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Thin capitalisation review: technical issues

1. On 16 May 2013 the Government announced as part of Budget 2013 that it has agreed to two key elements of the review of the thin capitalisation rules: applying the rules to groups of non-residents who "act together", and excluding shareholder debt from a company's worldwide group debt. A brief summary of what was proposed as part of this review is at the end of this note.

2. While the Government has agreed in principle to make those changes, the technical details have yet to be settled (for example, how "acting together" should be defined). This note sets out the views of Treasury and Inland Revenue on these technical issues.

3. We welcome feedback on these matters. Please direct your feedback or any questions you might have to policy.webmaster@ird.govt.nz. Please provide any feedback by 28 June 2013.

Acting together test

4. The issues paper proposed that the thin capitalisation rules would apply if a group of non-residents who are "acting together" owned 50% or more of a company. Acting together would not be exhaustively defined. This is similar to the approach taken in the United Kingdom.

5. Submitters were concerned about the uncertainty such a definition would create. We are therefore considering an alternative. Under this alternative, the thin capitalisation rules would apply if:

- 50% or more of the entity's shares are owned by a group of non-residents who (directly or indirectly) hold debt in the entity in proportion to their equity in the entity; or
- the entity has fewer than 25 shareholders and the shareholders have a shareholders' agreement that sets out how the entity should be funded, and 50% or more of the shares are owned by non-residents; or
- 50% or more of the entity's shares are held by are non-residents that are effectively co-ordinated by a person or group of people, such as a private equity manager or managers.

6. We envisage that proportionality would be the most commonly used test as it is a key indicator of "acting together". We want the thin capitalisation rules to apply when people are in the position to be able to arbitrarily substitute debt for equity. When debt is held in proportion to equity, the level of debt does not change shareholders' exposure to the equity risk of the company. The ultimate return to the shareholders will not change if the entity is 20% debt-funded or 80% debt-funded.

7. We are not convinced that shareholders are likely to arrive at proportional debt and equity without a level of coordination.

8. We are aware that the substituting debenture rules use a proportionality test. If we applied a proportionality test in the thin capitalisation rules we would ensure that the substituting debenture rule did not also apply to entities subject to the thin capitalisation rules.

9. The fewer than 25 shareholders test is designed to align with the stapled stock rules. Those rules do not apply if a company is not widely held and there is a shareholders' agreement that is used to staple debt and equity. Not being widely held, in effect, means a company has fewer than 25 shareholders. We expect that if there are 25 or more shareholders and they have agreements that specify how the entity should be funded then the stapled stock rules will generally apply.

10. The test's third limb is designed to target situations where numerous entities (e.g. partnerships) invest into a New Zealand operation but are all effectively co-ordinated by a single person or group of persons, such as a private equity manager. Our concern is that by providing only bright-line tests (e.g. fewer than 25 shareholders), the thin capitalisation rules could be easily structured around by such a person.

Shareholder debt excluded from worldwide group debt proposal

11. The issues paper proposed that shareholder debt be excluded from an entity's worldwide group debt levels. There are two situations where we expect this rule to have meaningful effect. The first is where the thin capitalisation rules apply because of the acting together test. In that case, the issues paper proposed that the worldwide group of the company would be the same as the New Zealand group. Because of this, excluding shareholder debt is important; there would otherwise never be any denial for a company with shareholders acting together. This is discussed in further detail below.

12. The second situation is where a group of companies has a high level of shareholder debt. The purpose of the worldwide group debt test is to act as a rough but convenient proxy for what a commercial level of gearing is for a group of companies. This purpose is not achieved if a group of companies is financed through shareholder debt because that debt does not face the same constraints as genuine external debt. The gearing level of the worldwide group might be much higher than what an external lender would be comfortable with.

13. We do not expect this to have much impact on publicly listed multinational groups because of consolidation. The ultimate shareholders of the parent company are unlikely to have significant debt with the company and inter-company debt within the group will be removed upon consolidation.

Effect of exclusion on those acting together

14. Under the proposals in the issues paper, this rule has a significant impact for those who come within the definition of "acting together". Due to difficulties in constructing a meaningful worldwide group in such a case, it was proposed that the worldwide group of the entity would be the New Zealand group.

15. This means that debt a shareholder borrows from a third party and pushes down to a New Zealand entity will not be treated as external debt. Equally, debt lent directly from a third party to a New Zealand entity, but secured against a shareholder's other assets, will also be treated as shareholder debt. In both of these cases the debt will not be counted as debt for the purposes of the 110% test.

16. Several submitters disagreed with this proposal. Submitters considered that genuine third-party debt that is pushed down should be counted in the worldwide group test. For those who provide a guarantee, submitters stated that treating it the same as shareholder debt overstates the value of the guarantee.

17. We have considered these points but ultimately do not agree. A fundamental principle of the thin capitalisation rules is to ensure that a non-resident does not allocate a disproportionate amount of its global debt to its New Zealand operations. However, in the case of non-residents acting together, there is no worldwide consolidation. It would therefore be possible for a non-resident to allocate debt that truly belongs to its other operations to its New Zealand investment.

