business test as it can be easier to access consolidated accounting information for an entire group of FIFs than to access information for each separate company.

The requirements for being able to apply the active business test to a group of foreign companies under the attributable FIF income method are more relaxed than those that apply to a group of CFCs:

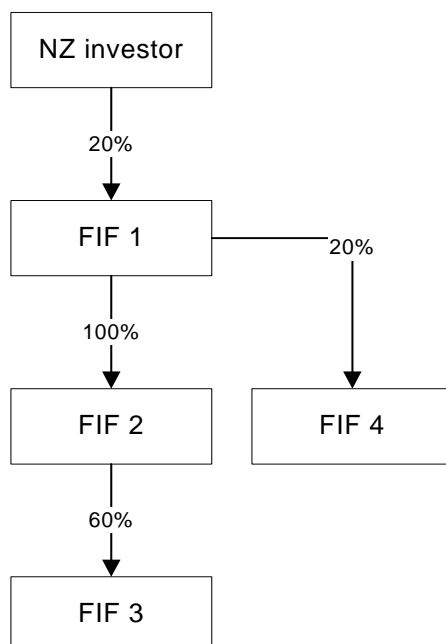
- The CFC rules require the investor to have a more than 50% income interest in each CFC. Under the attributable FIF income method it is the FIF for which that method is used which must have a more than 50% voting interest in the lower-tier foreign companies. Voting interests include interests that are held directly or indirectly.
- The CFC rules also require all the CFCs to be in the same jurisdiction in order to apply the active business test on a consolidated basis to a group of CFCs. Under the attributable FIF income method the foreign companies can be in different jurisdictions (so long as none of those companies is a CFC).
- Finally, the CFC rules require the investor to remove amounts corresponding to income interests not held by the investor (i.e. minority interests). The attributable FIF income method omits this requirement so amounts belonging to other investors are included in the calculations. This concession is made purely because of concerns about the practical difficulties for a non-controlling shareholder of identifying amounts attributable to other shareholders. The above modifications to the CFC rules occur through new section EX 50(4B).

Requirement to apply FIF calculation methods to lower-tier foreign companies (sections EX 50(6), EX 50(7) and EX 50(7B))

In many cases a New Zealand investor will own shares in a foreign company which itself owns shares in a second foreign company. If the investor chooses to use the attributable FIF income method in respect of the first foreign company, they will generally be required to “look-through” and to apply a FIF calculation method with respect to their indirect interest in the second foreign company. This is achieved by the formula in sections EX 50(6) and (7) and is consistent with the existing practice under the branch equivalent method.

Example

If the NZ investor chooses to use the attributable FIF income method for FIF 1, it would generally have to apply a FIF calculation method to FIF 2 and FIF 4. If the investor then chooses to apply the attributable FIF income method to FIF 2, it would then generally have to apply a FIF calculation method to FIF 3.



If the investor had instead decided to apply a different FIF calculation method (such as the fair dividend rate or cost methods) to FIF 1, then they would not be required to look-through and apply a FIF calculation method to FIFs 2, 3 or 4, as they only have an indirect interest in these FIFs.

The Bill proposes several exceptions to the “look-through” rule in section EX 50(6). The purpose of these exclusions is to enable investors to apply the active business test using consolidated accounting information in situations where they have a direct interest in a FIF that holds shares in other foreign companies. In such cases it may be easier to access consolidated accounting information, than it would be to access separate accounting information for each company.

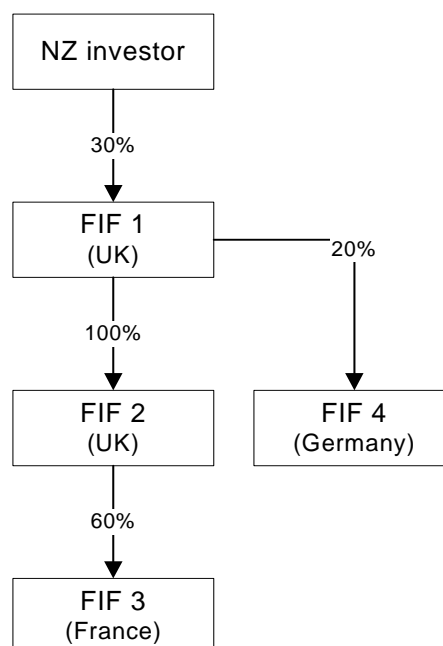
Consider a New Zealand investor with an interest in a FIF that owns a second foreign company. The investor will have no additional FIF income from the second foreign company if:

- The second foreign company is able to apply and pass the active business test on its own terms, independent from the upper-tier FIF. Note that the New Zealand investor would have to have an indirect interest of 10% or more in the second foreign company for that company to be able to apply the active business test in the first place; or

- The FIF and the second foreign company are able to apply and pass the active business test as part of the same test group. To be part of the same test group the FIF must hold a 50% or greater voting interest in the second foreign company, and the second foreign company must not be a CFC; or
- The FIF is able to apply and pass the accounting-based active business test in section EX 21E even after some relevant amounts from the second foreign company are included in the “added passive” item. The relevant amounts will differ depending on the level of shareholding that the FIF has in the second foreign company. If the FIF holds a joint venture interest in the foreign company the amounts which would be recorded in that FIF’s accounts under New Zealand Equivalent to International Accounting Standard 31 (NZIAS 31) would need to be included. If the FIF holds 20% or more, but less than 50% of the foreign company, then amounts recorded under the equity method in that FIF’s accounts under NZIAS 28 would need to be included. If the FIF holds less than 20% of the foreign company then any dividends and holding gains recorded under NZIAS 39 for that company would need to be included. Note that including such amounts in the “added passive” item is optional, but the look-through rule will continue to apply to indirect FIF interests that do not qualify for one of the above exclusions.

Example

Consider the following group structure.



If the New Zealand investor chooses to apply the attributable FIF income method to FIF 1 it can apply the active business test using information from the consolidated accounts of FIF 1. Each line item in these accounts will include amounts from FIF 2 and FIF 3. These amounts will be included in the “reported passive” item for the purposes of the test.

Amounts from FIF 4 will be included as a separate line item (income from equity in associates) in the consolidated accounts of FIF 1. If the investor chooses to add this line item to the “added passive” item for applying the active business test to the test group and that test group still passes the active business test with these amounts included then the investor would not apply a FIF calculation method to FIF 4.

Now assume that FIF 1 receives \$400,000 of interest payments from FIF 2, \$240,000 of royalty payments from FIF 3 and \$100,000 in dividends from FIF 4. FIF 1 earns \$5m of sales income and \$200,000 in interest from unrelated entities. FIF 2 earns \$2m of sales income, FIF 3 earns \$3m of sales income and FIF 1 is entitled to 20% of the \$1m earned by FIF 4. Because FIF 2 and FIF 3 are controlled by FIF 1 their earnings appear in full in the consolidated accounts. The intra-group royalty and interest payments are disregarded in the consolidated accounts. Income from FIF 4 comprises \$200,000 of income from associates under the equity method (the dividend is not recognised in income and instead reduces the carrying value of the investment).

The New Zealand investor chooses to apply the active business test using the consolidated accounts of FIF 1, FIF 2 and FIF 3 and by adding amounts from FIF 4 to the “added passive” item. Reported passive is \$200,000 (third-party interest), added passive is \$200,000 (from FIF 4) and total revenue is \$10.4m, so the percentage of total passive to total revenue is 3.85%. Because this is less than 5% the New Zealand investor does not attribute any income from FIF 1, FIF 2, FIF 3, or FIF 4.

All figures in \$000s	Consolidated accounts of FIF 1, FIF 2 and FIF 3	FIF 1	FIF 2	FIF 3	FIF 4
<i>Income</i>					
Sales	10,000	5,000	2,000	3,000	
Less cost of goods sold	3,400	1,000	900	1,500	
Gross profit	6,600	4,000	1,100	1,500	
<i>Other income</i>					
Interest (400 from FIF 2)	200	600	0	0	
Royalty (from FIF 3)	0	240	0	0	
Income from equity in associates (FIF 4)	200	200	0	0	
<i>Operating expenses</i>					
Interest	0	0	400	0	
Royalty payment	0	0	0	240	
Net profit before tax	7,000	5,040	700	1,260	1,000 (of which 200 belongs to FIF 1)
Active business test					
Reported Passive	200				
Added Passive (from FIF 4)	200				
Total Passive	400				
Total Revenue	10,400				
% Total Passive to Total Revenue	3.85%				

Exemption for intra-group payments (sections EX 50(4B)(a), (b) and (c) and EX 50(4C))

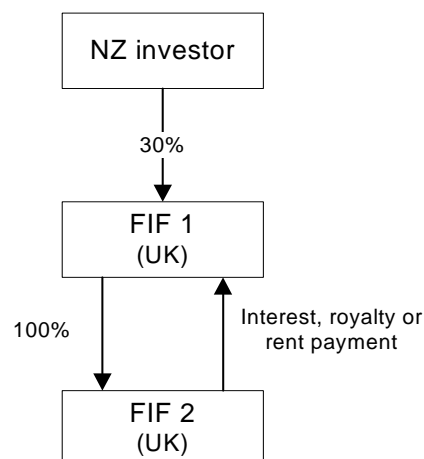
In the event that the active business test is not satisfied for a particular FIF, and the holder of the FIF interest uses the attributed FIF income method to calculate attributed income, the method treats the FIF in many ways as a CFC. However, there are some key differences.

Under the existing CFC rules there is an exemption for interest, rent and royalty payments between commonly-controlled CFCs, so long as both CFCs are in the same jurisdiction and the CFC that makes the payment is a non-attributing active CFC (i.e. passes the active business test).

The Bill modifies the requirement for foreign companies that are not CFCs, so that a similar exemption applies when the recipient foreign company has more than 50% of the voting interests in the foreign company that makes the payment. For payments between CFCs, the requirement that the CFCs be associated companies is unchanged, but some changes have been made to “same jurisdiction” test (see commentary on attributed foreign income – liability to tax). Payments between FIFs will have to pass a similar “same jurisdiction” test in order for the exemption to apply.

Example

Interest, royalty and rent payments from FIF 2 to FIF 1 would normally be attributable income of FIF 1. However because FIF 1 and FIF 2 are in the same jurisdiction (the UK) and FIF 1 holds more than 50% of the voting interests in FIF 2, the payments would be excluded from the definition of attributable income.



Amendment to definition of passive Telecommunications income

Subsection EX 20B(3)(m)(ii) of the Income Tax Act 2007 deems certain telecommunications services income to be attributable income to the extent to which the equipment is owned by “the CFC or by another CFC that is associated with the CFC”. This subsection is amended so it also covers situations where a CFC (or a FIF using the attributable FIF income method) is associated with a (second) FIF or CFC. In the absence of this change it would be possible to reduce a foreign company’s attributable income by dealing with an associated foreign company that is not a CFC.

RATIONALISING OTHER FIF CALCULATION METHODS

(Clauses 8(2), 15(2), 25(1), 25(2), 26(1), 26(3) to (7), 27, 28, 30, 33, 35(1), 35(3), 35(4), 35(5), 35(6), 36(7), 35(8), 35(10), 36 to 40, 42, 62, subclauses 126(2), (6) and (7), and clause 131)

Summary of proposed amendments

Investors who are unable to use the active income exemption (due to having a less than 10% shareholding or insufficient access to information) will use the rules that were developed for portfolio FIFs.

To achieve this, the fair dividend rate and cost methods will be available to most FIF interests and not just those that are a less than 10% interest. Investors will only be able to choose to use the comparative value method if they are a natural person or a trustee of a family trust. In addition, the accounting profits and branch equivalent methods will be repealed.

