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WEEKLY COMMENT: FRIDAY 17 OCTOBER 2014

1. This week I complete looking at the Foreign Investment Fund ("FIF") taxation regime by taking a look at the deductibility of FIF losses, particularly losses calculated using the AFI method, and the disclosure requirements. A complete updated paper on the *NZ Taxation of Foreign Investment Funds (FIFs)* is attached to provide a comprehensive reference to the issues discussed over the past 6 weeks.

Overview of the treatment of FIF losses

2. Section DN 5(1) states that a person is allowed a deduction for a FIF loss. Section DN 7 states that a FIF loss is calculated using the relevant FIF calculation method.

3. The ability to deduct FIF losses has already been covered when the various methods were discussed. To summarise:

   (a) FIF losses resulting from the use of the existing AP method can be deducted from other (non-FIF) income. This method cannot be used in income years beginning on or after 1 July 2011.

   (b) FIF losses resulting from the use of the BE method will be ring-fenced and can only be deduced from current or future FIF income calculated using the BE or AFI methods. There are restrictions on the extent to which losses calculated using the BE method can be carried forward and deducted from income calculated using the AFI method.

   (c) FIF losses resulting from the use of the AFI method will be ring-fenced and can only be deduced from current or future FIF income calculated using the AFI method.

   (d) FIF losses calculated using the CV method, on portfolio FIF interests (i.e. that are not FIF interests of 10% or more in a foreign company) are ignored under the 'reduction of losses to zero' rule, except for FIF interests that are non-ordinary shares.

   (e) FIF losses calculated using the CV method, on non-portfolio FIF interests in a foreign company of 10% or more at all times in the year, may be deducted from other (non-FIF) income in income years beginning before 1 July 2011. In income years beginning on or after 1 July, the 'reduction of losses to zero' rule will also apply to non-portfolio FIF interests of 10% or more.

   (f) FIF losses calculated using the CV method for non-ordinary shares may be deducted from other (non-FIF) income.

   (g) No FIF losses can arise under the DRR, FDR or Cost methods.

Jurisdictional ring-fencing rule for deducting FIF losses

4. Under s. DN 5(2), the deduction for a FIF loss calculated under the AFI method is subject to the jurisdictional ring-fencing rule in s. DN 8. The ring-fencing rule, as it applies to elective attributing FIFs, was described earlier.

5. If the FIF net loss is from a FIF that is not an elective attributing FIF, the person is allowed a deduction in the income year up to the amount of:

   (a) The total attributed CFC income of the person for the income year from CFCs resident in the same country as the FIF for the relevant accounting period; and

   (b) The total FIF income, calculated using the AFI method, of the person for the income year from other FIFs resident in the same country for the relevant accounting period.

6. If the FIF net loss is from a FIF that is an elective attributing FIF, as discussed earlier, the person's deduction in the income year is limited to:

   (a) The total attributed CFC income of the person for the income year from CFCs resident in the same country as the FIF for the accounting period, and elective attributing CFCs in the income year with the same election commencement year as the FIF; and

   (b) The total FIF income, calculated using the AFI method, of the person for the income year from other FIFs resident in the same country as the FIF for the accounting period, and elective attributing FIFs in the income year with the same election commencement year as the FIF.

Rules for carrying forward and offsetting FIF losses

7. Subpart IQ applies when, for a country and a tax year, a person has:

   (a) A FIF net loss for the tax year; or

   (b) A FIF net loss carried forward from an earlier tax year; or

   (c) FIF income calculated under the BE or the AFI method and another person makes available to the person an amount of attributed CFC net loss or FIF net loss.

8. An attributed FIF net loss arises on the last day of the tax year in which the loss is attributed. Note that:

   (a) A person's FIF net loss can be carried forward to a tax year only if the person, if a company, meets the minimum shareholding continuity requirements of 49% as set out in s. IA 5.

   (b) FIF net losses carried forward must be used, according to s. IA 9, in the order in which they arose, and adjusted as required if assessments are amended.

9. Special rules for making a FIF loss available to another company in the group apply, under s. IQ 4, when a company has a net FIF loss from the current year, or carried forward from an earlier year, remaining after applying it against its own FIF income for the current year:

   (a) The group of companies must be a wholly-owned group;

   (b) The usual shareholding commonality requirements for group tax loss offsets apply;

   (c) The part-year loss offset rules in Subpart IP do not apply;

(d) The maximum FIF loss offset that a company can make use of in an income year is determined after deducting the company's own FIF and CFC losses from the same jurisdiction, either incurred in that year or brought forward.

10. There are specific rules that apply, under s. IQ 2, when FIF income for a tax year and a particular jurisdiction, is set off against a FIF net loss carried forward or set off against a loss made available, under s. IQ 4, by another company in the same group.