18. A related objective of the thin capitalisation rules is to ensure that the level of debt put into a New Zealand company is commercially viable. As discussed above, the 110% worldwide group test is designed to be a rough but convenient proxy for a commercial level of gearing. If debt is secured against assets unrelated to the New Zealand operation, either because of a guarantee or because debt has been borrowed and then pushed down, there is no guarantee that this objective of a commercial level of debt will be achieved.

Effect of rule on widely held entities
19. Submitters were also concerned about the practicality of a widely-held company being required to exclude shareholder debt from its worldwide group. For example, a widely-held company may have publicly issued bonds, some of which may have been purchased by a shareholder.

20. To address this concern, we are considering altering this rule so that debt owed to a shareholder does not have to be excluded if the entity is publicly listed and has publicly traded debt and that shareholder owns less than 10% of the company.

Extension of the rules to trusts

21. At present the thin capitalisation rules apply only to trustees of non-complying trusts where more than 50% of the settlements came from non-residents. The rules do not apply to the trustees of other trusts that have been settled by non-residents. This is not appropriate.

22. The thin capitalisation rules generally drive off the ownership interests a person has in a company. This is not possible with trusts as there is nothing directly analogous to a shareholder.

23. This necessarily makes applying the rules effectively to trusts complex. Nevertheless, we believe it important to put effective rules for trusts in place as we are aware of a number of instances where trusts settled by non-residents are used to invest into New Zealand. The thin capitalisation rules would have applied had those investments been made by a company formed by non-residents. Therefore it is an important base protection measure.

Non-residents acting together: trusts
24. The alternative "acting together" test described above does not appear to be convertible to trusts. For example, the rule would be ineffective if it referred to people who provided settlements to a trust and extended debt to a trust in proportion. Unlike companies, trusts have no obligation to provide returns to settlors in proportion to the amount settled. Accordingly, a proportionality rule does not seem to work.

25. We therefore propose that, for trusts, the "acting together" test would remain as described in our original issues paper regardless of how it is defined for companies. In practice, this means if the alternative "acting together" is ultimately adopted, there will be two tests: one that applies to trusts and one that applies to companies.

Power to appoint trustee
26. In addition to the above, we are also proposing that a trust be subject to the thin capitalisation rules if a person that is subject to the thin capitalisation rules (i.e. is an entity described in section FA 2) has the power to appoint or remove a trustee of the trust.

27. This is an anti-circumvention measure. It is designed to ensure that the thin capitalisation rules apply if a non-resident takes over effective control of a trust (by being given power to appoint the trustee) that was originally settled by a New Zealand resident. We note that linking a trust and a person with power to appoint a trustee is not a novel concept: they are already treated as associated persons (section YB 11).

Worldwide group is New Zealand group for all trusts
28. We propose that the worldwide group of any trust (including a trust settled by a single non-resident) will be the same as the trust's New Zealand group. In addition, similar to the

shareholder debt exclusion for companies, any debt extended by a person associated with the trust (such as the trustees, settlor and beneficiaries of the trust) will be excluded from the trust's worldwide group debt.

29. Practically, this means a trust will not be constrained in how much debt it can obtain from genuine third-party lenders. However, there will be constraints on how much debt the trust can obtain from its associates – 60% (if the total gearing of the trust is 60% or less) or 10% of its genuine third-party debt.

30. This will also apply to any companies that are controlled by a trust that is subject to the thin capitalisation rules.

NZ group is trust and companies owned by trust are excess debt entities

31. We are also considering two more technical changes to ensure these changes to the thin capitalisation rules work as intended.

32. The first is that the New Zealand group of the trust should be only the trust. At present the New Zealand group is the trust and, roughly speaking, all New Zealand entities associated with the trust. This is not appropriate; the trust may not have a controlling interest in those other entities and those entities themselves may not be subject to the thin capitalisation rules.

33. Relatedly, a change will also be made so that an entity owned by a trust that is an excess debt entity will itself be an excess debt entity. Otherwise the rules will not work as intended; the trust will be subject to the thin capitalisation rules but any companies owned by that trust may not be (say, for example, if the trustees of the trust are all residents).

Securitisation vehicles

34. Several submitters were concerned about the implications for securitisation vehicles of including more trusts in the thin capitalisation rules.

35. In principle we are not convinced that securitisation vehicles should be completely carved out from the rules. We note that, for banks, securitisation vehicles are generally included in the bank's New Zealand banking group; securitisation vehicles used by banks are already subject to the banking thin capitalisation rules. Moreover, securitisation vehicles are similar in form, although not intent, to a trust that is fully debt financed by a taxpayer and is used by the taxpayer as a vehicle into which to shift assets (e.g. plant and equipment).