Investors with non-ordinary shares (i.e. shares that are economically equivalent to debt) will apply the comparative value method in cases where an end of year market value is available and the deemed rate of return method in cases where it is not.

Application date

The changes apply to income years beginning on or after 1 July 2011.

Key features

Under the existing FIF rules sections EX 46 and EX 62 limit an investor's choice of calculation method and their ability to change from a method they are currently using.

The Bill reforms these rules so that the fair dividend rate and cost methods will be available to most FIF interests and not just those that are a less than 10% interest. Investors will only be able to choose to use the comparative value method if they are a natural person or a trustee of a family trust.

Non-portfolio investors will generally be able to change to the fair dividend rate or cost method in respect of their first income year beginning on or after 1 July 2011.

Background

In 2007 some new methods were introduced for calculating income from less than 10% shareholdings in foreign companies (portfolio FIFs). As a consequence, such investors calculate income based on an assumed 5% rate of return (fair dividend rate method), although natural persons and trustees of family trusts can choose to be taxed on the actual returns of all of their foreign portfolio investments (although any losses are reduced to zero).

These new methods were limited to FIF interests of less than 10%. In cases where the investor cannot use the active income exemption, it makes sense to tax foreign investments consistently.

Accordingly, it is proposed that all investors who are unable to use the active income exemption for FIFs (due to having a less than 10% shareholding or insufficient access to information) will use the rules that were introduced in 2007 for portfolio FIFs.

Detailed analysis

Fair dividend rate and cost methods

The fair dividend rate and cost methods will no longer be limited to FIF interests of less than 10%. The Bill aims to achieve this by removing subsection EX 46(7)(a) and subsection EX 46(9)(a).

If a person does not choose a calculation method (and is not required to use a certain method), they are deemed to have chosen to use the fair dividend rate method, or the cost method if it is not practical to use the fair dividend rate method. This is achieved by changes to the default calculation methods in section EX 48.

Proposed repeal of accounting profits method

The Bill proposes that the accounting profits method be repealed with application from an investor's first income year beginning on or after 1 July 2011. Persons who used the accounting profits method in the year preceding the repeal of this method would be able to change to any other method (see new subsection EX 62(2)(a)), subject to the limits on the choice of method in section EX 46.

Comparative value method

Investors will only be able to choose the comparative value method if:

- a) the interest is a non-ordinary share under subsection EX 46(10); or
- b) if they are a natural person or a trustee of a family trust and do not use the fair dividend rate or cost method for any of their other interests.

This simply reflects the existing limitations on choosing the comparative value method under the portfolio FIF rules. The Bill aims to achieve this by removing subsection EX 46(6)(c) (which prevented the above limitations from applying to FIF interests of 10% or more).

Where a person chooses to use the comparative value method for one FIF interest they will not be able to use the fair dividend rate method or cost method for their other FIF interests. This result is achieved by existing section EX 46(8)(b).

Note that an investor would be required to use the comparative value method if they have a "non-ordinary share" (share that is equivalent to debt) as defined in section EX 46(10) and it is practical to get an end of year market value for that share. Subsection EX 46(6)(d) already achieves this.

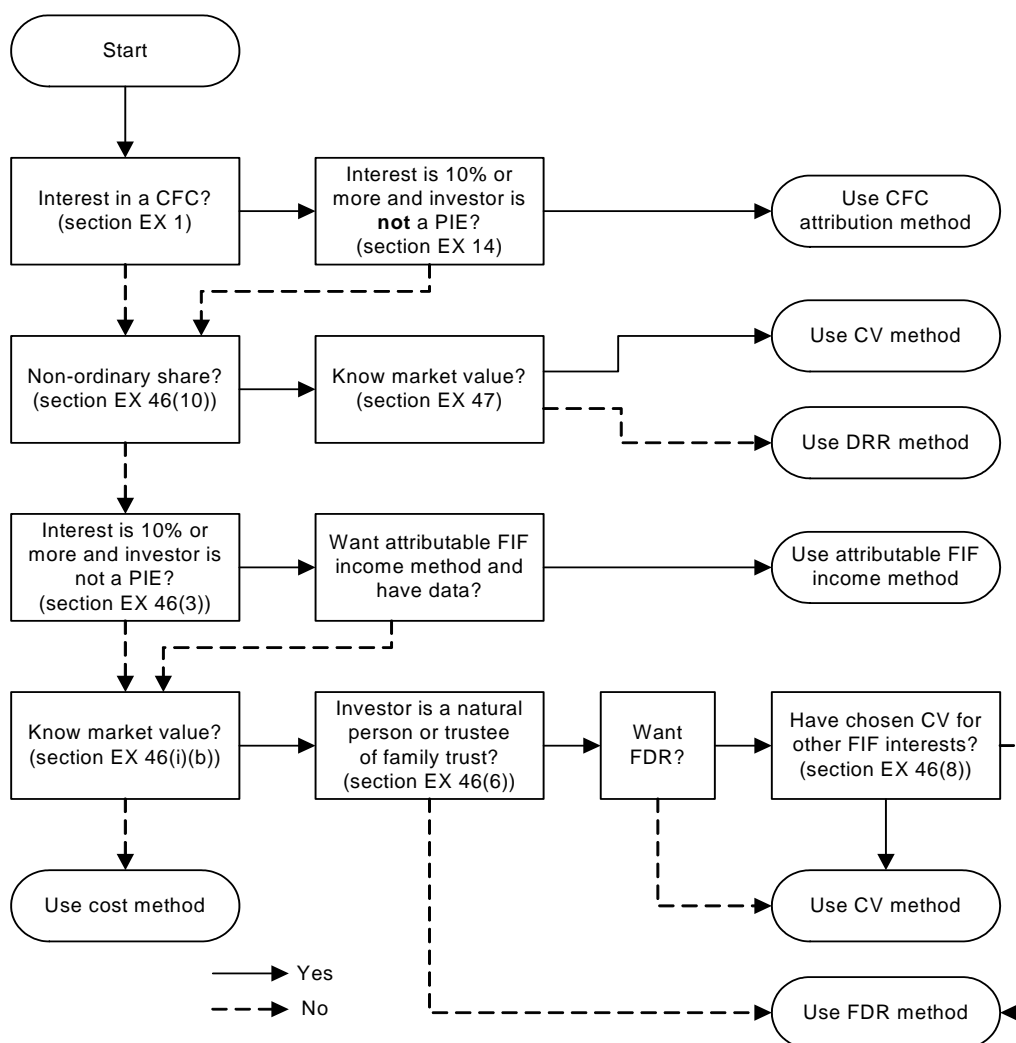
Investors will only be able to get a loss for an entire portfolio under the comparative value method if they have a non-ordinary share. Other losses for an entire portfolio using the CV method will be treated as zero income. The removal of subsection EX 51(7)(a) achieves this result.

Deemed rate of return method

Under the proposed rules investors will only use the deemed rate of return method when they have a non-ordinary share and it is **not** practical to get an end of year market value for that share. This is achieved through the repeal of section EX 46(4) and amendments to section EX 46(5). Now that non-portfolio investors can use the fair dividend rate and cost methods (which apply tax to an assumed 5% return), it is no longer necessary to allow taxpayers to choose to use the deemed rate of return method as this applies tax at a higher than 5% return.

Limits on choice of calculation method (section EX 46)

The following diagram summarises the main limitations that would apply to an investor’s choice of calculation method under the proposed amendments. Note the diagram does not include the rules in section EX 62 which limit an investor’s ability to change from a method that they are currently using to a different method. Changes to section EX 62 are described below.



Limits on changes of method (section EX 62)

In general, once investors start to use a calculation method for a FIF interest they are required to continue using the same calculation method. Section EX 62 supports this approach by providing a set of rules that limit an investor's ability to change from a FIF calculation method that they are currently using to a different FIF calculation method. The Bill proposes several changes to this section to reflect the changes to the available calculation methods. The limits on the choice of method under section EX 46 also apply when changing a method.

A proposed amendment to section EX 62(2)(a) would allow investors who used the accounting profits method in the year preceding the repeal of this method to change to any other method (see new subsection EX 62(2)(a)).

A proposed amendment to section EX 62(2)(c) would allow investors to switch from the comparative value method when it is impossible to find out the end of year market value of the interest or if they are prevented from using it because they are not a natural person or a trustee of a family trust or using it in respect of a non-ordinary share (i.e. section EX 46(6) prevents them from using it).

A new provision is proposed after section EX 62(9) that would allow investors to change to the fair dividend rate method (and by implication also the cost method) from the accounting profits method, the branch equivalent method or deemed rate of return method in respect of their first income year beginning on or after 1 July 2011. This reflects the fact that the accounting profits and branch equivalent methods have been repealed and the deemed rate of return method will only be used in the case of non-ordinary shares where it is not practical to get an end of year market value for the share.

A proposed amendment to section EX 62(6) would allow investors to change from the branch equivalent method to the attributable FIF income method. It would also allow investors to change to or from the attributable FIF income method on one occasion (not counting the initial change from branch equivalent method to attributable FIF income method). An investor will only be able to change to or from the attributable FIF income method a second time if there has been a change in circumstances that significantly changes their ability to obtain enough information to use the attributable FIF income method and if altering their income tax liability is not the principal purpose or effect of the change (section EX 62(7)). This is consistent with the existing restriction on changing to or from the branch equivalent method.

PIES WITH NON-PORTFOLIO INTERESTS IN CFCs OR FIFs

(Clauses 7(1), 9(2), 12, 18, 23 and 26(2))

Summary of proposed amendments

Proposed amendments will deem all CFC interests held by a portfolio investment entity (PIE) to **not** be CFC interests. Note this will not mean that the foreign company would stop being a CFC, it just means the PIE will use the FIF rules as opposed to the CFC rules. A similar amendment will prevent PIEs from using the attributable FIF income method.

Application date

The changes would apply to income years beginning on or after 1 July 2011.

Key features

Under proposed amendments to sections EX 14 and EX 34 an investor would only have a CFC interest if they have a 10% or more interest in the controlled company and if they are not a PIE. If they are a PIE they will have an ordinary (non-CFC) FIF interest in the company.

Proposed amendments to section EX 46 would prevent a PIE from using the attributable FIF income calculation method.

A proposed amendment to section CW 9 will prevent all PIEs from accessing the foreign dividend exemption (currently only multi-rate PIEs are excluded from this exemption). Note that PIEs will not actually be taxed on foreign dividends as they will be treated as only having FIF income from their FIFs (see section EX 59(2)).

Background

The interaction of the PIE rules and the active income exemption rules can lead to individuals who invest through a PIE being treated differently to other individual investors. If PIEs were able to access the active income and foreign dividend exemptions they would be able to pass foreign income through to their members with no New Zealand tax. In contrast, New Zealand tax would be payable in cases where a non-PIE company distributed untaxed foreign income.

Under the existing rules, PIEs can hold a 10-20% interest in a CFC (that is not a foreign PIE equivalent). In such cases they are required to apply the active income exemption to such interests. However, if the investors in the PIE held their share of the CFC directly, they would usually be required to use a FIF calculation method (as an interest of less than 10% in a CFC is not a CFC interest).

PIEs that have a 10% or greater interest in a CFC or FIF should not be considered to have a CFC interest, should not be able to use the attributable FIF income method to access the active income exemption, and should not be able to use the dividend exemption in section CW 9.

