Review of the thin capitalisation rules

An officials' issues paper

January 2013

Prepared by the Policy Advice Division of Inland Revenue and the New Zealand Treasury

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Review of the thin capitalisation rules – an officials' issues paper.
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CHAPTER 1

Summary

1.1 Since 2007 the government has overhauled New Zealand's international tax system, making New Zealand a more attractive place to invest from or to base a multinational enterprise. The introduction of the fair dividend rate method for foreign portfolio investment and the active income exemption for direct investment have removed barriers to sensible investment choices, and brought New Zealand into line with other OECD economies.

1.2 This issues paper proposes further reform of the international tax system, but this time focuses on investments made by foreigners in New Zealand. It proposes changes to the thin capitalisation rules to ensure New Zealand collects its fair share of tax from such investments.

1.3 Past tax reviews have concluded that some reasonable level of tax can be imposed on foreign investors without unduly affecting incentives to invest. The thin capitalisation rules are one mechanism we use to ensure we do tax this investment.

1.4 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. For the most part, the thin capitalisation rules appear to be effective in the standard case of a large multinational, listed on a stock exchange, with subsidiary operations in New Zealand. However, they seem deficient in the case of private equity investment.

1.5 One reason is that the rules currently apply only when a single non-resident controls the New Zealand investment, but private equity investors often work together in groups in a way that mimics control by a single controlling investor. In addition, the rules can also be ineffective when debt funding for an entire global group comes from the ultimate shareholders, rather than from third parties. While listed multinationals are unlikely to be obtaining their debt from shareholders, closely held investment vehicles can more easily do so.

1.6 We are proposing that the thin capitalisation rules for inbound investment be widened to extend to investments that are not controlled by a single non-resident. That is, they would apply to 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.

1.7 Our primary concern in this situation is the use of related-party debt when overall debt levels are high. To deal with this concern, related-party debt would be excluded from the debt-to-asset ratio of a multinational'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 world wide 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.

1.8 The proposed rule should not affect the use of genuinely external debt, such as a loan from a third-party bank, even when the overall level of debt is high.

1.9 We propose a number of other technical changes to the rules.

1.10 We propose that any changes, if they proceed, would take effect from the income year beginning after enactment of any legislation.

1.11 The proposed changes to the rules are likely to reduce the returns to foreign investors in a limited number of cases (the outcome for affected taxpayers depends crucially on how the foreign tax laws treat the investment). This is a consequence of the fact that we want these investors to pay more New Zealand tax.

1.12 However, on balance we consider that the effect of reduced returns for these taxpayers will not have a significant effect on overall levels of investment and there are likely to be overall net benefits for New Zealand because of the increased tax collection. Since our starting point is that it is sensible to impose some tax on foreign investment, we have designed our proposals to reduce tax deductions for related-party debt that is unduly reducing the effective rate of New Zealand tax, while limiting the effect on other debt.

Summary of proposed changes

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).

How to make a submission

1.13 You are invited to make a submission on the proposed reforms and points raised in this issues paper. Submissions should be addressed to:

Review of the thin capitalisation rules
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington 6140

1.14 Or email policy.webmaster@ird.govt.nz with "Thin capitalisation review" in the subject line.

1.15 Electronic submissions are encouraged. The closing date for submissions is 15 February 2013.

1.16 Submissions should include a brief summary of major points and recommendations. They should also indicate whether the authors would be happy to be contacted by officials to discuss the points raised, if required.

1.17 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Introduction

2.1 The government has extensively modernised New Zealand's international tax rules in recent years.

2.2 In 2007, the tax treatment of offshore portfolio investment by New Zealanders was overhauled. The fair dividend rate method of taxing portfolio investors replaced an inefficient system which favoured investment in certain countries and discouraged investment through mutual funds.

2.3 Then in 2009, the tax treatment of offshore direct investment was reformed. Following the reform, New Zealand multinationals with foreign subsidiaries were no longer taxed on the active foreign income of those subsidiaries, such as income from manufacturing or retail sales. This reduced barriers to global expansion from a New Zealand base. In 2011 this "active income exemption" was extended to direct (more than 10%) but non-controlling interests in foreign companies.