36. Nevertheless, we consider the proposal to define a trust's worldwide group as its New Zealand group should address some of the concerns submitters raised. If the debt in a securitisation vehicle has come from genuine third parties there will be no restriction on the level of debt in the trust, irrespective of whether the on-lending concession applies.

37. Interest deduction denial will only potentially occur if some of the debt in the securitisation vehicle has come from those associated with the trust – which we believe is a proxy for who are the ultimate economic owners of the trust. We think this is appropriate.

Capitalised interest

38. We are considering limiting the capitalised interest restriction proposal to assets that are not carried at fair value. Submitters raised that, for assets carried at fair value, capitalising interest has no real impact because of the ultimate requirement that they be carried at fair value.

39. We also discussed the accounting treatment of assets that are not carried at fair value. Submitters informed us that, even then, the value of these asset can be impaired if the value of the asset falls below its book value. However, this impairment will only occur in certain situations. Moreover, even if the value of an asset should be impaired, the impairment does not

have to be recorded if it can be offset against off-balance sheet increases in other assets (such as internally generated goodwill). We are not comfortable with this treatment.

Asset uplift

40. Submitters were concerned with the proposal to disallow any increases in the value of internally generated intellectual property (IP) following a company restructure. They stated this was a departure from the general practice in the thin capitalisation rules, which simply follows accounting.

41. We have discussed this issue with submitters. We understand that whether or not the value of goodwill and other internally generated IP can be increased following an internal restructure is an accounting grey area. We also understand that, where this occurs, that the uplift must be justifiable.

42. Nevertheless, we are still concerned about asset uplifts as while potentially rare, it is still possible. The reason goodwill and other internally generated IP cannot generally be recognised in a company's accounts is because it is notoriously difficult to value. We are not convinced that it is possible to accurately measure the value of such IP, short of selling it to a third party at arm's length. For this reason, our view is that such increases in asset value not be included as an asset for thin capitalisation purposes.

43. We note that as it is rare such a change should cause little difficulty for taxpayers.

Impairments recognised outside of New Zealand

44. We also discussed with some submitters an issue that arose in consultation. That is, if a New Zealand group's assets decline in value and need to impaired, whether it is possible to recognise that impairment in an offshore company (such as an Australian parent) and not in New Zealand.

45. From our discussions, at this stage we are of the view that this cannot occur. We therefore do not consider the need for any remedial change. However, if we become aware of situations where this has happened we will revisit this decision.

Appendix – summary of the original proposals

The thin capitalisation rules aim to discourage the excessive debt-funding of New Zealand operations of multinational enterprises by reducing tax deductions for interest in extreme cases. The issues paper was released in response to deficiencies identified in the rules – in particular how they apply to private equity investors, and joint-ventures made by non-residents.

The issues paper identified that a key reason for the deficiency was that the rules apply only when a single non-resident controls the New Zealand investment. However, other investors are able to work together in a way that mimics a single controlling investor.

In addition, the rules were also seen as ineffective when debt funding for an entire global group comes from the ultimate shareholders, rather than from third parties.

The paper proposed that the thin capitalisation rules for inbound investment be widened to apply to investments made by groups of non-residents as long as those investors were acting together, either by explicit agreement or because they were being co-ordinated by some party such as a private equity manager.

The primary concern in that situation was the use of related-party debt when overall debt levels were high. To deal with this concern, the issues paper proposed that related-party debt would be excluded from the debt-to-asset ratio of a company's worldwide group for the purposes of the thin capitalisation calculations. When non-residents' New Zealand debt levels are high, the worldwide debt-to-asset ratio can be used to justify the high level of debt. Excluding related-party debt from the worldwide ratio would ensure the worldwide debt ratio could be used to justify high debt levels in New Zealand only to the extent it reflected genuinely third-party borrowing by the worldwide group.

The issues paper also proposed five other changes to the thin capitalisation rules. These are summarised in the table below.

Issue	Current rule	Proposed rule
Foreign controller	Must be a single non-resident controller for the rules to apply.	Must be a single non-resident controller, or a group of non-residents holding an interest of 50% of or more and acting together.
110% safe harbour	Worldwide debt includes all debt of the group.	Worldwide debt excludes debt linked to shareholders of group companies.
Resident trustee	Resident trustee is subject to the rules if the trust is a non-complying trust and more than 50% of settlements are made by a single non-resident.	Resident trustee is subject to the rules if more than 50% of settlements on the trust are made by a non-resident, a group of non-residents acting together, or another entity that is subject to the rules.
Capitalised interest	Capitalised interest is included in assets when the debt-to-asset ratio is calculated.	Capitalised interest excluded from assets when a tax deduction has been taken in New Zealand for the interest.
Consolidation for outbound groups	Individual owner of an outbound group of companies is treated separately from the group.	Individual owner's interests consolidated with those of the outbound group.
Asset uplift	Some taxpayers are recognising increased asset values as a result of internal sales of assets.	Ignore increased asset values as a result of internal sales of assets (exception for internal sales that are part of the sale of an entire worldwide group).