REPLACING THE GREY LIST EXEMPTION WITH AN AUSTRALIAN EXEMPTION

(Clauses 5, 8(1), 9(1), 15(1), 19(1), 24, 31, 32 and 34)

Summary of proposed amendments

The exemption for rights of 10% or more in FIFs that are resident in one of eight grey list countries is replaced with an exemption for rights of 10% or more in FIFs that are resident and subject to tax in Australia and that do not receive certain Australian tax concessions.

Application date

The proposed changes would apply to income years beginning on or after 1 July 2011.

Key features

Under the changes proposed in the Bill, the section EX 35 exemption will require an investor to have a direct income interest of 10% or more in a FIF that is resident and subject to tax in Australia. The FIF must not have had its liability for Australian tax reduced by an exemption related to income earned outside of Australia or from the concession for offshore banking units. The new provision is designed to accommodate cases where the FIF is not technically subject to tax in Australia because it is taxed as part of an Australian consolidated group in such a way that the head company pays tax on behalf of the FIF.

The exemption in section EX 35 does not apply to investments held by portfolio investment entities, superannuation schemes, unit trusts, life insurers or group investment funds. This is consistent with the exclusions from the existing grey list exemption.

Background

As part of last year's CFC reforms the exemption for CFCs located in eight grey list countries was replaced with an exemption for CFCs that are resident and subject to tax in Australia. (Section EX 22)

Consistent with this change, the Bill replaces the remaining grey list exemption for FIFs with an exemption for FIFs that are resident and subject to tax in Australia.

Branch equivalent tax accounts of
companies and conduit tax relief
accounts

REPEAL OF BRANCH EQUIVALENT TAX ACCOUNTS OF COMPANIES AND CONDUIT TAX RELIEF ACCOUNTS

(Clauses 4, 6, 10, 11, 52, 59 to 61, 63, 65, 67, 68, 75 to 96, 98, 100 to 102, 104 to 111, 113 to 115, 117 to 125, subclauses 126(5), (8), (10), (12) to (15), (17), (19), (22), (23), (26), (28) and (31) to (33), and clauses 127, 128, 130, 133 to 135 and 137 to 139)

Summary of proposed amendment

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 made major changes to the tax treatment of foreign investments.

Those changes made branch equivalent tax accounts of companies (BETAs) and conduit tax relief accounts (CTRAs) obsolete.

However, the government at the time announced that these memorandum accounts would be retained for a transitional period of two years, to allow the use of remaining BETA debits (to prevent double-taxation of foreign income) and the distribution of conduit-relieved income (to prevent the dilution of foreign dividend payment credits).

This Bill proposes provisions to remove the BETAs and CTRAs at the end of the relevant period, and to repeal associated provisions and references.

Application date

The proposed repeal of BETAs and related provisions applies, for most provisions, from the beginning of the fourth income year the taxpayer is under the new international tax rules (that is, the first income year beginning on or after 1 July 2012).

A restriction on elections to use BETA debit balances, limiting the use to relieving tax on attributed foreign income that is allocated to the second year under the international tax rules or to an earlier year, would apply from the first income year beginning on or after 1 July 2009.

The proposed repeal of CTRAs and related provisions would apply from the beginning of the first income year beginning on or after 1 July 2011.

Key features

BETAs will be repealed after three years under the new international tax rules passed in 2009, but debit balances will be able to be used to relieve tax on attributed foreign income only where that income is allocated to the second year under the new rules or to an earlier year. BETAs remain for the third year only to allow determination of income and filing of returns for the second year.

CTRAs will be repealed after two years under the new international tax rules. Dividends not paid before that date will not be able to have conduit tax credits attached to them.

Detailed analysis

All references in this part of the Commentary are to the Income Tax Act 2007, unless noted.

Branch equivalent tax accounts (BETAs) of companies

Branch equivalent tax accounts of companies are being phased out. Branch equivalent tax accounts of individuals (non-companies) are unaffected.

Paragraph FM 6(3)(d)

Proposed repeal of this paragraph along with BETA accounts of companies. Dividends between companies in a consolidated group are normally ignored, but are still taken into account for the purposes of the rules relating to BETAs. Once BETAs of companies cease to exist, this paragraph will become redundant.

Section GB 40

Proposed repeal of this section. Arrangements to avoid continuity restrictions on BETA account balances will cease to be relevant when BETA account balances are repealed. Arrangements affecting balances prior to repeal will still be caught, since the section applied at the time.

Paragraphs OA 2(1)(d), 5(5)(a), 5(5)(c), 6(5)(a), 6(5)(c), sub-paragraphs OA 7(2)(d)(i) and (ii), paragraphs OA 8(6)(c) and (g)

Proposed repeal or alteration of these provisions. With the repeal of BETAs of companies from the first income year beginning on or after 1 July 2012, no further credits or debits will arise in the accounts and there will not be any balances in the accounts. No further BETA debits will be used by companies to meet tax liabilities.

Section OA 9, paragraphs OA 10(1)(d) and 10(3)(c), subsection OA 14(6), and paragraphs OA 15(1)(c) and 15(3)(c)

Proposed repeal or alteration of these provisions. If an amalgamating company has a BETA, BETA debits and credits have to be transferred across to the BETA of the amalgamated company. The requirement to transfer the credits will no longer be necessary if either the amalgamating or amalgamated company has no BETA account.

Paragraph OB 4(3)(h)

Proposed repeal of this provision. From the beginning of the first income year beginning on or after 1 July 2012, a company will not be able to make an election to use a BETA debit balance to meet an income tax liability. In addition, even if it makes an election prior to that date, it will not be able to make the election in respect of a tax liability for income relating to an income year beginning on or after 1 July 2011. Paragraph (h) will therefore be redundant.

Subsections OE 7(3) and OP 101(2)

When the repeal of BETAs of companies was announced, the government said that there would be a two-year transitional period during which existing debit balances could continue to be used.

That is, companies will still be able to reduce their tax liability for attributed foreign income earned in the first two income years following application of the new income tax rules.

Because the amount of income for the second year will not be known immediately, it will be impractical to make elections to use BETA debit balances before the end of the second year. For that reason, BETAs will remain for a third year.

New requirements have been introduced in sections OE 7 and OP 101 to prevent elections to use BETA debits unless:

- the election is made before the end of the third income year; and
- the election relates to a tax liability for attributed foreign income that has been allocated to the second year or to an earlier year.

These requirements apply retrospectively from the date of application of the new international tax rules.

Subsections OE 1(1) and (3), sections OE 2 to OE 4, OE 6 to OB 16B, OP 97 to OP 98, OP 100 to OP 104B and OP 108B

It is proposed to repeal these provisions, which impose requirements on BETA companies to keep BETAs and make appropriate entries in them, with effect from the first income year beginning on or after July 2012. The BETA regime for companies and requirements to keep such accounts will be no longer required from that date.

Accounts must still be kept for the final year of the BETAs, even if only a part tax year because of the repeal (BETAs always have a 31 March “balance” date, which may not correspond to the end of an income year). Relevant information must also be provided in an imputation credit account (ICA) return for the final year, and records must continue to be kept for the normal record-keeping period (see commentary on changes to the Tax Administration Act 1994, below).

Subsection OE 5

This provision is modified to apply only to BETA accounts of individuals, following the repeal of the rules for companies.

Section OZ 16

It is proposed to repeal this provision at the same time as BETAs of companies. This was a transitional provision to reduce remaining balances in BETAs following changes to the corporate tax rate in Budget 2010.

Sub-paragraph YC 17(12)(b)(iii) and subsection YC 18B(3)

It is proposed to repeal or modify these provisions to remove redundant references to BETAs.

Paragraph 22(2)(f) and subsection 22(7) of the Tax Administration Act 1994

References to BETA accounts will be redundant from the time those accounts are repealed, so are being removed. Records for periods when BETA accounts were in existence are still required to be kept – that requirement arose before repeal.

Paragraph 69(1)(e) of the Tax Administration Act 1994

It is proposed to repeal this paragraph. BETA information of companies will no longer have to be included in the annual ICA return under this section, once returns have been completed for the tax years up and including the year during which BETAs were repealed. It is possible that the BETA will not exist for the entire tax year in the year BETAs are repealed. Nevertheless, under the existing provision, it is still required to include relevant BETA information in the ICA return (the person was a BETA company during the tax year).

Section 77 of the Tax Administration Act 1994

It is proposed to repeal this provision. The provision previously required an amended annual ICA return if a retrospective election to be a BETA company was made, to ensure a complete record of BETA transactions would be returned. It will not be possible to make elections to become a BETA company from the beginning of the income year beginning on or after 1 July 2012, retrospective or not. Since an ICA return must already (under paragraph 69) be provided for any tax year falling wholly or partly within the last income year for which a BETA exists, section 77 is now redundant.

Conduit tax relief accounts

Sections CW 11 and HA 17

It is proposed to repeal section CW 11. Dividends that are fully credited for conduit tax relief will no longer be exempt income of conduit tax relief holding companies if they are paid later than the beginning of the first income year of the recipient beginning on or after 1 July 2011. There are a number of consequential amendments to remove references to section CW 11 in other provisions.

Section FE 21(12)(a)(iii)

It is proposed to repeal this section. It will neither be possible for companies to attach conduit tax relief credits to dividends, nor to be conduit tax relief holding companies, from income years beginning on or after 1 July 2011. This makes section FE(12)(a)(iii) redundant from the beginning of that income year.

Section GZ 2

It is proposed to repeal section GZ 2 of the Income Tax Act 2007, which is an anti-avoidance rule, on the same date as CTRAs. After the repeal of CTRAs, this section becomes redundant and its removal from the Act therefore aids clarity.

The rule in section GZ 2 was enacted to prevent people running up CTRA credit balances in anticipation of them being cancelled under the new international tax rules, and then effectively directing tax-relieved income to residents.

The rules apply to an arrangement involving transactions that occurred between the date on which repeal of conduit accounts was announced and the enactment of the international tax rules, after which further conduit tax relief was prevented.

The anti-avoidance rule will still apply to such arrangements even after repeal of section GZ 2. The rule still applies because the arrangement was entered into before the repeal and the rule would have applied at that time, triggering the imposition of additional income tax.

Section HG 2(4)(c)

It is proposed to repeal this section. This provision states that partnerships are not subject to the “no streaming” rules in subsection HG 2(2) in respect of CTR additional dividends. However, there will be no such dividends paid in any income year beginning on or after 1 July 2011.

Section LQ 5

It is proposed to repeal this section. Since conduit tax credits will no longer be attached to dividends by a company in any income year beginning on or after 1 July 2011, CTR additional dividends will not be payable by the company from that time either.

Paragraph OA 2(1)(c), subsections 5(4) and 6(4), paragraph OA 7(2)(c), and subsections OA 8(5) and 18(1)

It is proposed to repeal these paragraphs and subsections. With the repeal of CTRAs from the first income year beginning on or after 1 July 2011, no further credits or debits will arise in the accounts and there will not be any balances in the accounts. No further CTR credits will be attached to dividends.

Paragraphs OA 10(1)(c), 10(3)(b), subsection OA 10(4) and paragraphs OA 15(3)(b), OB 24(3)(c) and OB 53(3)(c)

It is proposed to repeal or alter these paragraphs. At one time, if an amalgamating company had a CTRA but the amalgamated company did not, CTR credits were to be converted to imputation credits and FDP was to be paid. The requirement to transfer the credits ceased when the new international tax rules came into force.

Sections OC 19 and OP 70

These sections are being repealed at the same time as CTRAs cease. They allow for a transfer from a CTRA to a foreign dividend payment memorandum account in certain circumstances. With no CTRA, such transfers will no longer be possible.

