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WEEKLY COMMENT: FRIDAY 10 OCTOBER 2014

1. This week I continue looking at the Foreign Investment Fund ("FIF") taxation regime by taking a look at the key issues relating to the use of the attributable FIF income ("AFI") method. The AFI method allows a person to use the active business test. The first point to note that a person is regarded as using the AFI method even if the active business test is passed and there is no attributable FIF income or loss.

2. The AFI method is applied as if the FIF was a CFC, with two important differences:

   (a) The requirements for applying the active business test using accounting information are significantly relaxed; and

   (b) The rules requiring "look-through" to an underlying FIF are also less onerous.

Applying the accounting standards active business test to FIFs

3. When the active business test using accounting standards is applied under the AFI method for FIFs, information from accounts prepared for the FIF using United States generally accepted accounting principles ("US GAAP") is permitted to be used. This is in addition to information from accounts prepared under NZ IFRS ("IFRS") or International IFRS ("IFRSE"). (Information from US GAAP accounts cannot be used for the active business test for a CFC.)

4. However, the FIF's income must be included in accounts prepared under IFRS or IFRSE – either through the FIF's accounts being consolidated into the IFRS or IFRSE accounts, or through the FIF's income being included using the equity method (in IAS 28 or IAS 31) or by inclusion of dividends and fair value changes (under IAS 39).

5. If the FIF income, based on the income interest, that is included in the IFRS or IFRSE accounts, is consistent with the corresponding proportion of income in the FIF's own accounts, the information from the FIF's own accounts (which could be accounts prepared under US GAAP) can be used without adjustment when applying the active business test. If the FIF's profit in the IFRS or IFRSE accounts does not correspond to the proportion that reflects the income interest in the FIF's own accounts, the underlying information will need to be adjusted accordingly when used in the active business test.

6. In addition, the IFRS or IFRSE accounts that include the FIF income must be audited by a chartered accountant who is independent of the FIF and the NZ holder of the FIF interest, and the auditor must provide an unqualified audit opinion. This is apparently so that whatever accounting standard may be used by the FIF itself, the resulting income will be subject to an audit that checks compliance with IFRS or IFRSE.

Applying the active business test to a group of FIFs

7. Under sections EX 50(4B) and EX 50(7B), the active business test applied to a group of FIFs is different from the active business test applied to a group of CFCs in three respects:

   (a) The top tier FIF must have more than a 50% voting interest in the lower tier foreign companies (it is not necessary for the NZ investor to have more than a 50% income interest in each FIF, as would be the case if they were CFCs);

   (b) The foreign companies included in the FIF group can be in different countries, providing that none of the companies is a CFC (whereas all CFCs in a group must be in the same country); and

   (c) Minority interests do not have to be removed when using FIF financial information to calculate whether the active income test is passed (whereas the CFC rules require minority interests to be removed).

Exceptions to the "look-through" rule for underlying FIFs

8. When the AFI method is used for a top tier FIF, the default rule is to "look-through" the FIF and apply the FIF rules to an underlying FIF. (This is not the case if any other FIF calculation method is used because, as stated in s. EX 29(2), the other methods only deal with direct FIF interests.) However, there are several exceptions to the "look-through" rule when the AFI method is used:

   (a) The first exception to the "look-through" rule, under s. EX 50(6), is when the indirect income interest would not be an attributing interest for the person if held as a direct income interest because, for example, a FIF exemption applies. As noted in *Weekly Comment* 5 September 2014, under amendments to s. EX 50(6) and (7) and s. EX 58 in s. 95 and s. 97 of the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*, applying to the 2014-15 and later income years, the exemption in s. EX 35 will not be available for an indirect attributing interest in an Australian resident FIF if that indirect interest corresponds to a direct income interest of less than 10%, even if the direct interest in the CFC or upper level FIF is 10% or more. If the exemption is not available, the "look-through" rule applies to the underlying Australian FIF.

   (b) The second exception to the "look-through" rule, under s. EX 50 7B(a)(i), is when the NZ holder of the top tier FIF can demonstrate that the underlying FIF meets the requirements to apply the AFI method and passes the active business test.

   (c) The third exception to the "look-through" rule, under s. EX 50(7B)(a)(ii), is when the lower tier FIF is part of the same test group as the top tier FIF and the group passes the active income test. As noted earlier, for a lower tier FIF to be part of a group, the top tier FIF must have a more than 50% voting interest.