2.4 In tandem with the changes to domestic tax law, the government has also begun a programme of updating our double tax agreements. New Zealand has already obtained substantially lower withholding tax rates for dividends and royalties with Australia and the United States, and is likely to obtain those lower rates with other countries in future.

2.5 The treaty reform provides another reason for multinational enterprises to keep their New Zealand base. However, treaty reform entails reciprocal obligations: the same concessions that have been made to New Zealand investors abroad must also be made to foreign investors here. In some cases this removes an element of protection for the New Zealand tax base.

2.6 This puts the spotlight on the effectiveness of other base-protection measures aimed at non-residents such as thin capitalisation, transfer pricing and non-resident withholding tax. More generally, it has been some time since these sorts of measures were introduced or reviewed, and there are concerns that they are not working as well as they could.

2.7 This issues paper proposes changes to the thin capitalisation rules to ensure New Zealand collects its fair share of tax from inbound foreign investment.

The thin capitalisation rules

2.8 In 1997 thin capitalisation rules were introduced to prevent non-residents from allocating an excessive proportion of their world-wide interest expenses against their New Zealand sourced income. The need for such rules arose because interest is deductible at the company tax rate but withholding tax of only 10% or 2% was payable on the corresponding interest income. Equity investment, however faces the full company tax rate. Thus there are inherent incentives for taxpayers to capitalise companies with debt instead of equity. The rules are briefly summarised in the Appendix.

CHAPTER 3

Scope of review

3.1 This document highlights a number of respects in which the thin capitalisation rules are currently not operating in the way intended, resulting in too little tax paid in New Zealand. The apparent problems with the rules have been identified by Inland Revenue in the course of its audit work. This document proposes amendments to the law to correct the problems that have been identified.

3.2 The focus of the document is ensuring that more tax is collected in cases where New Zealand-sourced income appears to be escaping tax. That is, the focus is on base maintenance.

3.3 The document will not consider the levels of existing "safe-harbour" debt-to-asset thresholds (60% for inbound investors, 75% for outbound). The safe harbour for inbound investors was reduced to its current level in the 2011-12 tax year, and the outbound threshold has been in operation only since 2009.

3.4 The document will not consider fundamental changes to the treatment of debt held by finance or insurance companies, although this may be reviewed later.

3.5 This document will not consider rules which reclassify debt as equity, such as the "substituting debenture" rule, although this could be a focus for future work.

CHAPTER 4

Current problems with the rules and proposed solutions

Comments applying to all the proposals in this paper

Costs and benefits

4.1 Every proposal in this issues paper will, in a minority of cases, reduce the amount of interest deduction that may be taken. In that way, it will also reduce returns for some foreign investors. Some investors might pull out of New Zealand. An important question is whether or not the potential withdrawal of investment is outweighed by some additional tax revenue.

4.2 The McLeod tax review ("Tax Review 2001") considered the taxation of foreign investment into New Zealand. The review found that some reasonable level of tax could be imposed on foreign investors without unduly affecting incentives to invest. This is in New Zealand's best interests.

4.3 However, there is some level at which additional taxes will cause more harm than good. We are therefore interested in your views about the costs of the proposals for taxpayers and investors.

Application and transition

4.4 If implemented, we propose the changes would all be applied from the first income year beginning after enactment of the legislation.

4.5 We expect that some investors will change their mix of debt and equity funding accordingly.

4.6 We have attempted to design the proposals so that genuinely external debt funding, which could be difficult to alter, will not usually be affected. This is likely to reduce the effect of changes to the mix.

4.7 Nevertheless, there could be constraints on the ability of companies to substitute equity for related-party debt. We are interested in submissions on this point.

Questions we would like you to consider

- What is the likely cost of the proposals? The cost might include additional compliance costs, increased funding costs, and the cost of restructuring funding to prevent denial of interest deductions. Your information will be most useful to us if it is quantitative and supported by independent research. It will also be more useful if you can identify which costs are transitional costs and which will persist.
- How might taxpayers change their behaviour if the proposals were implemented?
- Are there any possible effects of the proposed changes that we have not identified?

Problem 1: Single non-resident requirement

4.8 The inbound thin capitalisation rules apply to a resident company only if the company is controlled by a single non-resident (section FE 2(1)(c)).