Subpart OD and sections OP 78 to 80, OP 83 to 87, OP 89 to 94 and OP 96

The subpart and sections, which impose requirements on CTR companies to keep CTRAs and make appropriate entries in them, are being repealed with effect from first income year beginning on or after July 2011. From that time, there will be no CTRAs to meet requirements for.

Accounts must still be kept for the final year of the CTRAs, even if only a part tax year because of the repeal (CTRAs always have a 31 March “balance” date, which may not correspond to the end of an income year). Relevant information must also be provided in an ICA return for the final year, and records must continue to be kept for the normal record-keeping period (see commentary on changes to the Tax Administration Act 1994, below).

Section OZ 17

It is proposed to repeal this provision at the same time as CTRAs. This was a transitional provision to reduce remaining credit balances in CTRAs following changes to the corporate tax rate in Budget 2010.

Paragraphs RF 8(1)(c) and (f), subsections RF (9)(1), 9(6) and (7), paragraph RF 10(3)(a), subsection RF 10(4), paragraph RF 10(5)(e) and subsection RF 10(7)

It is proposed to repeal these paragraphs at the same time as CTRAs, since it will no longer be possible to attach CTR credits to dividends or to pay a CTR additional dividend.

Sections YD 9 to YD 11

It is proposed to repeal these sections at the same time as CTRAs. A CTRA holding company must be a CTR company, so these provisions will become redundant once CTRAs are repealed.

Paragraph 22(2)(k) and sections 29, 30A and 68A of the Tax Administration Act 1994

References to CTR accounts or to CTR credits will be redundant from the time those accounts are repealed and CTR credits can no longer be attached to dividends, so it is proposed to remove these references.

Paragraph 69(1)(f) of the Tax Administration Act 1994

It is proposed to repeal this paragraph. CTRA information will no longer have to be included in the annual ICA return under this section, once returns have been completed for the tax years up and including the year during which CTRAs were repealed. It is possible that the CTRA will not exist for the entire tax year in the year CTRAs are repealed. Nevertheless, under the existing provision, it is still required to include relevant CTRA information in the ICA return (the person was a CTR company during the tax year).

REMEDIAL AMENDMENTS: BRANCH EQUIVALENT TAX ACCOUNTS OF COMPANIES

(Clauses 99, 103, 112 and 116)

Summary of proposed amendment

Minor changes to the Income Tax Act 2007 are included in this Bill to ensure that branch equivalent tax accounts (BETAs) cannot go into credit.

Application date

Income years beginning on or after 1 July 2009.

Key features

Following the changes in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, all credit balances in branch equivalent tax accounts of companies (BETAs) were cancelled.

However, debit balances remained for a transitional period of two years. As these debit balances are used, credits are put into the account to cancel them out.

Minor changes to the rules are included in this Bill to ensure that BETAs cannot go back into an overall credit balance as a result of these credits.

Credits arising under sections OE 6, OE 9, OP 100 and OP 103 are now limited to the amount of an overall debit balance in the account at the time.

Changes to the thin capitalisation regime

APPLYING THE THIN CAPITALISATION RULES TO ACTIVE FIFS

(Clauses 44, 45(1), 45(2), 46(3), 47(4) and 56)

Summary of proposed amendments

The Bill modifies the thin capitalisation rules that apply to investors with CFCs so that these also apply to investors in FIFs that use the attributable FIF income method (i.e. active income exemption) or the section EX 35 Australian exemption. In the absence of such rules there could be an incentive for businesses to reduce their taxable income by stacking additional debt against their New Zealand operations when in fact they are using these funds to equity finance their exempt offshore investments.

Application date

The proposed changes would apply to income years beginning on or after 1 July 2011.

Key features

Amendments are proposed to the thin capitalisation rules so that investors using the attributable FIF income method, or that use the exemption for FIFs resident in Australia, are subject to the same thin capitalisation rules that currently apply to investors in CFCs.

More specifically, the amendments to outbound thin capitalisation rules would apply to New Zealand residents with CFCs or with FIFs for which they use the attributable FIF income method or New Zealand residents that use the section EX 35 exemption for FIFs resident in Australia. Assets from these entities will be included in the worldwide group assets but not in the New Zealand group's assets for the purposes of determining if the New Zealand group's debt to asset ratio is below 110% of the worldwide ratio (in which case there is no denial of interest deductions).

Background

One fiscal risk with the active income exemption is that it can create an incentive for businesses to reduce their taxable income by stacking additional debt against their New Zealand operations when in fact they are using these funds to equity finance their exempt offshore investments. This concern was addressed for CFCs through the use of thin capitalisation rules which limit the amount of New Zealand debt to 75% of the investor's New Zealand assets. A similar risk arises in respect of investors in FIFs that use the active income exemption. The Bill amends the thin capitalisation rules so that they also apply to investors in FIFs that use the active income exemption or the Australian exemption.

NEW THIN CAPITALISATION TEST FOR LOW-ASSET COMPANIES

(Clauses 47(1), 47(3), 47(5), 48, 49 and 136)

Summary of proposed amendment

A new thin capitalisation test is proposed for certain New Zealand-based groups with offshore investments. This will give certain New Zealand taxpayers an alternative test to comply with the thin capitalisation rules. Where New Zealand multinational groups have a high level of arm's length debt, and if certain other conditions are met, they can choose that the test for thin capitalisation be based on a ratio of interest expenses to pre-tax cash flows, rather than on a debt-to-asset ratio.

Note that further changes to the thin capitalisation rules are associated with the extension of the active income exemption for controlled foreign companies to non-controlling interests. Those changes are discussed in the previous section of this commentary.

Application date

For income years beginning on or after 1 July 2009.

This measure would apply retrospectively so that companies that may have experienced difficulties immediately after the extension of the thin capitalisation rules will be able to obtain relief.

Key features

A new thin capitalisation test is proposed for certain New Zealand-based multinationals.

The test is available to such a group if:

- the worldwide debt of the multinational is more than 75% of its worldwide assets (excluding any recognised goodwill); and
- at least 80% of the worldwide group's debt is from lenders that are not associated with a member of the group; and
- the New Zealand part of the multinational group and the worldwide group both have net income and net interest expenses (not net losses or net interest income).

The test is not available to entities that are non-residents or controlled by a single non-resident.

When the alternative test may be used, the taxpayer will calculate a ratio of net interest expense to net income, rather than the debt-to-asset ratio used under the existing test.

To the extent that the ratio for the New Zealand group is less than the minimum of:

- 50%; and
- 110% of the ratio for the worldwide group;

there will be no denial of interest deductions under the rules. To the extent these conditions are not met, interest deductions will be denied.

Detailed analysis

All references are to the Income Tax Act 2007 unless stated.

Background

The thin capitalisation rules, which limit excessive interest deductions against the New Zealand taxable income of multinationals, were extended in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009.

Prior to the extension, they applied only to non-residents and residents controlled by non-residents. After the extension, they also applied to other taxpayers with controlling interests in foreign companies. As part of the Bill, the rules will be further extended to some taxpayers with non-controlling interests in foreign companies (see commentary on applying the thin capitalisation rules to active FIFs).

The extension of the rules has created difficulties for a small number of New Zealand-based groups reported to have high indebtedness.

The rules currently deny interest deductions if a group has a New Zealand debt-to-asset ratio that is both more than 75% and more than 110% of the worldwide debt-to-asset ratio of the group (that is, if debt appears to be concentrated in New Zealand).

The problem arises partly from the way assets are measured. Measurement is based on generally accepted accounting practice (GAAP). GAAP does not allow the recognition of some intangible assets, such as internally developed goodwill. Companies that have highly valuable brands, for example, cannot include those in the measure of assets unless they were purchased on the open market. This increases the debt-to-asset ratio and increases the potential for interest deductions to be denied.

A New Zealand company with valuable brands that looks to expand offshore by taking on debt may therefore find itself subject to the thin capitalisation rules, even though it is not unreasonably arranging to have its debts in New Zealand.

There are good reasons for the exclusion of internally developed goodwill and some other intangible assets from the GAAP measure of assets. Primarily, it can be extremely difficult to value intangible assets if there has not been an arm's-length transaction.

However, in cases where a company has significant intangible assets that cannot be counted, it is possible that a debt-to-asset ratio will be a misleading measure in terms of whether excessive debt has been stacked in New Zealand.

Alternative test

To address the problem some New Zealand-based groups are facing, a new test has been developed as an alternative to the existing test based on the debt-to-asset ratio. It uses a measure that approximates an interest coverage ratio (interest-to-cash-flows). Arm's-length lenders may be prepared to lend against cash flows even when recognised assets are low (interest coverage is often used in lending covenants).

Requirements for use of alternative test

Paragraph FE 5(1B)(aa)

An excess debt outbound entity is, broadly speaking, a person who is subject to the thin capitalisation rules solely by reason of a direct or indirect outbound investment from New Zealand.

This paragraph provides that an excess debt outbound entity is not required to apply the existing thin capitalisation rule in section FE 6, if it is able to choose and does choose to apply the alternative rule in section FE 6B.

Subsection FE 5(1BB)

This subsection provides that a person is able to choose the alternative rule in section FE 6B if the following four requirements are all met:

- Both the New Zealand group and the worldwide group of the person must have a positive amount of adjusted net profit for the year (adjusted net profit is further defined in subsection FE 5(1BC) and is determined mainly using financial accounts).
- Both the New Zealand group and the worldwide group of the person must have a positive amount of net interest expense, determined using the rules in the Income Tax Act as if there were no thin capitalisation rules, as if the relevant members of the worldwide group were residents, and as if the group were consolidated to eliminate internal balances and transactions (see commentary on section FE 12B).
- The worldwide group's debt-to-asset ratio, excluding any recognised goodwill but otherwise determined using the existing thin capitalisation rules, must be 75% or more.
- 80% or more of the worldwide group's debt (calculated in the normal way under the thin capitalisation rules) must be from people that are not associated persons of a member of the group.

The first two requirements are to prevent distortion when the formula in section FE 6B is applied.

The third requirement is that the worldwide group is highly indebted if all of its intangible assets are disregarded. If the group is not highly indebted in this circumstance, the existing test is more likely to work (it is less likely to be difficult for the company to push some debt offshore, for example).

The fourth requirement is to ensure that most of the debt is genuinely arm's-length debt, and not, for example, capital injected by shareholders in the form of debt.

Definition of adjusted net profit

Subsections FE 5(1BC) and FE 5(1BD)

The adjusted net profit of a group is a proxy, albeit an imprecise one, for net cash flow from operations. It corresponds approximately to the “earnings before interest, tax, depreciation and amortisation” measure used in financial markets, usually referred to by its acronym EBITDA.

The formula begins with net profit before tax for the relevant group (New Zealand or worldwide), determined using generally accepted accounting practice and consolidating companies for the purposes of eliminating intra-group transactions (see commentary on section FE 12B). A net loss is treated as a negative net profit. A pre-tax measure is used partly because the measure of tax expense used for GAAP purposes is unlikely to be a meaningful indication of current tax liabilities (or associated cashflows).

For the New Zealand group, certain income arising from an interest in a foreign company is then removed, again using generally accepted accounting practice to measure this income. The income is removed if the interest is an income interest in a controlled foreign company, or an interest in a foreign investment fund that qualifies for the Australian exemption in subsection EX 35(1), or an interest in a foreign investment fund for which the attributable FIF income method is used.

This income is removed because it is not subject to tax in New Zealand. An important part of what the thin capitalisation rules are trying to do is to ensure excessive deductions are not allocated to income that is not taxable in New Zealand.

Net interest deductions (deductions less income), as determined under the Income Tax Act but again on a consolidated basis, are then added to the remaining net profit. This gives an estimate of cash flows before interest expense. In the case of the worldwide group, relevant members are treated as if they were resident for this purpose.