11. The total FIF net loss for a FIF that is not an elective attributing FIF that can be subtracted from a person's income in a tax year is the lesser of:

    (a) The CFC and FIF income from FIFs and CFCs resident in the same jurisdiction in the accounting period corresponding to the tax year; or

    (b) The FIF's net loss carried forward or made available by another group company, either as a whole (if the year is "after transition" – i.e. an income year beginning on or after 1 July 2009) or in part (if the year is an income year beginning on or before 30 June 2009, in which case the carried forward BE loss is able to be "converted" into a "equivalent CFC loss" and treated as a CFC loss from then on).

12. If, for some reason, the lesser amount referred to above cannot be fully used in the tax year, it ceases to be a FIF loss, under s. IQ 2(3), and becomes an ordinary loss to carry forward and use without being jurisdictionally ring-fenced or limited to FIF income.

13. For an elective attributing FIF, the rules are adjusted so that the net loss that can be subtracted is limited to the lesser of the income from elective attributing FIFs with the same election commencement year, or the FIF loss carried forward as described above.

Treatment of BE losses incurred in income years commencing before 1 July 2009

14. The CFC rules changed significantly in income years commencing on or after 1 July 2009. For FIF losses calculated using the branch equivalent ("BE") method, which employed the "old" CFC rules, a complex set of "conversion" rules were introduced. These are contained in s. IQ 2B. The key points are:

    (a) The main thrust of the rules is that a BE loss carried forward to an income year beginning on or after 1 July 2009 can be converted into an "equivalent CFC loss".

    (b) A BE Loss that is converted ceases to be a BE loss. The equivalent CFC loss is treated as arising on the last day of the conversion year.

    (c) A person can elect that a BE loss not be carried forward under the conversion rules.

15. The conversion method involves determining the "jurisdictional income ratio" for each year, which is the ratio of BE income for the year to FIF income calculated using the AFI method. This ratio is then used to convert the BE loss for that year into an equivalent CFC loss, which is carried forward subject to the current jurisdictional; ring-fencing and loss utilisation rules.

Effect of FIF net loss if AFI method not available

16. A special rule applies when a person is required to change from using the BE method to the AFI method for a FIF, for income years beginning on or after 1 July 2011, and the person is not able to use the AFI method because the interest is less than 10% and the person does not have any FIF interest in the jurisdiction for which the AFI method could be used, and also does not have an income interest of 10% or more in a CFC in the same jurisdiction.

17. In such circumstances the person is allowed, under s. IQ 2C, to deduct the BE loss up to the amount of the FIF's income, and carry the excess BE loss forward.

FIF disclosure requirements

18. Section 61 of the *Tax Administration Act 1994* ("the TAA") requires taxpayers to disclose an attributing interest in a FIF that is held at any time in the income year. The Commissioner can exempt a person from this requirement. The 2014 exemption is published as *2014 International Tax Disclosure Exemption ITR25* and applies for the income year ended 31 March 2014.

19. In summary, the 2014 disclosure exemption **removes** the requirement of a resident to disclose:

    (a) An interest of less than 10% in a foreign company if it is not an attributing interest in a FIF or if it falls within the $50,000 de minimis exemption. The de minimis exemption does not apply to a person that has opted not to use the de minimis exemption. Such a person must disclose FIF income or loss in any of the four subsequent income years even if the total cost of all attributing interests is $50,000 or less.

    (b) If the resident **is not** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10%, if the foreign entity is incorporated (in the case of a company) or otherwise tax resident in a treaty country or territory, and the fair dividend rate or comparative value method of calculation is used.

    (c) If the resident **is** a widely-held entity, an attributing interest in a FIF that is an income interest of less than 10% if the fair dividend rate or comparative value method is used for the interest. The resident is instead required to disclose the end-of-year New Zealand dollar market value of all such investments split by the jurisdiction in which the attributing interest in a FIF is held or listed.

20. The 2014 disclosure exemption also removes the requirement for a non-resident or transitional resident to disclose interests held in foreign companies and FIFs.

21. The forms for the disclosure of FIF interests are as follows:

    (a) IR443 form for the deemed rate of return method;

    (b) IR445 form for the fair dividend rate method (for widely-held entities);

    (c) IR446 form for the comparative value method (for widely-held entities);

    (d) IR447 form for the fair dividend rate method (for individuals or non-widely-held entities);

    (e) IR448 form for the comparative value method (for individuals or non-widely-held entities);

    (f) IR449 form for the cost method;

    (g) IR458 electronic form for the attributable FIF income method (this form can also be used to make electronic disclosures for all other methods).

22. The IR445 and IR446 forms, which reflect the disclosure for fair dividend rate and comparative value for *widely-held entities*, must be filed online. As discussed in paragraph 19(c) above, this disclosure is by country rather than by individual investment. In order to

be exempt from the general requirements, the alternative disclosure must be made electronically.

23. The IR447, IR448 and IR449 forms, applying to the fair dividend rate and comparative value methods for *individuals or non widely-held entities* as well as the cost method for all taxpayers, may be completed online. In that case, the online Form is the same as the one used for the IR445 and IR446.

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