4.9 The case of a single controlling investor is the most obvious case in which a shareholder can arbitrarily determine the level of debt in the company, unless prevented by a thin capitalisation rule. Subject to any non-tax constraints that might be imposed by, for example, an unrelated lender, a controlling shareholder can classify their investment as either debt or as equity, or any mixture of the two.

4.10 However, there are other cases in which more than one shareholder can explicitly agree between themselves to set the level of debt in a company.

4.11 The risks of New Zealand-sourced income escaping New Zealand tax seem very much the same in these cases as in the single non-resident shareholder case, and this suggests widening the scope of the existing rules.

4.12 At the other extreme from the case of a single non-resident controller, a single shareholder among many shareholders of a listed company will be unable to control the level of debt in the company. It is also very unlikely that the shareholders would explicitly agree between themselves to manipulate the level of debt unless this process was initiated by the company itself, in which case the stapled-stock rule in section FA 2B might well apply.

Proposal: Single non-resident requirement

4.13 We propose that the inbound thin capitalisation rules be widened to include companies in which non-residents who are not necessarily associated persons according to the tax definition, but who act together, hold an interest of 50% or more.

4.14 The intention of the change would be to make companies subject to the rules when shareholders can collectively act in the same way as an individual controlling shareholder to determine the level of debt the company will hold.

4.15 What it means to "act together" would not be defined exhaustively in legislation.

4.16 However, acting together will include at least:

- explicitly co-operating with each other through a written or tacit shareholder agreement;
- being effectively co-ordinated by a person or group of people, such as a private equity manager or managers.

Example: James, Henry and Judith each hold one third of the shares in NZ Co and they have a shareholder agreement which determines what they may do with their holdings and regulates certain other actions. The three non-residents are "acting together".

Example: An investment promoter contacts ten people and convinces them to form a consortium to buy out NZ Co. The promoter arranges for a partnership to be legally documented and the ten people contribute their capital, which is used to purchase all of NZ Co's shares. The promoter effectively administers the partnership and directs its activities. The ten investors are "acting together".

Example: X Co, which manages investments on behalf of foreign investment partnerships, arranges for two partnerships (not legally associated) to incorporate companies. The newly incorporated companies each purchase 49% of the shares in NZ Co. X Co holds the remaining 1%. The companies are "acting together".

4.17 We would not expect portfolio shareholders of a public company to be acting together and would look to clarify that in any legislation.

4.18 Widening the application of the thin capitalisation rules in this way raises questions about the definition of the "worldwide group" of a company. When there is a single non-resident controller, the worldwide group is the group of the controller. When there is no single controller, it is not clear whose worldwide assets and liabilities should be included in the worldwide group, or to what extent those assets and liabilities should be included. If a bank was one of the parties acting together, there could be further complications because registered banks are subject to separate thin capitalisation rules.

4.19 Therefore, and to avoid significantly increased complexity of the rules, we propose that when there is no single non-resident controller, the worldwide group for the purposes of the 110% safe harbour will be the New Zealand group. On its own, this would negate the extension of the rules to people acting together, because the New Zealand group's debt-to-asset ratio would always be less than 110% of the worldwide group's ratio. Further measures to overcome this problem are outlined as part of other proposed changes in this paper.

4.20 An alternative to widening the rules to cover groups acting together would be to widen the rules to cover all companies in which non-residents hold an interest of 50% or more. Using this approach, defining "acting together" would be unnecessary as acting together would not be a consideration. However, such a test could bring in shareholders that are very unlikely to be able to influence the level of debt held by the company (publicly listed companies would need to be explicitly excluded).

4.21 Another alternative approach would be to prescribe specific and exhaustive criteria which would indicate when people would be considered to be acting together. For example, the thin capitalisation rules might apply whenever there was a shareholder agreement. Such an approach is not favoured because of the risk that the specific criteria would be easily circumvented unless there were complex criteria to prevent it.

Questions we would like you to consider

- Is it preferable to have an "acting together" test, or to include all companies in which one or more non-residents hold a 50% interest, whether or not they are acting together?
- If the "acting together" test is preferable, are there other cases where people are acting together which should be explicitly included? Explicitly excluded?
- If the alternative is preferable, which cases should be explicitly excluded?