Depreciation and amortisation, measured under GAAP, and again on a consolidated basis are then added back. These are non-cash expenses.

When there is no interest apportionment (i.e. no denial of deductions)

Subsections FE 5(1D) and (1E)

An excess debt outbound entity is not denied any interest under the apportionment rule in section FE 6B, if its New Zealand group’s ratio of net interest to adjusted net profit is less than the minimum of:

- 50%
- 110% of the worldwide group’s net interest to adjusted net profit ratio.

In other words, as long as the ratio is below a maximum ratio of 50% and net interest deductions correspond similarly to net profit in each of the New Zealand and worldwide groups, no interest deductions will be disallowed.

Net interest is defined in the same way as in subsections FE 5(1BB) and (1BD). The use of a net interest figure allows entities to reduce their apparent interest deductions for the purposes of thin capitalisation by on-lending their borrowings to foreign companies (pushing some debt offshore) and receiving corresponding interest income.

Adjusted net profit is defined in subsections FE 5(1BC) and (1BD).

The apportionment calculation

Section FE 6B

If a person is able to apply the alternative apportionment calculation, chooses to do so, and is not excepted by subsections FE 5(1D) and (1E), section FE 6B is the section used to perform the actual apportionment.

The amount of interest deduction denied is given by the formula in subsection (1). In practice, deductions are denied by adding back income rather than reducing deductions.

The terms in that formula are based on the interest-to-income ratio given by section FE 5(1E) and the thresholds seen in section FE 5(1D). “Net interest” is the actual amount of net interest deduction for the taxpayer (not the group) in the absence of the thin capitalisation rules.

Parallels with the existing interest allocation calculation in section FE 6 are evident.

Example: interest deductions denied

X Co, a resident company with a single resident shareholder, owns 100% of Y Co, a foreign company. X Co would have net interest deductions of \$1 million in the absence of the thin capitalisation rules, and the worldwide group would have net interest deductions of \$3 million. X Co’s adjusted net profit is \$3 million and the worldwide group’s adjusted net profit is \$12 million. Assume X Co is able to use the alternative apportionment calculation. Then:

net interest is \$1 million;

NZ group ratio is .333... ($\$1 \text{ million} \div \3 million);

threshold ratio is .275 ($1.1 \times \$3 \text{ million} \div \12 million); and

the formula gives a result of \$175,000 ($\$1 \text{ million} \times [.333... - .275] \div .333...$).

Therefore only \$825,000 of interest deductions is effectively permitted.

Note that if X Co instead had \$825,000 of interest deductions in the first place, and the worldwide group’s deductions were unchanged, the NZ group ratio would be exactly equal to 110% of the ratio for the worldwide group, and deductions would not be denied.

Machinery provision

Section FE 12B

Section FE 12B specifies that certain amounts used in the thin capitalisation test are to be calculated using generally accepted accounting practice and on a consolidated basis.

In the case of interest deductions and interest income, there are specific instructions to use tax concepts rather than accounting concepts to calculate the base amounts, but consolidation of these amounts is still undertaken using accounting principles. This is similar to the treatment of debt under the existing thin capitalisation test, in which the relevant debts are determined by the tax rules but consolidation occurs using accounting principles.

Section FE 12B also limits the consolidation of amounts of any non-resident group members to the amount that is attributable to New Zealand-sourced income.

Administrative requirements

Section 65B of the Tax Administration Act 1994

Taxpayers who use the proposed new rule must meet the following administrative requirements:

- Firstly, the taxpayer must advise the Commissioner, in any manner the Commissioner may specify that the rule has been applied.
- Secondly, the taxpayer must provide reconciliations of adjusted net profit to GAAP net profit, and of goodwill to items presented in the GAAP balance sheet, in any manner the Commissioner may specify.

The advice and reconciliations must be furnished to the Commissioner by the due date for the taxpayer's tax return for the relevant tax year under section 37 of the TAA.

These requirements will enable Inland Revenue to monitor the extent of use of the alternative thin capitalisation rule and the appropriateness of the measures used in it.

STATE-OWNED BANKING GROUPS

(Clauses 45(3), 57, 58 and 126(29))

Summary of proposed amendment

The thin capitalisation rules are proposed to be altered to permit the Kiwibank group of companies to be treated separately from the rest of the New Zealand Post group. This is to reduce compliance costs and to ensure that the appropriate thin capitalisation test is used for the non-banking part of the New Zealand Post group.

Application date

For income years beginning on or after 1 July 2009.

This measure would apply retrospectively.

Key features

The thin capitalisation rules are proposed to be altered so that:

- a state-owned banking group (the Kiwibank group of companies) is not subject to the thin capitalisation rules by reason of New Zealand Post's non-banking activities; and
- the New Zealand Post group may exclude the Kiwibank group of companies from its New Zealand group, so that it will apply the ordinary thin capitalisation rules rather than the thin capitalisation rules for banks.

These alterations apply only so long as the Kiwibank group of companies is not subject, in its own right, to the thin capitalisation rules (for example, by directly acquiring a controlled foreign company).

Detailed analysis

All references are to the Income Tax Act 2007 unless stated.

Background

The thin capitalisation rules, which limit excessive interest deductions against the New Zealand taxable income of multinationals, were extended in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009.

Prior to the extension, they applied only to non-residents and residents controlled by non-residents. After the extension, they also applied to other taxpayers with controlling interests in foreign companies.

The New Zealand Post group has such controlling interests, so is newly subject to thin capitalisation.

Because of the way the existing rules work, every New Zealand member of the group is subject to the rules, including Kiwibank. And because Kiwibank is a registered bank, the entire group must apply the special subset of thin capitalisation rules that apply to banks.

This requires undertaking costly calculations for the non-bank members of the group (for bank members the calculations are based on information that is already produced) and allows debt to be, roughly, 96% of assets. 96% was determined to be an appropriate ratio for a bank when the thin capitalisation rules for banks were introduced, but is unusually high for the significant non-banking operations of the group (75% is the standard ratio for groups without a registered bank).

Changes to rules

The Bill changes the rules so that a New Zealand state-owned banking group can be treated separately from non-banking activities in the same group.

Subsection FE 2(5)

New subsection FE 2(5) removes the requirement for a member of a state-owned banking group, to which section FE 36B applies, to take into account CFC or FIF interests held by associates outside the group (such as under sections FE 38, FE 41 or EX 15).

In effect, this removes Kiwibank from the scope of the interest apportionment rule in section FE 7; interests held by non-banking members of the New Zealand Post group no longer need to be counted. However, it only removes Kiwibank from this scope because no member of the banking group currently has its own interest in a non-portfolio FIF or CFC. If a member were to acquire such an interest, all members of the group would be within the scope of section FE 7 again.

Section FE 36 and 36B

The definition of a New Zealand banking group is proposed to be altered so that, in the exclusive case of a registered bank that is 100%-owned by the New Zealand government the group consists of:

- the registered bank;
- a company with a direct 100% voting interest in the registered bank; and
- those entities that are part of the financial reporting group for which the registered bank is the reporting entity, or would be part of it but for relevant materiality thresholds. The terms “financial reporting group” and “reporting entity” are defined by the Financial Reporting Act 1993.

This isolates the Kiwibank group from the rest of the New Zealand Post group. Without the alteration, the entire New Zealand Post group including Kiwibank would be treated as a New Zealand banking group.

The isolation relies on the definition of a New Zealand group for a company that is not part of the Kiwibank group. Paragraph FE 28(1)(c) excludes members of a New Zealand banking group from that New Zealand group (a New Zealand banking group exists despite the non-application of section FE 7 to that group). In other words, that company's New Zealand group will be all the New Zealand-based entities in the New Zealand Post group except those in the Kiwibank group. That company will therefore use the standard apportionment rule in section FE 6 and not the banking rule in section FE 7.

The new rule in section FE 36B may not apply in certain situations. Specifically, a member of the New Zealand banking group (determined as if section FE 36B applied) may have interests in an offshore company that would bring it within the scope of section FE 2, even ignoring interests of associated persons outside the group under sections EX 15, FE 38 and FE 41. If that is the case, the existing rules in section FE 36 are invoked. (To prevent circularity, subsection FE 2(5) is ignored when deciding whether or not section FE 2 would apply).

That is, if a member of the Kiwibank group had an interest in a controlled foreign company or certain interests in foreign investment funds, the entire New Zealand Post group would again be a New Zealand banking group.

A decision has been taken at this stage not to develop more complex rules which might apply if both the banking and non-banking operations of New Zealand Post had offshore operations (currently only the non-banking operations do). In that case, there is a fall-back to the rules existing before the Bill.

A more comprehensive solution may be considered at a later date, perhaps in conjunction with other work on thin capitalisation.

APPLICATION TO NON-RESIDENTS WITH NO FIXED ESTABLISHMENT

(Clauses 46(1), 46(2), 50, 51 and 53 to 55)

Summary of proposed amendment

The Bill proposes changes to the thin capitalisation rules to limit their application in the case of non-resident companies that do not carry on business through a fixed establishment in New Zealand. Such companies will no longer be subject to the rules if all their New Zealand-sourced income that is not relieved under a double tax agreement is non-resident passive income.

Application date

Income years beginning on or after 1 July 2011.

Detailed analysis

The thin capitalisation rules currently apply to non-resident companies that have New Zealand-sourced income that is not relieved under a double tax agreement, even if the company has an insignificant physical presence in New Zealand.

This is to ensure that such non-residents are not artificially lowering their taxable income by debt-funding their New Zealand activities or investments.

However, the inclusion of such companies causes difficulties with the definition of the “New Zealand group” under the rules, and may bring in non-resident entities that should not logically be included.

When the New Zealand-sourced income is “non-resident passive income”, it is subject to a withholding tax in New Zealand which is typically a final tax. That is, no interest deductions may be taken against the income. In such a case, it is not necessary to apply the thin capitalisation rules.

The Bill makes changes to stop the thin capitalisation rules applying to non-resident companies that are currently caught by the rules only because they have New Zealand-sourced income, but have purely non-resident passive income.

EXEMPTION FROM THE OUTBOUND RULES

(Clause 47(2))

Summary of proposed amendment

Section FE 5(1B)(b) provides an exemption from the thin capitalisation rules for excess debt outbound companies if total interest deductions for the New Zealand group do not exceed \$250,000. This exemption is rendered effectively redundant by section FE 6(3)(ac)(ii) which reduces to zero the deductions subject to apportionment under the rules where the finance costs of an outbound entity do not exceed \$1 million. Accordingly, it is proposed that section FE 5(1B)(b) is repealed.

Application date

Income years beginning on or after 1 July 2011.

Detailed analysis

Section FE 5(1B)(b) and section FE 6(3)(ac)(ii) provide overlapping exemptions from the thin capitalisation rules for excess debt outbound companies. Because the threshold for the latter exemption is more generous, section FE 5(1B)(b) is now largely redundant and ought to be repealed.

There are some minor differences in scope between section FE 5(1B)(b) and section FE 6(3)(ac)(ii), as noted below. It is not considered that these differences affect the case for a simple repeal of section FE 5(1B)(b).

Section FE 5(1B)(b) sets the \$250,000 exemption threshold based on interest deductions under sections DB 6 to DB 8, whereas the \$1 million threshold in section FE 6(3)(ac)(ii) also takes account of “FRD” (basically, fixed-rate dividends: see section FE 6(3)(ab)). In this regard, section FE 6(3)(ac)(ii) is less generous than section FE 5(1B)(b) and it is possible that, where fixed-rate equity is used in place of ordinary debt, the latter may provide an exemption where the former does not. However, since the thin capitalisation rules now extend to cover FRD, the approach taken in section FE 6(3)(ac)(ii) is appropriate. Again, this supports the conclusion that section FE 5(1B)(b) can be repealed.

