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WEEKLY COMMENT: FRIDAY 2 AUGUST 2013

1. In Weekly Comment 1 March 2013 I discussed the contents of *Review of the thin capitalisation rules – An officials' issues paper* released in January 2013 ("the January IP"). The Government subsequently announced, as part of the 2013 Budget measures, that it would proceed to implement the two key proposals:

   (a) The expansion of the rules so that they will apply when a group of otherwise unrelated foreign investors work together in groups in a way that mimics control by a single controlling investor; and

   (b) The exclusion of related party debt from the worldwide debt-to-asset ratio when determining the threshold for denying interest deductions.

2. On 6 June 2013 Inland Revenue released *Thin capitalisation review: technical issues* ("the Technical Note") which sets out the views of Treasury and Inland Revenue on the technical details relating to the proposals. These technical details have been formulated after the feedback requested in the January IP. It is possible they could change as a result of the feedback that was requested by 28 June 2013, but the Technical Note provides a clear indication, in the meanwhile, of officials' thinking on the subject.

Expansion of the rules to apply to a group of foreign investors "acting together"

3. The proposal in the January IP was 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. What it means to *act together* would not be exhaustively defined, but would 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.

4. Submissions on the January IP apparently raised concerns about the uncertainty the proposal would cause, so the Technical Note contains a revised alternative under which the thin capitalisation rules would apply if:

   (a) 50% or more of the entity's shares are owned by a group of non-residents who (directly or indirectly) hold debt in proportion to their equity in the entity; or

   (b) The entity has fewer than 25 shareholders and

(i) The shareholders have a shareholders' agreement that sets out how the entity should be funded; and

(ii) 50% or more of the shares are owned by non-residents; or

(c) A person or group of people, such as a private equity manager, effectively coordinates non-residents who hold 50% or more of the entity's shares.

5. At present, interest deductions are denied when certain debt instruments are recharacterised as equity:

   (a) So-called "substituting" debentures, issued to a shareholder or a class of shareholders, where the amount of the debenture is determined by reference to specified aspects of the shares of the company, for which a deduction for any interest payable is denied under s. FA 2; and

   (b) Stapled debt securities where, under an arrangement with the (widely held) issuing company, the debt security can be disposed of only together with the share, for which interest deductions are denied under s. FA 2B.

6. Officials have stated that:

   (a) The substituting debenture rule would not apply to entities subject to the thin capitalisation rules (as the debt in proportion to equity rule would apply to such entities instead);

   (b) The stapled debt securities rule would effectively be expanded to include companies that are not widely held and in which non-residents hold 50% or more of the shares; and

   (c) The "catch-all" rule where non-residents are effectively coordinated by a private equity manager is required to ensure that the thin capitalisation rules cannot be circumvented by structuring so as to avoid the brightline tests.

7. Officials have stated that the revised *acting together* test would not be effective for trusts, as settlors do not require a return on settlements. The proportionality rule does not seem to work (i.e. measuring debt in proportion to settlements). Therefore, officials' are of the view that the *acting together* test for trusts should be as originally proposed in the January IP (and set out in paragraph 3 above). The Technical Note also contains a number of other complicated suggestions for trusts described in paragraph 14 onwards below.

8. This means that there will be two *acting together* tests: one that applies to trusts and one that applies to companies.

9. The proposal in the January IP that for entities subject to the *acting together* test the worldwide group would be the same as the New Zealand group is unchanged. This means the 110% rule will be ineffective. Instead, genuine third party debt will be allowed, but shareholder debt will be limited to a maximum of 10% of the genuine third party debt, as explained further below.

Excluding shareholder debt from the worldwide group debt proposal

10. In the January IP officials proposed that the worldwide group debt threshold would not include any debt that is linked to shareholders of group entities, and 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 was 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.

11. Note also that in the January IP, officials stated 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.

12. These proposals are unchanged. In addition, in the Technical Note officials have proposed an exception under which debt owed to a shareholder can be included in the worldwide debt ratio if the entity:

(a) Is publicly listed; and

(b) Has publicly traded debt; and

(c) That shareholder owns less than 10% of the company.

13. The effect of the proposals to exclude shareholder debts, as noted above, will be to limit these types of debts to 10% of total funding, otherwise interest deductions will be denied:

(a) For taxpayers that are subject to the thin capitalisation rules due to the *acting together* test, this will result from the fact that the worldwide group (which will also be the NZ group) will have a level of debt that excludes all shareholder debts. Therefore, when applying the worldwide group test, allowable total NZ debt (including shareholder debt) cannot exceed 110% of "worldwide debt", which will in fact be third party debt excluding shareholder debt.

(b) For other taxpayers subject to the thin capitalisation regime under the existing rules, excluding shareholder debt from the worldwide group debt ratio will also mean shareholder debt in NZ must be limited to an additional 10%, or interest deductions will be denied.

Extension of the rules to trusts

14. In the January IP, officials stated their concern 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.

15. The proposal in the January IP was that the thin capitalisation rules should 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.

16. In the Technical Note, officials have proposed that:

    (a) Due to the difficulty in applying a "debt proportional to equity" type test to trusts, for the purposes of determining whether persons are *acting together*, the *acting together* test for trusts would remain as proposed in the January IP and described in paragraph 3 above.

    (b) A trust would 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 s. FE 2) has the power to appoint or remove a trustee, to cover situations where a non-resident takes over control of a trust originally settled by a NZ resident.

    (c) The worldwide group of any trust (including a trust settled by a single non-resident) would be the same as the New Zealand group, and any debt from 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: this means there will be no constraints on genuine third party debt, but related party debt will be limited to 60% (if the trust is able to use the safe harbour by having total debt of 60% or less), or 10% of its third party debt (if the 110% of the worldwide group test is used).

    (d) The worldwide group of any company controlled by a trust that is subject to the thin capitalisation rules will also be the same as the New Zealand group, and the worldwide debt ratio of such a company will also exclude related party debt.

    (e) Two other technical changes may be warranted to ensure the rules work as intended:

        (i) The NZ group of the trust should be only the trust; and

        (ii) An entity owned by a trust that is an excess debt entity will itself be an excess debt entity.

    (f) There should be no specific exclusion for securitisation vehicles: there will be no restriction on genuine third party debt in any case, but the rules will apply if some of the debt has come from those associated with the trust.

Excluding capitalised interest from asset values

17. In the January IP, officials proposed that where asset values include capitalised interest costs, those interest expenses should be deducted from asset values to the extent that the expenses have been deducted for New Zealand tax purposes.

18. Following submissions, officials are considering limiting this restriction to assets that are not carried at fair value. Officials have accepted submissions that, for assets carried at fair value, capitalising interest has no real impact because of the requirement that they be carried at fair value.

Prohibiting uplifted asset values

19. In the January IP, officials expressed concern regarding uplifted asset values for intangibles and internally generated goodwill following internal reorganisations. Consequently, officials

proposed 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.

20. This proposal has been retained in the Technical Note. However, in the January IP officials noted that an exception might be made if:

    (a) The sale of assets took place as part of the sale of the entire group to a previously non-associated party; and

    (b) The increased asset value reflected the fair value of the assets to the buyer, as determined under GAAP; and

    (c) A sensible rule can be written for determining when the sale of assets is linked to the sale of the entire group.

21. In the Technical Note, officials mentioned discussing with submitters the possibility of recognising asset impairment in an offshore company. Officials do not consider this can occur at present, so no remedial change is proposed relating to this.

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