Problem 2: Worldwide group is NZ group and worldwide debt is shareholder debt

4.22 Interest is not denied under the thin capitalisation rules if the debt-to-asset ratio of the New Zealand group of a company or trustee is less than 110% of the debt-to-asset ratio of the corresponding worldwide group (section FE 6).

4.23 In some cases the worldwide group is almost the same as the New Zealand group, and so the 110% safe harbour is always available. This allows the non-resident investor to use as much debt, including shareholder debt, as they wish. This is inappropriate.

Example: Jan incorporates SPV Co in the Cayman Islands, capitalising it with $90 of shareholder debt and $11 of equity. SPV Co buys NZ Co, capitalising it (using its own funds) with $90 of debt and $10 of equity. The worldwide debt-to-asset ratio is 90.1%. The New Zealand debt-to-asset ratio is 90%, so no interest deductions will be denied.

4.24 The 110% safe harbour contemplates a foreign parent with substantial foreign operations and third-party borrowing, in which case the comparison to a worldwide ratio is more meaningful.

Proposal: Worldwide group is NZ group or worldwide debt is shareholder debt

4.25 We propose that when determining the worldwide ratio in the inbound rules, debt will not be counted if it is linked to shareholders of group entities.

Example: Jan (see previous example) cannot include shareholder debt when calculating the worldwide debt-to-asset ratio. The worldwide debt-to-asset ratio is therefore 0%.

Example: Aus Co owns NZ Co. Aus Co borrows $100 on commercial terms from an unrelated bank. Aus Co has $150 of assets, which is the sole security for the loan. NZ Co has $75 of assets and $52 of shareholder debt. The worldwide debt-to-asset ratio is 67%. The New Zealand debt-to-asset ratio is 69%, so the 110% safe harbour applies.

4.26 The intention of the proposal is that the worldwide group test will be used only when it is meaningful – that is, when New Zealand debt levels are being compared to debt levels of a multinational organisation with genuinely external funding.

4.27 Where funding is not genuinely external, and so could effectively be a substitute for equity, there is a reasonable case for using thin capitalisation rules to alter the mix of debt and equity funding. This prevents foreign investors from unduly reducing the effective New Zealand tax rate.

4.28 In contrast, when debt is from truly unrelated parties the shareholder does not benefit from a lower effective tax rate and there is not such a strong case for preventing interest deductions.

4.29 Determining the particular conditions for linking a debt to shareholders is a complex matter. However, our preliminary views are that, we might exclude debt from the worldwide ratio in the following cases:

- the debt is owed to a person having an income interest in a group entity; or
- the debt is owed to a person that has received funds directly or indirectly from a group entity, a person with an income interest in a group entity, or an associated person, on the condition or expectation of both parties that some or all of those funds would be used to provide the debt.

4.30 The second condition is to prevent back-to-back loans.

4.31 It might also make sense to exclude a debt if security for the debt or a guarantee of repayment comes from outside the worldwide group. These features might indicate that debt has been artificially increased to a level that would not be sustainable if the worldwide group was standing alone. Our instinct is that such an exclusion would be necessary to make the proposal effective, but we are seeking your feedback about cases in which this would not be appropriate.

Example: Cayman Co and Bahama Co each own 40% of NZ Co. They also each own 47% of Tiger Co, which is not part of the worldwide group for thin capitalisation purposes. Tiger Co has $100 of assets. NZ Co has $20 worth of assets. NZ Co borrows $20 from a bank. The loan is secured over NZ Co's asset and Tiger Co's assets. The loan may not be included in the worldwide group's debt for the purposes of the debt-to-asset ratio.

4.32 Because it is difficult to anticipate all the ways in which shareholder debt might be transformed into apparently external debt, a specific anti-avoidance rule might be required in addition to the listed exclusions.

4.33 The proposal we are making is an additional restriction on the availability of interest deductions. All the existing restrictions continue to apply, including the inclusion of all debt – from related or unrelated sources – in the New Zealand group calculations.