The \$250,000 exemption under section FE 5(1B)(b) is not available when the New Zealand group includes an entity with an income interest in a CFC that is deriving rent from land in the CFC’s local jurisdiction. There is no equivalent exclusion from the \$1 million exemption under section FE 6(3)(ab), which means that this rule will seldom bite in practice.

Zero rate of AIL on bonds

ZERO RATE OF AIL ON QUALIFYING BONDS

(Clause 142)

Summary of proposed amendment

The Bill seeks to remove a potential tax barrier to non-resident investment in New Zealand corporate bonds. More specifically, the approved issuer levy would apply at a zero percent rate (as opposed to the usual 2 percent rate) on interest that is paid in respect of debt securities that satisfy a set of strict requirements designed to limit the zero rate to bonds that are widely held and issued in New Zealand and to guard against the fiscal risk of closely-held debt being packaged or reclassified so as to qualify for the zero rate.

The 2% rate of AIL will be retained and AIL will be considered to be paid when either the 2% rate, or the new nil rate applies. This ensures that a nil rate of non-resident withholding tax (NRWT) can still apply when the borrower and the lender are not associated.

Application date

The proposed changes would apply to interest payments made on or after the date the Bill is enacted. This means that the zero rate will be able to be used in respect of future interest payments on bonds which have been issued prior to the Bill being enacted.

Key features

The debt security must first comply with the existing AIL registration requirements in section 32M of the Tax Administration Act 1991 and section 86H of the Stamp and Cheque Duties Act 1971 to get the 2% rate of AIL.

The Bill proposes inserting a new section 86IB into of the Stamp and Cheque Duties Act 1971 which would set out the requirements that a registered security must meet to qualify for the zero rate of AIL. These are:

- that the security is denominated in New Zealand dollars; and
- that the security was offered to the public for the purposes of the securities Act 1978; and
- that the security was not issued as a private placement; and
- that the security is not an asset-backed security; and
- that the registry and paying agent activities for the security are conducted through one or more fixed establishments in New Zealand; and
- that the security is listed on an Exchange registered under the Securities market Act 1988 (i.e. the NZDX) or satisfies a widely-held test.

The widely-held test is outlined in new section 86IB(2). A bond needs to satisfy the widely-held test at, or before the time of the interest payment. This means that if the test has been satisfied on one previous occasion it is not necessary to re-apply the test a second time.

There are two parts to the widely-held test. Firstly, the securities must be held by at least 100 separate persons whom the issuer could not reasonably expect to be associated with the issuer or with one of the other 99 persons holding the bonds. The second part of the widely-held test is that no person or group of associated persons holds more than 10% of the value of the securities at the time the test is applied.

Regardless of whether they pay AIL at 2% or 0%, the approved issuer will generally need to continue to file an AIL return/payment slip by the 20th day of the month following the month in which an interest payment was made. This slip will now require the approved issuer to record the total amount of interest payments which have been zero-rated.

Background

New Zealand's non-resident withholding tax (NRWT) and approved issuer levy (AIL) rules have been identified as a potential tax barrier to non-resident investment in New Zealand corporate bonds.

NRWT generally applies at a rate of 10% on interest payments made by a New Zealand borrower to a non-resident lender. However, in cases where the New Zealand borrower and the lender are unrelated, an approved issuer levy (AIL) of 2 percent can be paid as an alternative to paying NRWT.

The AIL and NRWT rules can increase the effective interest rate of bonds issued to non-residents. For example, a non-resident investor who requires a 10 percent return to buy bonds from a New Zealand company would require the company to pay an interest rate of 10% to the investor and a further 0.2% to Inland Revenue, increasing the company's cost of funds.

One way to remove the tax barrier to non-resident investment in bonds would be to have a zero rate of AIL apply on all debt instruments between unrelated persons. However, this would have very high fiscal cost. In addition to the foregone AIL revenues (about \$62m a year), an unrestricted exemption could encourage some domestic lending activity to shift offshore. In such cases, the margin earned on the loan would no longer be subject to New Zealand tax. This could pose a significant fiscal risk because of the importance of the banking sector to New Zealand's corporate tax base. This makes it critical to ensure that interest paid on closely-held debt (such as loans, syndicated loans and private placements) is excluded from any exemption.

Accordingly, the Bill limits the zero rate of AIL to bonds that meet a set of strict requirements designed to limit the zero rate to bonds that have been widely-held and issued in New Zealand and to guard against the risk of closely-held debt being packaged or reclassified so as to qualify for the zero rate.

Detailed analysis

In order to access the zero rate of AIL, the issuer of the security must register to pay AIL in the first place. The issuer of the security must be an approved issuer under section 32M of the Tax Administration Act 1991 and must have registered the security under section 86H of the Stamp and Cheque Duties Act 1971. This allows them to pay AIL at a rate of 2%.

The Bill amends section 86I of the Stamp and Cheque Duties Act so that AIL is considered to be paid when either the existing 2% rate is paid, or the new nil rate applies. When AIL is considered to be paid, a nil rate of non-resident withholding tax will apply under section RF 12 of the Income Tax Act so long as the borrower and lender are not associated and so long as the interest is not jointly derived with a New Zealand resident.

Regardless of whether they pay AIL at 2% or 0%, approved issuers will need to continue to file an AIL return/payment slip by the 20th day of the month following the month in which the interest payment was made. This slip will now require the approved issuer to record the total amount of interest payments which have been zero-rated. A person will not generally be able to get the zero rate of AIL in respect of any interest payments in which they fail to provide this information by the 20th day of the following month. However, there is scope for the Commissioner to provide a later deadline in a notice given to the approved issuer. Alternatively an approved issuer that is late at supplying this information would still be able to get a 2 percent rate of AIL (i.e. under section 86I(a)) if they pay AIL at a later date along with any interest and penalties.

The Bill proposes inserting a new section 86IB into the Stamp and Cheque Duties Act 1971 which would set out the requirements that a registered security must meet to qualify for the zero rate of AIL.

Issued in New Zealand

To qualify for the zero rate of AIL the bonds must be issued in New Zealand.

Bonds issued offshore do not contribute to the development of capital markets within New Zealand. The objective of the zero rate of AIL is to remove a potential obstacle to the further development of the New Zealand bond market (bonds issued in New Zealand and denominated in New Zealand dollars) as opposed to reducing taxes on foreign debt funding more generally.

The first requirement is that the securities are denominated in New Zealand dollars.

A supporting requirement is that the activities of the registrar and paying agent for the security are conducted through one or more fixed establishments in New Zealand (i.e. these activities are carried out in New Zealand). Bonds will be registered with a registrar whose role is to check that the bonds comply with relevant legal obligations and that the amount of bonds on issue matches the amount of bonds authorised by the company. A paying agent is an agent who accepts payments from the issuer of a security and then distributes the payments to the holders of the security.

Issued publicly

Two requirements are used to limit the zero rate to bonds that are issued publicly.

Firstly the securities must be an offer of securities to the public under the Securities Act 1978. The Securities Act does not expressly define an offer of securities to the public, but section 3 of the Act provides guidance as to how the phrase should be interpreted. Section 3 of the Act lists people who are not considered to be members of the public. These include associates, institutional investors, underwriters and investors who pay a minimum subscription price of at least \$500,000 before allotment of the securities. The Securities Act requires the preparation of an investment statement, a registered trust deed and (generally) a registered prospectus before a debt security can be issued to the public.

Secondly the securities were not issued as a private placement. A “private placement” is not a formally defined term in the Income Tax Act so this exclusion relies on the ordinary commercial meaning of a private placement. For example, securities that were exclusively issued to a group that were pre-selected by the issuer would probably be considered to be a private placement.

Not an asset-backed security

The securities cannot be asset-backed securities. Again, an “asset-backed security” is not formally defined so would be interpreted using the ordinary commercial meaning of this term. For example, securities whose interest payments were directly financed out of cash-flows from a pool of financial assets such as mortgages or other loans could be considered to be asset-backed securities. The purpose of this requirement is to deny the nil rate of AIL in cases where a group of loans have been bundled together and securitised into a bond. The concern is that such securities could be used to effectively shift the margin earned on closely-held loans (such as mortgages) outside the New Zealand tax base. Note that this measure is not intended to exclude bonds that are simply secured against a collateral asset which the bond holder can claim in the case of default.

Listed on the NZDX or widely-held

Finally the securities must either be listed on an exchange registered under the Securities Market Act 1988, or alternatively pass a widely-held test. Currently, the NZDX is the only debt exchange that is registered under the Securities Market Act. Securities listed on the NZDX will not need to apply the widely-held test and are expected to generally satisfy the other requirements listed above.

The widely-held test is outlined in new section 86IB(2). A bond needs to satisfy the widely-held test at, or before the time of the interest payment. This means that if the test has been satisfied on one previous occasion it is not necessary to re-apply the test a second time.

There are two parts to the widely-held test. Firstly, the securities must be held by at least 100 separate persons whom the issuer could not reasonably expect to be associated to the issuer or with one of the other 99 persons holding the bonds. For example, if there are two associated persons who each hold a bond, these persons should only be counted as one person for the purposes of this test.

Note that the securities need not all be issued on the same date so long as the debt securities are identical (i.e. they are fungible). For example if half the bonds were issued in January and half in August and by the 14th of September the total number of bondholders has reached 100 persons, then the test could be satisfied in respect of interest payments made on or after the 14th of September. This means that issuers can build up to 100 investors over time, although they will only get the nil rate of AIL in respect of interest payments made on or after the first day that the securities satisfy the test.

If the number of persons who holds the bonds subsequently drops below 100, the test will still be satisfied so long as this threshold was not met simply because of an arrangement (that the issuer could reasonably be expected to be aware of) that was intended to temporarily increase the number of persons holding the bonds.

The second part of the widely-held test is that no person or group of associated persons holds more than 10% of the value of the securities at the time the test is applied. If a person subsequently comes to hold more than 10% of the bonds, the test will continue to be satisfied.

Miscellaneous remedial changes

REVALUING INHERITED FORMER GREY-LIST SHARES

(Clause 41)

Summary of proposed amendment

The Bill proposes re-valuing some foreign shares which were inherited prior to the introduction of inheritance rules in October 2005. Some investors claim that these shares have a nil or low cost. This means they qualify for the \$50,000 “de minimis” exemption from the FIF rules, even though the market value of the shares at the time of the bequest may have been considerably higher than \$50,000. It is not appropriate that these shares continue to be exempt from tax.

Application date

The revaluation of these shares will occur on the date the Bill is enacted.

Key features

It is proposed that a new section EX 67B will apply to shares in FIFs that were inherited at zero cost or at the cost of the person that made the bequest. It will only apply if the FIF was a grey list company at the time the shares were inherited and if the shares were inherited prior to 1 April 2007 (when the grey list exemption was abolished for portfolio shares). These shares will be subject to a deemed sale and reacquisition at market value on the date that the Bill is enacted.

The consequences of this deemed sale and reacquisition would be:

- a taxable capital gain if the interest is held on revenue account; and
- entry into the normal FIF attribution rules unless the total cost of FIF interests (including the newly determined market value of the re-valued interests) is less than \$50,000, or some other exemption (e.g. sections EX 31-39) applies.

Any resulting tax liabilities will be able to be spread over 3 years, with at least one third paid in the first year, one half of the remaining tax paid in the second year, and the rest in the third year after the year the disposal takes effect.