   (d) The fourth exception to the "look-through" rule, under s. EX 50(7B)(b) and EX 50(7C), is when the top tier FIF passes a modified active income test that includes additional amounts that relate to its shareholdings in underlying foreign companies. There are specific requirements to be met if this exception is to apply:

      (i) The top tier FIF must pass the active business test on its own, before any amounts relating to underlying FIFs are taken into consideration;

      (ii) After passing the test on its own, the test is conducted a second time, with the income (or loss) amounts from the underlying FIF(s) included in the item "added passive" and also in the item "reported revenue";

(iii) The amounts can be a share of the associate's profits recognised under the equity method under NZIAS 28 or an equivalent IFRSE or US GAAP standard: this could be a net amount, or even a negative amount, if, for example, one underlying FIF had a profit and another underlying FIF had a loss;

(iv) Alternatively, the amounts could be recognised under proportionate consolidation under NZIAS 31 or an equivalent IFRSE or US GAAP standard (if, for example, the top tier FIF has income from a joint venture);

(v) Alternatively, the amounts could be dividends from the underlying FIF and fair value changes under NZIAS 39 or an equivalent IFRSE or US GAAP standard: in this case, s. EX 50(4B)(q)(ii) does not allow the dividends to be also included in the formula item "removed passive".

(vi) For an example on how this fourth exception operates, refer to pages 29-30 of Tax Information Bulletin Vol. 24, No. 6, July 2012.

Exemption for intra-group payments when using the AFI method

9. Attributable income is calculated for a FIF using the AFI method in more or less the same way as for a CFC. However, the exemptions for intra-group payments are slightly different:

(a) It is not necessary for the paying and receiving FIF to be associated companies (as is the case with CFCs), however, they must be commonly controlled – i.e. there must be a group of persons who hold more than a 50% voting interest in both the paying and receiving companies – s. EX 50(4C)(ab).

(b) The paying company must be a FIF for which the AFI method is used, and be a company that would be a non-attributing CFC or FIF – s. EX 50(4C)(a) & (b).

(c) Both the paying and the receiving company must be resident and subject to tax in the same jurisdiction.

Intra-group payments concession for "look-through" entities such as US LLCs

10. As noted above, both the paying and receiving companies must both be subject to tax in the same jurisdiction in order for the intra-group payment exemptions to apply. The rules are relaxed slightly if the paying company is not subject to tax, but the receiving company is subject to tax – as would be the case if the paying company is a "look-through" entity, such as a US LLC.

11. There are some additional specific requirements that must be met if this concession is to apply:

(a) Both the paying and the receiving company must be tax resident in the same country under s. YD 3 (which does not necessarily require the companies to be liable for tax in the country of residence);

(b) The paying company must be wholly owned, under the laws of NZ and the foreign country, by another FIF or CFC resident in the same country;

(c) The other FIF or CFC must be liable to tax in the foreign country in the same period as the paying CFC or FIF would have been liable for tax if it was not a "look-through" entity;

(d) Neither the paying FIF, nor the receiving FIF or CFC can be treated as a dual resident;

(e) Neither the paying FIF nor the receiving FIF or CFC can have a fixed establishment or a permanent establishment outside the country.

12. Note that this concession does not apply to the situation where the receiving company is not subject to tax – such as, for example, if the receiving company is a US LLC, unless the receiving LLC itself meets the other requirements above – i.e. is itself owned by a FIF or a CFC that is also resident in the US and subject to tax in the US.

Elective attributing FIFs

13. A taxpayer can elect, under s. EX 73, not to apply the active business test to a FIF for which they use the AFI method. For such an "elective attributing FIF", there is a full calculation of attributable income.

14. A FIF cannot be an elective attributing FIF if it carries on a business of banking or insurance or is controlled by somebody who does.

15. An election for a FIF to be an elective attributing FIF is prospective – it applies from the year following the year in which notice is provided to the Commissioner, although Inland Revenue has some discretion to allow a late election.

16. An election cannot be easily revoked. The concern is apparently that an election can be revoked after attributing deductions have been taken but before the corresponding attributable income arises. A revocation must not be made for a purpose or effect of reducing a tax liability and Inland Revenue must agree to the revocation in writing.

17. However, an election can expire automatically if the FIF ceases to be a FIF for which the taxpayer uses the AFI method: for example, if a FIF exemption commences to apply.

18. Notices of election or revocation must be in a letter containing the relevant details, including the identity of the FIF and the period for which the election is made, and be sent to competent.authority@ird.govt.nz.

19. Strict rules apply to the use of the losses from an elective attributing FIF:

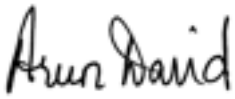
(a) The losses are tagged with the name of the FIF and the election commencement year;

(b) In addition to jurisdictional ring-fencing, tagged losses may only be used against FIF income from the same FIF, or from another FIF with the same election commencement year;

(c) Tagged losses cannot be used against attributable income from a non-elective attributing FIF, even from the same country;

(d) Unused tagged losses are forfeited if the election made in respect of the FIF expires or is revoked;

(e) Losses in the year of revocation will be normal attributed losses from that year, or not recognised at all.



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