4.34 Overall, the proposal appears to be superior to alternatives we have considered. A real difficulty with the current 110% safe harbour is that it appears to be suitable only for large multinational groups with considerable holdings outside New Zealand and ultimately public shareholdings.

4.35 One option would have been to prohibit the use of the 110% worldwide group test if less than 50% of the worldwide group's assets were outside New Zealand or the New Zealand group was not controlled by a single non-resident. This would have been a simpler option to administer. However, it would also have arbitrarily denied interest deductions in rare cases of genuinely high levels of external gearing. External borrowing does not reduce the effective New Zealand tax rate for a foreign equity investor, so there is not a strong theoretical case for forcing a reduction of gearing in these cases.

4.36 Abroad, other countries have adopted an "arm's-length" test, which would allow debt deductions in these sorts of cases as long as it could be demonstrated that an unrelated (non-shareholding) party would be prepared to advance the same amount of debt as has been actually taken on by the domestic operation. In practice, it is difficult to decide what an arm's-length level of debt is, and we do not favour such an approach. We are also concerned that, in practice, an arm's-length test is ineffective in preventing excessive interest deductions. We also observe that a 60% debt-to-asset ratio is unusually high for normal multinational businesses.[1]

4.37 The proposal we are making will increase compliance costs for some taxpayers. However, the number of people affected is likely to be small. In practice, and particularly since the introduction of specialised thin capitalisation rules for registered banks, the 110% test is relied upon in few cases.

Questions we would like you to consider

- Is there an economic case for including shareholder debt in the worldwide ratio?
- Are the proposed conditions for linking debt to shareholders complete?
- Are there common shareholder lending arrangements that we are not aware of which should be addressed by adding additional conditions?
- Alternatively, are the proposed conditions for linking debt too broad?
- If so, what exceptions might be needed to ensure that external debt is not caught?

[1] We looked at a sample of approximately 80 foreign-controlled New Zealand groups who were surveyed by Inland Revenue to obtain financial data. We then obtained worldwide group debt-to-asset ratio from the Orbis database for these companies. Of 64 companies for which data was available, only 2 had a worldwide ratio exceeding 60%.

Problem 3: Trusts as main shareholder (non-resident with effective control)

4.38 The thin capitalisation rules apply to a trustee of a non-complying trust settled by a non-resident if the non-resident has made more than 50% of the total settlements on the trust (subsection FE 2(1)(d)).

4.39 They do not apply to other resident trustees. This causes problems in practice.

4.40 For example, suppose a New Zealand business is owned by a resident trustee of a trust, and that the trust has been settled by a resident subsidiary of a foreign company. If the trustee has complied with New Zealand tax obligations, it is a complying trust. The settlor is a special purpose vehicle, has few assets and no interest expenses. The trustee borrows most of its capital directly from the foreign company, but is not subject to the thin capitalisation rules so has unrestricted interest deductions.

4.41 On the face of it, the rules should apply to trustees more broadly than they currently do.

Proposal: Trusts as main shareholder (non-resident with effective control)

4.42 We propose that the thin capitalisation rules will apply to a resident trustee if 50% or more of settlements made on the trust have been made by a non-resident or a group of non-residents acting together, or by an entity that is subject to the inbound thin capitalisation rules (the rules already apply to any non-resident trustee).

4.43 The intention of the proposal is to prevent a trustee from borrowing on behalf of a group to avoid the application of the thin capitalisation rules.

4.44 It is noted that in the case of a foreign trust earning only foreign-sourced income, there is unlikely to be any interest deduction in the first place, and so the application of the thin capitalisation rules would be of no consequence.

4.45 We expect this proposal to have minimal effect on legitimate business structures.

Questions we would like you to consider

- Is there any reason that the thin capitalisation rules should not apply to a resident trustee if a majority of the settlements on the trust were made by a non-resident or a person subject to the inbound thin capitalisation rules?
- Are there some cases in which it would be normal, for non-tax reasons, to use a trust to hold group companies?

Problem 4: Problems with individuals or trustees holding NZ groups

4.46 Section FE 3(2) excludes, from the New Zealand group of a resident natural person or trustee, an excess debt outbound company or a member of the New Zealand group of an excess debt outbound company. This means that a natural person or trustee may be considered separately from companies, including CFCs, they own, and not be required to consolidate those interests.

