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WEEKLY COMMENT: FRIDAY 1 MARCH 2013

1. *Review of the thin capitalisation rules - An officials' issues paper* ("The Issues Paper") was released in January 2013. Submissions closed on 15 February 2013. The Issues Paper is primarily in response to officials' stated view that the thin capitalisation rules "seem deficient in the case of private equity investment". A number of other problems with the rules identified by Inland Revenue in the course of its audit work are also addressed. The proposals are all aimed at reducing interest deductions. The changes would take effect from the income year beginning after enactment of any legislation.

2. The thin capitalisation rules are aimed at stopping tax reductions in New Zealand through essentially contrived excessive debt funding. The rules can broadly be divided into "inbound rules", that relate to New Zealand investments by non-residents, and "outbound rules" affecting New Zealand residents with foreign investments.

3. The inbound rules currently apply only when a single non-resident controls the New Zealand investment, because this is the most obvious case in which a shareholder can arbitrarily determine the level of debt in the company. Officials are seeking to expand the rules so that they will apply when a group of otherwise unrelated foreign investors work together in groups in a way that mimics controlled by a single controlling investor.

4. The general rule to avoid excessive debt funding is that the New Zealand debt-to-asset ratio should not exceed 110% of the worldwide debt-to-asset ratio. A secondary "safe harbour" rule provides that if the New Zealand debt-to-asset ratio does not exceed 60%, in the inbound rules, or 75%, in the case of the outbound rules, no interest deductions will be denied.

5. Officials have identified that the general rule can be undermined when the worldwide debt-to-asset ratio includes shareholder debt. This is most likely to occur in closely held investment vehicles. Therefore, it is proposed that related party debt should be excluded from the worldwide debt-to-asset ratio for the purposes of the general rule.

6. In addition, another four technical changes to the rules are proposed:

   (a) That a resident trustee be subject to the rules if more than 50% of settlements on the trust are made: by a non-resident, or by a group of non-residents acting together, or by another entity that is subject to the rules.

   (b) That capitalised interest be excluded from assets when a tax deduction has been taken in New Zealand for the interest.

(c) That individual owners, of an outbound group of companies, have their interests consolidated with those of the outbound group.

(d) That increased asset values as a result of internal sales of assets be ignored (except for internal sales that are part of the sale of an entire worldwide group).

Widening the application of the inbound rules beyond holdings by a single non-resident

7. Under s. FE 2(1)(c), the inbound thin capitalisation rules currently apply to a resident company if a non-resident has an ownership interest of 50% or more, or control of the company by any other means. The proposal is that the inbound 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.

8. Officials propose that what it means to *act together* would not be defined exhaustively in legislation. However it will include at least:

   (a) Explicitly cooperating with each other through a written or tacit shareholder agreement; or

   (b) Being effectively coordinated by a person or group of people, such as a private equity manager or managers.

9. Three examples are provided that suggest that the proposed change would have a very wide application:

   (a) *Example 1*: Non-residents James, Henry and Judith each hold one third of the shares in NZ Co and have a shareholder agreement which determines what they may do with their holdings and regulates certain other actions. The 3 non-residents are *acting together*.

   (b) *Example 2*: An investment promoter contacts 10 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 10 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 10 investors are *acting together*.

   (c) *Example 3*: X Co, which manages investments on behalf of foreign investment partnerships, arranges for 2 partnerships (not legally associated) to incorporate companies. The newly incorporated companies each purchased 49% of the shares in NZ Co. X Co holds the remaining 1%. The companies are *acting together*.

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

11. It is recognised that widening the application of the inbound rules in this way will make it very difficult to define the "worldwide group". To avoid significant increased complexity, officials propose that when there is no single non-resident controller, the worldwide group will be the same as the New Zealand group. Clearly, that would mean that the current general 110% rule would be ineffective, as the New Zealand debt-to-asset ratio would always comply. The suggested response to this is a complex set of rules to define the types of debt that would be excluded from the calculations: see paragraph 16 below.

12. Officials also considered, but do not favour, the following alternatives:

    (a) Widening the rules to cover all companies in which non-residents hold an interest of 50% or more, so that defining *acting together* would be unnecessary. But this could unnecessarily affect shareholders that are very unlikely to be able to influence the New Zealand debt level, and listed companies would need to be explicitly excluded.

    (b) Prescribing specific and exhaustive criteria to indicate when people would be considered to be *acting together*. But this approach is not favoured because of the perceived risk that specific criteria could be easily circumvented.

