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WEEKLY COMMENT: FRIDAY 2 NOVEMBER 2012

1. The *Taxation (International Investment and Remedial Matters) Act 2012* introduced a new alternative thin capitalisation measurement rule for 'outbound companies' – New Zealand resident companies with interests in:
   - CFCs; or
   - FIFs for which the attributed FIF income method is used; or
   - FIFs that satisfy the requirements for the exemption in section **EX 35** (for Australian resident FIFs).
2. Companies that are eligible to use this alternative measurement rule can retrospectively apply it to all income years beginning on or after 1 July 2009. Companies that wish to amend tax returns for earlier years will have to rely on the Commissioner accepting late amendments under section 113 of the *Tax Administration Act 1994*. *Standard Practice Statement 07/03: Requests to amend assessments* published in *Tax Information Bulletin* Vol 19, No 5 (June 2007) should also be referred to.
3. The alternative test involves calculating the company's NZ Group's *interest-income ratio* and comparing it to a set threshold, which is the lower of:
   - 50% of the NZ group's ratio; or
   - 110% of the company's Worldwide Group interest-income ratio.
4. If the Group's interest-income ratio exceeds the threshold, the company's interest deductions are reduced by the percentage of the Group's ratio that the excess represents.
5. The rationale behind the introduction of this measure was that some New Zealand companies may have goodwill that is not a recognised asset under GAAP. The use of the standard test by such companies could potentially result in an unfair apportionment of interest deductions.
6. This week I look at:

   (a) The eligibility requirements to use the test.

   (b) How the interest-income ratio is calculated; and

   (c) The consequences of breaching the threshold; and

   (d) The compliance requirements.

Eligibility requirements

7. The group must be eligible to use the new test:

   (a) The test is based on comparing interest deductions to adjusted net profit ("ANP"), so the first requirement is that ANP (see the next section below) must be more than zero, for both the company's NZ Group and the company's Worldwide Group.

   (b) Interest deductions allowed under sections **DB 6 to DB 9** must exceed interest income for the company's NZ Group.

   (c) Interest deductions allowed under sections **DB 6 to DB 9** must exceed interest income for the company's Worldwide Group (treating any non-resident members as NZ residents).

   (d) The total group debt of the company's Worldwide Group must be at least 75% of total group assets, not including goodwill.

   (e) At least 80% of the company's Worldwide Group's total group debt must have been borrowed from lenders who are not associated with the Group under **subpart YB** (which sets out the rules for determining association between persons).

   [**s. FE 5(1BB)** as inserted by s. **53(3)** of the *Taxation (International Investment and Remedial Matters) Act 2012*]

How the interest-income ratio is calculated

8. The threshold test involves: calculating the interest-income ratio for an excess debt outbound company's NZ Group, and comparing it to a set threshold ratio. If the interest-income ratio is higher than the threshold, the company will have income under a set formula.

(a) Interest-income ratio

9. The interest-income ratio is the proportion that 'net interest' bears to 'adjusted net profit', and is calculated for each of: the NZ Group and the Worldwide Group as follows:

(Net interest)/(Adjusted net profit)

(b) Threshold ratio

10. The threshold interest-income ratio above which the company will have income is the lower of:

    (a) 50% of the NZ Group's interest-income ratio; and

    (b) 110% of the Worldwide Group's interest-income ratio.

(c) Adjusted net profit

11. Adjusted net profit ("ANP"), for each of: the company's NZ Group and the company's Worldwide Group, is:

[Group NPBT – attributed + net interest + depreciation + amortisation]

12. All of the amounts comprising ANP, apart from net interest, are calculated under GAAP, and are explained as follows:

    (a) Group NPBT is the Group net profit or loss before tax calculated using GAAP. A loss is treated as a negative number.

(b) Attributed is the attributed CFC and FIF income that is included in NPBT. For the Worldwide Group "attributed" will be zero.

(c) Net interest is the interest deductions allowed for financial arrangements that provide funds to the group, reduced by any interest income from financial arrangements on-lent to borrowers who meet the requirements for the on-lending concession in s. FE 13. For the Worldwide group "net interest" is calculated by treating any non-resident members as NZ residents.

(d) Depreciation and amortisation is simply the depreciation and amortisation expenses that are included in NPBT.

(d) Net interest

13. Net interest is the same as it is in the ANP calculation and is calculated as explained in paragraph 12(c) above.

(e) Group calculations

14. The Group calculations must be performed under the GAAP rules for the consolidation of companies.

15. If a NZ Group member is not resident in NZ, amounts relating to that member are only included in the consolidation to the extent that:

(a) The non-resident member carries on business in NZ through a fixed establishment in NZ; or

(b) The non-resident member derives income from NZ, (from 1/7/11: other than non-resident passive income), for which there is no treaty relief.

[**s. FE 5(1BC), (1BD), (1D), (1E) & (1F)** as inserted by s. **53(3) & (5)** and **s. FE 12B** as inserted by s. **55** of the *Taxation (International Investment and Remedial Matters) Act 2012*]

The consequences of breaching the threshold

16. If the threshold ratio is breached, an excess debt outbound company has income equal to a proportion of its 'company's net interest'. The proportion of its 'company's net interest' that must be returned as income is the amount by which the NZ group ratio exceeds the threshold ratio as a proportion of the NZ group ratio:

Income = (Company's net interest) x (NZ Group ratio – threshold ratio)/(NZ Group ratio)

17. Company's net interest is the company's interest deductions allowed for financial arrangements that provide funds to the group, reduced by the company's interest income from financial arrangements on-lent to borrowers who meet the requirements for the on-lending concession in s. FE 13.

[**s. FE 6B** as inserted by s. **54** of the *Taxation (International Investment and Remedial Matters) Act 2012*]

The compliance requirements

18. By the time its tax return for the year is due to be filed, an excess debt outbound company that uses the new threshold test, must provide the following information (in the form and the means prescribed) to the Commissioner:

    (a) Notice to the Commissioner that s. **FE 6B** has been applied.

    (b) A reconciliation of Adjusted Net Profit calculated under s. **FE 5(1BC)** to GAAP net profit.

    (c) A reconciliation of goodwill to items presented in the GAAP balance sheet.

    (d) Any further information that is required by the Commissioner.

    [**s. 65B** of the Tax Administration Act 1994 as inserted by s. **143** of the *Taxation (International Investment and Remedial Matters) Act 2012* applying for income years beginning on or after 1 July 2009]

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