4.47 This is in contrast to section FE 3(1), which ensures that a natural person or trustee must include all associated residents, even companies, in their New Zealand group, and must consolidate the debts and assets of those entities with those of the natural person or trustee (see also section FE 14(2)).

4.48 Section FE 3(1) applies to inbound investors, while section FE 3(2) applies to outbound investors, but there is no obvious basis for distinguishing between the two when it comes to consolidation of companies and non-companies.

Proposal: Problems with individuals or trustees holding NZ groups

4.49 We propose that the New Zealand group of an individual or trustee under section FE 3(2)(a) should no longer exclude excess debt outbound companies or those included in a New Zealand group of an excess debt outbound company.

4.50 The intention of the proposal is to require consolidation of an individual's or trustee's holdings with holdings of underlying entities, just as is required under section FE 3(1)(a).

Questions we would like you to consider

- Are there any reasons to treat the New Zealand owner of an outbound group separately from the group?
- What difficulties might arise in consolidating the interests of the owner and the outbound group?
- Would such difficulties be any different to the difficulties that arise when consolidating interests of an owner and an inbound group?

Problem 5: Capitalised interest

4.51 Recall that the debt-to-asset ratio of a group determines whether or not the thin capitalisation rules will limit interest deductions (section FE 6).

4.52 Asset values are determined according to generally accepted accounting practice. In at least the case of International Financial Reporting Standards, this means that asset values must sometimes include capitalised interest costs (NZ IAS 23).

4.53 Where a tax deduction has been taken for these interest costs, which is commonly the case, they should in theory be excluded from the asset value for thin capitalisation purposes.

Proposal: Capitalised interest

4.54 We propose that capitalised interest expenses should be deducted from asset values, to the extent the expenses have been deducted for New Zealand tax purposes.

4.55 Where a New Zealand tax deduction has been allowed for interest that is capitalised for accounting purposes, it is not appropriate that this be included in the New Zealand group assets.

4.56 Some compliance costs will be imposed by this proposal through having to separate out capitalised interest expenses. However, in previous consultation on capitalised interest expenses – in the context of the financial arrangement rules – we have been advised that it is a straightforward exercise to identify capitalised interest costs. We therefore believe compliance costs should be minimal.

Questions we would like you to consider

- Are there any capitalised interest costs which should be included in the value of assets for thin capitalisation purposes?
- Is our information about the ease of extracting information about capitalised interest costs correct?

Problem 6: Asset "uplift"

4.57 As noted in the previous section, the debt-to-asset ratio of a group determines whether or not the thin capitalisation rules will limit interest deductions (section FE 6). Asset values are determined according to generally accepted accounting practice.

4.58 For particular assets, including much intangible property, this means assets will be recorded at cost (less amortisation or impairment). Revaluation of such assets, including internally generated goodwill, is not permitted because a reliable value cannot be determined. In contrast, when money is paid to an unrelated party for an intangible asset, including goodwill, the amount paid is likely to be a more reliable indication of actual value.

4.59 The restriction on revaluations is being circumvented by some groups who report increased asset values following internal reorganisations. In these cases, existing subsidiaries are sold to other group companies for market value, which includes the value of internally generated intangibles. It is questionable whether or not this is permitted under generally accepted accounting practice. In any case, it raises concerns that artificially high debt deductions are being allowed because of unreliable (high) asset valuations.

4.60 There may be a case for restricting asset values in cases like these.

4.61 The concerns are likely to be lessened in cases in which the internal organisation coincides with an external acquisition – for instance, when an entire multinational group is purchased by an unrelated party which sets up a new holding company structure in New Zealand. In this case there has been an external purchase and purchased goodwill or other intangible assets are recognised at their fair value. Allocation of that goodwill between entities within the group could still be a concern, however, depending on the details of accounting for the acquisition, and how any resulting asset uplift has been distributed around the worldwide group.

Proposal: Asset uplift

4.62 We propose that when the total asset value of a New Zealand or worldwide group increases as the result of the sale of assets between associated persons, the increase will be ignored for thin capitalisation purposes.