Worldwide group is NZ group and worldwide debt is shareholder debt

13. Officials' concern is that in cases where the worldwide group is almost the same as the New Zealand group, the 110% threshold will never be breached. This would allow a non-resident investor to use as much debt, including shareholder debt, as they wish.

14. Officials propose that the worldwide ratio in the inbound rules will not include debt if it is linked to shareholders of group entities. The intention of the proposal is that the worldwide group test will be used only when New Zealand debt levels are being compared to debt levels of a multinational organisation with genuinely external funding.

15. The following examples are provided:

    (a) 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. In this case the worldwide debt-to-asset ratio is 90.1% and the New Zealand debt-to-asset ratio is 90% so no interest deductions will be denied under the current rules. Under the proposed rules, the worldwide debt-to-asset ratio will be 0%, because shareholder debt cannot be included, so all of the interest deductions will be denied.

    (b) Where there is genuine external debt funding, deductions will not be denied. For 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% and within the 110% safe harbor, so no interest deductions will be denied.

16. Officials recognise that determining the particular conditions for linking debt to shareholders is a complex matter. Their preliminary views are that debt would be excluded in the following cases:

    (a) The debt is owed to a person having an income interest in a group entity; or

    (b) 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. This condition would prevent back-to-back loans.

    (c) The security for the debt or a guarantee of repayment comes from outside the worldwide group, which could indicate that the debt has been artificially increased to a level that would not be sustainable if the worldwide group was standing alone. The following example is provided:

Example: Cayman Co. and Bahama Co each own 40% of NZ Co. They also 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 proposal is that the loan may not be included in the worldwide group's debt-to-asset ratio.

17. Officials believe that 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.

18. Officials have also considered, and do not favour, the following alternatives:

    (a) Prohibiting 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, as this would arbitrarily deny interest deductions in cases of genuinely high levels of external gearing.

    (b) An "arm's length" test, which some other countries have adopted, to see if it could be demonstrated that an unrelated party would be prepared to advance the same amount of debt as has been taken on by the domestic operation. Such an approach is not favoured because it is difficult to decide what an arm's length level of debt is, and in practice the test may be ineffective in preventing excessive interest deductions.

19. Officials observe that a 60% debt to asset ratio is unusually high for normal multinational businesses. They looked at a sample of approximately 80 foreign controlled New Zealand groups who were surveyed by Inland Revenue and obtained worldwide group debt-to-asset ratios from the *Orbis* database for these companies. Of 64 companies for which data was available, only 2 had a worldwide ratio exceeding 60%.

Inbound rules to apply to NZ resident trustees of trusts controlled by non-residents

20. Under s. FE 2(1)(d), the inbound 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. The rules do not apply to other resident trustees. But they apply to all non-resident trustees.

21. Officials are concerned that in circumstances where a New Zealand business is owned by a resident trustee of a trust, and the trust has been settled by a resident subsidiary of a foreign company, the trustee will be able to borrow its capital directly from the foreign company and will not be subject to the thin capitalisation rules.

22. The proposal is 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 rules. Officials note 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.

Consolidating individuals or trustees holdings with their New Zealand group holdings

23. Section FE 3(2), which applies to outbound investors, 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.

24. By contrast, s. FE 3(1), which applies to inbound investors, 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.

25. Officials propose that the New Zealand group of an individual or trustee under s. FE 3(2)(a) should no longer exclude excess debt outbound companies or those included in a New Zealand group of in excess debt outbound company. This will require consolidation of the individual's or trustee's holdings with holdings of underlying entities.

Excluding capitalised interest from debt values

26. When calculating the debt-to-asset ratio, 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).

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

Prohibiting "uplifted" asset values

28. Under generally accepted accounting practice, particular assets, including much intangible property, 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.

29. Officials are concerned that the restriction on revaluations is being circumvented by some groups, who report increased asset values following internal reorganisations. Existing subsidiaries are sold to other group companies for market value, which includes the value of internally generated intangibles. The proposal is that when the total asset value of a New Zealand or worldwide group increases as a result of the sale of assets between associated persons, the increase will be ignored for thin capitalisation purposes.

30. 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 the buyer, as determined under GAAP. However officials note that the allocation of goodwill between entities within the group would remain a concern, depending on the details of accounting for the acquisition, and how any resulting asset uplift has been distributed around the worldwide group. Officials maintain that 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.

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