Background

Under the FIF rules, if a person has attributing FIF interests that cost less than \$50,000, that person has no attributed FIF income (paragraphs CQ 5(1)(d) and (e)).

If a person inherits shares, then the cost base of those shares is their market value at the time of transfer or, if certain other conditions are met, their original cost to the transferer (see subpart FC which primarily relates to transfers to close relatives).

However, the inheritance rules in subpart FC are a relatively recent development, applying from 1 October 2005. Prior to the existence of these rules, it was often argued that inherited assets had a cost base of nil. A cost base of nil could have persisted until there was another transfer of the shares.

The problem relates mainly to inherited interests in FIFs from former “grey list” countries; most other FIF interests would have a market-value cost base following inheritance.

There are some existing provisions to force a cost based on market value for attributing interests in a FIF, if those interests were not acquired for market value see (sections EX 67 and GC 4). However these provisions did not apply to interests that were grey list FIF interests at the time of transfer, because such interests were not attributing interests in a FIF.

It is not an appropriate outcome that people who inherited shares prior to the abolition of the grey list should continue to be carved out of the FIF rules indefinitely. The grey list is supposed to have been repealed for portfolio FIF interests.

QUALIFYING COMPANIES AMENDMENT

(Clause 66)

Summary of proposed amendment

It is proposed that qualifying companies will be excluded from having any income interests in a CFC or interests of 10% or more in a FIF.

Application date

The change would apply to income years beginning on or after 1 July 2009.

Key features

It is proposed that section HA8B(b) be amended to replace “attributing interests” with “interests”.

Background

As part of the Taxation (International Tax, Life Insurance and Remedial Matters) Act 2009, an exemption was introduced for foreign dividends derived by companies. This means that the exemption applies to qualifying companies even though these companies are able to pass exempt income out to their shareholders with no further tax. This is inconsistent with the fact that exempt foreign income would usually be taxed if received directly by an individual taxpayer or when un-imputed dividends were paid by a company to individual shareholders.

An amendment was made in the Taxation (International Tax, Life Insurance and Remedial Matters) Act 2009 to address this issue. However, the amendment refers to “attributing interests” in a FIF. This means that non-attributing active FIFs and FIFs that qualify for the grey list exemption could be under-taxed as these are not attributing interests.

AMENDMENT TO NON-RESIDENT EXCLUSION FROM CONDUIT ANTI-AVOIDANCE RULE

(Clauses 64 and 129)

Summary of proposed amendment

It is proposed that the conduit anti-avoidance rule in section GZ 2 be amended to exclude conduit tax relief received by a CTR-group member to the extent that the CTR-group member is owned by non-residents.

Application date

The change would apply to income years beginning on or after 1 July 2009.

Key features

Under the conduit tax rules chains of New Zealand holding companies were defined as “CTR group members” and each CTR group member was treated as non-resident for the purposes of the conduit rules to the extent that it was owned by non-residents (see sections YD 9 to YD 11).

The conduit anti-avoidance rule is intended to apply to tax relief arrangements that ultimately benefit a New Zealand resident investor. Amendments are made to the conduit anti-avoidance rule in section GZ 2 and the application of sections YD 9 to YD 11 to ensure that the definitions of resident and non-resident are consistent with those that previously applied under the recently repealed conduit tax relief rules.

Background

The conduit anti-avoidance rule is intended to claw back conduit tax relief from arrangements that were entered into in anticipation of the repeal of the conduit rules, and that had the effect of reducing the tax liabilities of New Zealand shareholders. This reflects the fact that conduit tax relief was designed to relieve tax on non-residents investing through New Zealand into CFCs. Conduit tax relief was not intended to apply to income that was ultimately owned by New Zealand residents. The conduit anti-avoidance rule applies to arrangements that generated conduit tax relief credits between 4 December 2007 (when an issues paper announcing this policy was released) and the date from which conduit tax relief was repealed. The anti-avoidance rule does not apply to conduit tax relief received by the conduit tax relief company itself, or by a CTR holding company for the CTR company.

These exclusions are intended to ensure that the anti-avoidance rule does not apply to residents that are holding companies for non-resident investors. However the exclusions fail to accommodate conduit tax relief companies that are held through a chain of more than two New Zealand companies that are ultimately owned by non-residents. Under the conduit tax rules such chains of companies were defined as “CTR group members” and each CTR group member was treated as non-resident for the purposes of the conduit rules to the extent that it was owned by non-residents (e.g. a CTR-group member that was 100% owned by non-residents would be 100% non-resident) (see sections YD 9 to YD 11).

Consistent with this, the Bill amends the anti-avoidance rule in section GZ 2 so that this rule does not apply in respect of conduit tax relief received by a CTR-group member to the extent that the CTR-group member is owned by non-residents.

ATTRIBUTED FOREIGN INCOME – LIABILITY TO TAX

(Clauses 19(3) to 19(5), 21, 22(1), 22(4) and 126(3))

Summary of proposed amendment

The Bill expands the scope of income that can be excluded from attributed foreign income, by permitting some companies, which are not recognised for tax purposes in the country they operate in, to nevertheless be treated as resident in that country.

The Bill also adds requirements to prevent abuse of the rules that allow some income to be ignored.

Application date

Income years beginning on or after 1 July 2009.

This amendment is retrospective so that affected taxpayers can benefit from the policy from the inception of the international tax rules, consistent with the original intent.

Key features

- Income a controlled foreign company receives from a non-attributing active CFC (an active business) resident in the same country may be ignored for tax purposes even if one or both CFCs are not liable to tax in that country.
- Income a controlled foreign company receives from rental property in the same country may be ignored even if the CFC is not liable to tax in that country.
- Income a controlled foreign company receives from telecommunications services between the country it is resident in and New Zealand may be ignored even if the CFC is not liable to tax in that country.
- A CFC may be part of a test group in the country it is resident in, even if it is not liable to tax in that country.

For these to apply the following requirements must be met:

- the CFC is a resident of the country in question under section YD 3 (this does not require liability to tax);
- the CFC is wholly-owned (directly or indirectly through a wholly-owned chain of companies) under the laws of both New Zealand and the foreign country, by another CFC that is resident in that country under section YD 3;
- that other CFC is liable to tax in the jurisdiction on the income of the CFC by reason of its domicile, residence, place of incorporation or centre of management, in the same period as the CFC would be liable if it were an ordinary company liable to tax;

- neither the CFC nor the other CFC is treated as a dual-resident; and
- neither the CFC nor the other CFC has a fixed establishment or a permanent establishment outside the country.

The first, fourth and fifth requirements are extended to apply to all companies, not just those that are not liable to tax in a particular country. If these requirements are not met, it will not be possible to use the exemptions for payments from a non-attributing active CFC, rent from property in the same country or income from telecommunications services between the CFC's country of residence and New Zealand, or to be in a test group, regardless of liability to tax.

As well as applying to CFCs, the proposed changes will also apply in respect of FIFs that use the attributable FIF income method.

Detailed analysis

All references are to the Income Tax Act 2007 unless stated.

Background

Same country exemptions

Existing law provides that amounts that would be included in attributed foreign income, for taxpayers with interests in foreign companies, may be ignored in some cases where the income arises in the same country as the foreign company (see paragraphs EX 20B(5)(c), (7)(a), (7)(c), (11)(a), (12)(a), and paragraphs EX 21D(1)(a) and 21E(2)(a)). To take advantage of these "same country exemptions", the foreign company must show it is resident in that country by reason of liability to tax.

When same country exemptions do not apply (not liable to tax)

Some entities that New Zealand considers to be foreign companies are not treated as taxable entities in the country where they are registered or organised. For example, a United States Limited Liability Company (LLC) such as a so-called "Delaware company" is often considered by the United States to be analogous to a partnership for tax purposes. In that case, it is not liable to tax in that country (though its shareholders may be) and the foreign company is not able to tax advantage of the same country exemptions.

When the current position makes sense

Excluding entities such as LLCs from the same country exemptions is often the correct result. For example, if an LLC owns an ordinary active company in the same country, and is able to extract the profit from that active company in the form of an interest payment, there may be very little foreign tax imposed on the income of the LLC, its shareholders, or the active company. In that case, New Zealand would not be happy to exempt the income from tax here.

When the exemptions should apply even though there is no liability to tax

However, there are cases where excluding entities such as LLCs from the same country exemptions is unnecessary and even counterproductive.

In particular, if the LLC is wholly-owned by another company in the same country, and that other company is liable for tax on the LLC's income, the outcome should be similar to the case in which all the companies are liable to tax in that country. In those cases, normal tax is paid on the active income of the group in the foreign country and New Zealand should be prepared to exempt the income here.

Remedial amendments when liability to tax is not an issue

The widening of the same country exemptions to entities that are not liable to tax in the foreign country has highlighted a number of situations in which the existing exemption – for entities that are liable to tax in the foreign country – may be too wide.

Companies may be resident by reason of liability to tax in more than one country. Or they may be resident in one country but conduct significant operations in another. In that case, it may not be appropriate to assume that the country in which income is being earned is ultimately taxing the income.

Imposing additional conditions on the same country exemptions for all entities

Paragraphs EX 20B(7)(a), EX 20B(11)(a), EX 21D(1)(a) and EX 21E(2)(b), subsections EX 20B(16), EX 21D(10), EX 21E(14), and definition of associated non-attributing active CFC in section YA 1

To limit the use of the same country exemptions to cases where it is more likely that active income is being taxed normally by the relevant foreign country, the Bill proposes three additional conditions for residence.

These are:

- firstly, that the CFC is a resident of the country in question under section YD 3;
- secondly, that neither the CFC nor the other CFC (in cases where there is a transaction between CFCs) is treated as a dual-resident; and
- thirdly, that neither the CFC nor the other CFC has a fixed establishment or a permanent establishment outside the country.

The existing section YD 3 determines a single country of residence of a CFC (it does not require liability to tax).

A CFC is regarded as a dual-resident if one or more of three conditions is met:

- the CFC is treated as a resident of a country other than the country in section YD 3 under the tax law of the relevant jurisdiction;
- the company is liable to income tax by reason of its domicile, residence, place of incorporation, or centre of management in a country other than the country in section YD 3;

- the company is treated as a resident of a country other than the country in section YD 3, under an agreement that would be a double tax agreement if New Zealand was a party to it.

“Fixed establishment” is a defined term in the Income Tax Act. “Permanent establishment” is an analogous term used in double tax agreements and extensively discussed in the OECD’s commentary to the Model Tax Convention on Income and on Capital.

Widening the same country exemptions for entities with no liability to tax

Paragraphs EX 20B(7)(a), EX 20B(11)(a), EX 21D(1)(a) and EX 21E(2)(b), subsections EX 20B(16), EX 21D(10), EX 21E(14), and definition of associated non-attributing active CFC in section YA 1

At the same time as clarifying the requirements for all companies that use the same country exemptions, the Bill widens the scope of the exemptions to include entities that are not liable to income tax because they are not considered to be taxable entities in the country where they are resident.

A CFC that is not liable to tax in the relevant country may still make use of the exemption if it meets the other conditions (above) and two further conditions are met:

- The CFC is wholly-owned, under the laws of New Zealand and the foreign country, either directly or through a chain of wholly-owned companies, by another CFC that is resident in the same country under section YD 3; and
- The other CFC is liable to tax on the income of the CFC in the relevant country by reason of its domicile, residence, place of incorporation or centre of management, in the same period as the CFC would be liable if it was an ordinary company liable to tax there.

Example: using same country exemptions when not liable to tax

Hold Co owns 100% of LLC Co, which in turn owns 100% of Op Co. All three companies are CFCs incorporated in and managed from the United States, and are treated as residents of the United States under section YD 3. None of the companies have operations outside the United States.