4.63 The intention of the proposal is that it will not be possible to revalue assets upwards by means of an internal reorganisation, unless a straightforward revaluation of that asset would be permitted under generally accepted accounting practice. At least for tax purposes, it should not be possible to circumvent normal restrictions on revaluations by buying and selling entities or assets within a commonly controlled group.

4.64 An exception might be made if the sale of assets took place as part of the sale of the entire group to a previously non-associated party, and the increased asset value reflected the fair value of the assets to that party, as determined under generally accepted accounting practice. In this case, the sale to an external party has a cost which can be used as a reliable basis for determining underlying asset values. Whether or not such an exception is practical will depend on the ability to write a sensible rule for determining when the sale of assets is linked to the sale of the entire group.

Questions we would like you to consider

- Is it common to have internal sales of assets or entities which result in higher reported asset values?
- If so, what is the accounting authority for recognising these higher values?
- If this proposal is implemented, what difficulties might be involved in practice in identifying and removing increases in the value of assets?
- How might we distinguish increases in asset values associated with the sale of an entire worldwide group to a previously unrelated party?

APPENDIX

Summary of the current legislation

New Zealand's thin capitalisation rules limit the tax deductions that may be taken for interest expenditure. There are specific rules for foreign investors, New Zealanders investing abroad, and for registered banks. These rules are summarised in the following sections. The summary is intended to convey the broad thrust of the rules to put the rest of this document in context, but does not discuss the detail of the rules.

Foreign investors ("inbound" rules)

The inbound rules apply to non-residents directly earning New Zealand income, to New Zealand resident companies controlled by a single non-resident, and to certain resident trustees. They prevent large amounts of debt being concentrated in the New Zealand operations of a foreign-controlled multinational. For example, they might prevent a foreign parent from allocating external debt to New Zealand when it is properly attributable to overseas assets and operations.

To work out if any interest deductions that would normally be available are denied, a person subject to the rules must work out the debt-to-asset ratios of their New Zealand group and their worldwide group.

The New Zealand group is, crudely speaking, all the operations of the investor in New Zealand. Similarly, the worldwide group is the worldwide operations of the investor.

No deductions are denied if:

- the New Zealand group's debt-to-asset ratio is 110% or less of the worldwide group's ratio; or
- the New Zealand group's debt-to-asset ratio is 60% or less.

The intuition for the first condition (the "110% safe harbour") is that if the New Zealand group of a multinational is no more indebted than the worldwide group, the debt in New Zealand is a rough but convenient proxy for the group's external debt that is really attributable to New Zealand operations.

The second condition (the "60% safe harbour") is provided to reduce compliance costs. Many companies will have debt-to-asset ratios that are significantly lower than 60% for commercial reasons. Those companies need not undertake worldwide group calculations to justify their debt levels.

If neither condition is met, interest deductions will be reduced to the extent they relate to debt above the highest of the 60% (absolute) or 110% (relative) thresholds.

The inbound rules are the main focus of this document.

New Zealanders investing abroad ("outbound" rules)

The outbound rules apply to any resident with a controlling interest in a foreign company and to some residents with non-controlling but significant interests in foreign companies. If a person is subject to the inbound rules, the inbound rules take precedence.

The outbound rules prevent a New Zealand-based multinational from concentrating large amounts of debt in New Zealand. For example, they might prevent a New Zealand parent from allocating debt to New Zealand when it is properly attributable to the assets and operations of a foreign subsidiary.

The process for working out whether or not interest is denied is almost the same as it is for the inbound rules. In the normal case, a person considers their debt-to-asset percentages and interest is denied to the extent that:

- the New Zealand group's debt-to-asset ratio exceeds 110% of the worldwide group's ratio; and
- the New Zealand group's debt-to-asset ratio is 75% or more.

An alternative set of conditions, based on interest-coverage ratios, may be used in limited circumstances, and there are some exceptions to the rules for smaller businesses.

Registered banks

These rules apply, as the name suggests, to registered banks operating in New Zealand.

They require that banks have a minimum level of non-deductible capital – essentially equity – for tax purposes. If the bank's debt levels are too high, and so equity levels are too low, interest on the excessive portion is denied.

The rules for registered banks override both the inbound and the outbound rules. They are not affected by the changes in this document.