Op Co and Hold Co are liable to tax by reason of residence in the United States, but LLC Co is treated as a partnership for tax purposes and so is not liable to tax.

Op Co is a non-attributing active CFC.

Op Co pays interest to LLC Co.

The interest is not subject to tax in the United States in the hands of LLC Co, but is subject to tax in the hands of Hold Co.

LLC Co can ignore the payment of interest from Op Co, even though it is not liable to income tax in the United States. LLC Co is wholly owned by Hold Co, and Hold Co is liable to tax in the United States on LLC Co’s income (including interest income).

ACTIVE BUSINESS TEST – CLARIFICATIONS AND REMEDIAL AMENDMENTS

(Clauses 20, 22(2) and 22(3))

Summary of proposed amendment

The Bill proposes changes to the definitions of passive and total income used in the active business test for controlled foreign companies. These will make it easier to pass the active business test that is based on accounting data. The Bill also clarifies that when the active business test is applied to a group of CFCs, a CFC may not be included in more than one group.

Application date

Income years beginning on or after 1 July 2009.

This amendment is retrospective so that affected taxpayers can benefit from the policy from the inception of the international tax rules, consistent with the original intent.

Key features

The Bill proposes changes to ensure that:

- Rental income may be included in the measure of reported income in section EX 21E (which contains the active business test using accounting data).
- Income from financial arrangements that is received from a non-attributing active CFC may be excluded from the measure of passive income in section EX 21E.
- Income from some financial assets that are in the nature of accounts receivable may be excluded from the measure of passive income in section EX 21E.
- A CFC that is part of a “test group” for the purposes of the active business test under sections EX 21D or EX 21E cannot be part of another test group and cannot apply the test as an individual CFC.

The first three proposed changes fix unintended omissions. The final change is for clarification only, and does not – in our view – result in the effect of the law changing.

Detailed analysis

All references are to the Income Tax Act 2007 unless stated.

Background

The active business test is used when a New Zealand resident has an income interest in a foreign company. If the foreign company passes the active business test, the New Zealander may ignore the current income of the foreign company for tax purposes.

There are two forms of the test, one using accounting data and one using the usual provisions of the Income Tax Act for calculating income. In concept, both are similar – they measure the amount of passive income of the foreign company as a proportion of total (gross) income, and deem the company to be an active business if the proportion is less than 5%.

Passive income is exhaustively defined. For example, it explicitly includes rental income and interest income. However, there are numerous exceptions which allow a person to remove items if they wish. Total income is also defined.

It is possible for companies in the same country (in the case of some interests in foreign investment funds, companies in any country) to undertake the test as a group, using consolidated accounts. This may reduce compliance costs and also simplifies the treatment of holding companies or other companies with non-operational functions within the group.

Remedial changes

Paragraph EX 21E(10)(ab)

Reported revenue in section EX 21E(10) is the measure of total income for the purposes of the active business test using accounting concepts. Reported revenue includes “revenue” if IFRS is used, a term which is defined by International Accounting Standard 18. Lease income is generally excluded from the definition of “revenue” under that standard. Lease income is brought in under another item that is part of reported revenue, but only if it is income other than rent from finance or operating leases.

This means that rental income may not be able to be included in the measure of total income. This is not intended, and this Bill proposes an amendment to the definition of reported revenue so that rent may be included.

Paragraph EX 21E(9)(cb)

Reported passive in section EX 21E(7) is the measure of passive income that is used in the active business test using accounting concepts. One component of reported passive is income or loss from a financial asset, other than a derivative or a share on capital account. Accounts receivable can be financial assets. This means that gains or losses on accounts receivable – for example, due to exchange rate fluctuations – may be included in the measure of passive income. However, active businesses will have accounts receivable, so including them is not necessarily appropriate.

Reported passive also includes interest received from associated non-attributing CFCs. Such interest may not be ignored even though other forms of passive income from such CFCs can be (see paragraphs EX 21E(9)(a) to (c)).

The Bill makes a change to the measure of passive income to address these problems.

The change allows gains or losses on financial assets (including interest income) to be excluded from the measure of passive income if:

- they are included in the measure to begin with (see the existing provision at the beginning of subsection EX 21E(9)); and
- they could be excluded under the active business test that uses tax rules (see subsection EX 20B(12), but subject to the modification described below).

This allows the exclusion of amounts that are, broadly speaking, payments from related active entities and gains or losses relating to accounts receivable.

The exclusions in subsection EX 20B(12) are exclusions from financial arrangement income. The subsection does not apply to financial arrangement expenditure. However, in the context of section EX 21E, it would be inappropriate not to exclude expenditure if income was being excluded; section EX 21E refers to gains or losses from financial assets. Therefore, paragraph EX 21E(9)(cb) refers to any gain or loss on a financial asset that is a financial arrangement or agreement that subsection EX 20B(12) refers to (whether or not the arrangement or agreement actually generates income under that subsection). That is, a person may exclude gains under the exclusion, but only if they also exclude similar losses.

Clarification – test groups

Subsection EX 21B(4)

Subsections EX 21D(1) and EX 21E(2) each define a “test group” for the purposes of the active business test.

The Bill proposes a clarification to make it clear that a CFC may not be part of more than one test group, and may not apply the test on an individual basis if it is part of a test group.

ABILITY FOR COMMISSIONER TO IMPOSE CONDITIONS ON AN INSURANCE CFC DETERMINATION

(Clause 140)

Summary of proposed amendment

The Commissioner is currently able to issue a determination that an insurer is a non-attributing active CFC. The bill proposes that the authorising provision be amended to expressly give the Commissioner an ability to impose conditions for the application of the determination.

Application date

Income years beginning on or after 1 July 2009.

Key features

Proposed new section 91AAQ(5B) would allow the Commissioner to stipulate conditions that must be satisfied in addition to the existing requirements for a CFC or CFC group member to qualify as a non-attributing active CFC.

Background

As part of the Taxation (International Tax, Life Insurance and Remedial Matters) Act 2009, an exemption was introduced for insurance CFCs as a transitional measure until further work was done to develop special rules for financial CFCs more generally.

To qualify for this exemption the insurance CFC must first have applied for and obtained a determination from the Commissioner of Inland Revenue and this determination must not have expired or been revoked. Section 91AAQ of the Tax Administration Act 1994 regulates this process. The bill amends section 91AAQ to enable the Commissioner of Inland Revenue to be able to impose conditions on an insurance CFC determination. For example, a determination could be made conditional on the insurer informing the Commissioner of any significant changes to its organisational structure, funding or major business activities.

Note that the Commissioner already has the ability to revoke a previously issued determination.

FOREIGN DIVIDEND EXEMPTION – DEDUCTIBLE DIVIDENDS

(Clause 126(16))

Summary of proposed amendment

The Bill proposes a remedial amendment to the exemption for dividends received by companies. The amendment widens the definition of deductible foreign equity distribution to include dividends that are deductible to a person other than a company.

Application date

Date of introduction of the Bill, to prevent people taking advantage of the identified deficiency before it is remedied.

Key features

The proposed definition of deductible foreign equity distribution is widened to include payments received by a company that give rise to a deduction for foreign tax of any person, whether a company or not.

Previously, the definition was limited to amounts that were deductible to the company making the distribution, and to companies in the same group of companies as the distributing company.

Detailed analysis

All references are to the Income Tax Act 2007 unless stated.

Background

Most foreign dividends received by companies are exempt income (section CW 9). However, deductible foreign equity distributions are not exempt income. This limitation is intended to prevent double non-taxation of income (deductible in the foreign country, not taxable in New Zealand).

A deductible foreign equity distribution is defined to be, in the simplest case, a distribution that is deductible to the company making the distribution, or to another company in the same group of companies. There is also a further provision to deal with amounts sourced indirectly from amounts that may have been doubly non-taxed at an earlier stage.

We are aware of structures that have been contemplated by taxpayers and that can achieve effective double non-taxation of income without triggering the definition of deductible foreign equity distribution.

In particular, there are cases where New Zealand does not consider an entity to be a company, but the foreign country does and allows it a deduction that is attributable, directly or indirectly, to a dividend received by a New Zealand company.

Remedial change

Definition of deductible foreign equity distribution in section YA 1

The Bill proposes widening the definition of deductible foreign equity distribution to include payments that generate a deduction, for foreign tax purposes, for any person. This applies regardless of whether the person is an incorporated body or not (the Interpretation Act 1999 explicitly includes “an unincorporated body” in the definition of a person).

LOSSES OF CONTROLLED FOREIGN COMPANIES – TRANSITION

(Subclauses 70(1) and 70(2))

Summary of proposed amendment

The Bill proposes rewording transitional provisions dealing with losses arising under the old international tax rules, and being carried forward under the new international tax rules, to ensure the policy intent of these provisions is realised.

Application date

Income years beginning on or after 1 July 2009.

Detailed analysis

All references are to the Income Tax Act 2007 unless stated.

Subsections IQ 2B(1) and IQ 2B(2)

These provisions are intended to reduce carried-forward losses of controlled foreign companies (CFCs). This is because the losses arose at a time when all income was expected to be taxed, whereas only passive income will be taxed under the new international tax rules.

CFC losses are “ring-fenced” by country, so that they may be used only to offset CFC income from the same country. References to “a CFC or FIF that is resident in a country” were intended to refer to this ring-fencing, but may have created doubt that the transitional provisions apply to carried-forward losses of CFCs that have been liquidated or migrated.

The Bill rewords the provision to make clear that the transitional rule applies to all ring-fenced losses, as intended.

FOREIGN TAX CREDITS OF CONTROLLED FOREIGN COMPANIES – TRANSITION

(Clause 74)

Summary of proposed amendment

The Bill rewords transitional provisions dealing with foreign tax credits arising under the old international tax rules, and being carried forward under the new international tax rules, to ensure the policy intent of these provisions is realised.

Application date

Income years beginning on or after 1 July 2009.

Detailed analysis

All references are to the Income Tax Act 2007 unless stated.

Subsections LK 5B(1) and LK 5B(2)

These provisions are intended to reduce carried-forward foreign tax credits of controlled foreign companies (CFCs).

The Bill rewords the provision to make clear that the transitional rule applies to all carried-forward credits, as intended

The changes proposed are analogous to those for carried-forward losses (see commentary on carried-forward losses above).

OTHER REMEDIAL CHANGES

(Clauses 17, 70(5), 71, 126(19) and 141)

All references are to the Income Tax Act 2007 unless stated.

Paragraph (a) of the definition of fixed-rate share in section YA 1 is proposed to be amended with retrospective effect to make it clear that it applies to section FE 6 in the thin capitalisation rules. This corrects an oversight.

Section DX 3 is proposed to be repealed with effect from the 2013–14 income year. This repeal was missed when other provisions relating to supplementary dividend holding companies were repealed in an earlier amending act.

A proposed new subsection IQ 2B(11) provides an explicit currency conversion rule for determining carried-forward losses during a transitional period from the old to the new international tax rules. An explicit rule was not provided at the time the transitional rule was first enacted. The rule follows, broadly speaking, the existing treatment of foreign currency amounts in subpart YF. The amendment has retrospective effect.

The Bill corrects a drafting error in paragraphs IQ 3(1)(a) and (b), with retrospective effect (back to the application date of the Income Tax Act 2007). The paragraphs deal with carried-forward losses of foreign investment funds (FIFs) but erroneously referred to losses of controlled foreign companies (CFCs).

Clause 141 would re-enact a provision whose effective date had been unintentionally over-ridden because of an early application date in the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010.