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WEEKLY COMMENT: FRIDAY 24 OCTOBER 2014

1. This week I commence looking at the changes to the thin capitalisation rules enacted in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*. The new laws apply from the 2014-15 income year.

2. The changes were initially proposed in *Review of the thin capitalisation rules - An officials' issues paper* released in January 2013, which I discussed in *Weekly Comment* 1 March 2013. Following the Government Budget in 2013, on 6 June 2013 Inland Revenue released *Thin capitalisation review: technical issues*, which set out the views of Treasury and Inland Revenue on the technical details relating to the proposals. I reviewed this in *Weekly Comment* 2 August 2013.

3. The new laws can be broadly divided into the following main areas:

   (a) How the rules apply to companies controlled by non-resident shareholders acting together;

   (b) How to determine the New Zealand Group of non-resident shareholders acting together;

   (c) The Worldwide Group test for non-resident shareholders acting together;

   (d) Extending the application of the thin capitalisation rules to a broader range of trusts;

   (e) Three changes that are more in the nature of remedial measures:

      (i) Making the on-lending concession apply to all financial arrangements held by a trustee if some other requirements are met; (this measure is designed for securitisation vehicles);

      (ii) Ignoring changes in asset values that have resulted from transfers between associated persons; (this is so that internal restructures do not result in higher asset values, subject to a couple of exceptions);

      (iii) Making individuals and trustees exclude, from being group assets for the purposes of calculating their group debt percentage, CFC and certain FIF investments held indirectly through associated persons.

4. This week I look at how the rules apply to non-resident shareholders acting together. Next week I will look at the determination of the New Zealand Group. Week after next I will look at the Worldwide Group for shareholders acting together. And in the week after that I will look at the extension of the rules to a bigger range of trusts and the remedial measures.

Thin capitalisation rules apply to a group of non-residents acting together

5. Section FE 1(1) has been replaced with effect from the 2014-15 income year. The thin capitalisation rules apply to a taxpayer controlled by:

   (a) A non-resident owning body; or

   (b) A group of entities, including non-residents and entities controlled by non-residents, that act together.

Non-resident owning body

6. The concept of a non-resident owning body is central to the new rules. Under new s. FE 2(1)(cb) a New Zealand resident company will be subject to the new rules if the company has members who make up a non-resident owning body for the company:

   (a) Holding total ownership interests in the company of 50% or more, determined as if the members in the non-resident owning body were associated persons;

   (b) Having control of the company by any other means.

7. The requirements for a non-resident owning body, for a company and an income year, are as follows.

8. Firstly, there must be 2 or more members (– control by a single non-resident has always been subject to the thin capitalisation rules).

9. Secondly, each member must be:

   (a) A non-resident; or

   (b) The trustee of a trust in which 50% or more of the value of settlements made on the trust is from settlements made by:

      (i) A non-resident or an associated person of a non-resident; or

      (ii) Another person to whom the thin capitalisation rules apply (ignoring settlements made by the trustee); or

      (iii) A group of persons who act in concert, each of whom is subject to the thin capitalisation rules (ignoring settlements made by the trustee); or

   (c) The trustee of a trust where a person to whom the thin capitalisation rules apply has the power to appoint or remove a trustee (other than to protect a security interest); or

   (d) A New Zealand resident company in which a trustee as described in (b) and (c) above:

      (i) Holds ownership interests of 50% or more; or

      (ii) Has control of the company by any other means.

10. Thirdly, each member must hold ownership interests in the company or have a *linked trustee* (i.e. a trustee to whom the person has provided money under a settlement or arrangement) holding ownership interests in the company that meet the following requirements:

   (a) The **proportionate funding requirement**: If the company, for each member of the group, owes money (a *member debt*) to the member (or to the member's linked trustee or to a subsidiary company in which the member or the member's linked trustee has ownership interests): the member debt for a member, expressed as a fraction of the total member debt for the company, corresponds to the ownership interests or direct

ownership interests held by the member, expressed as a fraction of the ownership interests or direct ownership interests held by the members of the group; (note that in the case of a subsidiary, the subsidiary debt is equal to the product of the subsidiary debt and the ownership interest held in the subsidiary); or

(b) A **member-linked funding arrangement for a company that is not widely held**: If the company is not a widely-held company, the company is funded for the income year under an arrangement between the members of the group concerning debt (the *member-linked funding*) under financial arrangements where a member or a non-member associated with a member is a party to the financial arrangement, or guarantees the obligations under the financial arrangement if the worldwide group is the NZ group, or enters into a back-to-back type funding arrangement; or

(c) A **managed funding arrangement for the members as a group**: The company has member-linked funding provided in a way recommended to, or implemented for, the members as a group, by a person (for example, a private equity manager).

The proportionality rule

11. The definition of *non-resident owning body* specifies that each type of ownership interest (shares, decision-making rights, the right to receive income and the right to receive the net value of any assets) is to be considered when applying the proportionality rule. The initial version of the definition of non-resident owning body referred to debt "approximately" in the same proportion as equity. Officials thought more certainty could be provided by omitting the "approximately" and:

    (a) Making the rule work off proportionality of any of the four kinds of ownership interest; and

    (b) Including a specific ant-avoidance provision relating to arrangements to circumvent the proportionality rule (e.g. using a back-to-back loan).

12. *Tax Information Bulletin* Vol. 26 No. 7 August 2014 (the "TIB item") contains an **example** which shows:

    (a) The proportionality rule can operate among only some shareholders (i.e. the shareholders who provide debt funding), and does not have to reflect proportional ownership of all shareholders; and

    (b) How indirect ownership operates through a company; and

    (c) How indirect ownership operates through a *linked trustee*.

    Facts in the TIB example: There are 4 non-resident shareholders of a NZ resident company ("NZ Co"), but only 3 of them have provided debt funding:

    (a) Shareholder 1 holds shares in NZ Co indirectly through a wholly-owned holding company: the holding company's shareholding in NZ Co is 20%, therefore Shareholder 1's indirect holding in NZ Co is also 20%; Shareholder 1 has lent NZ Co $33.3m.

    (b) Shareholder 2 has a direct shareholding of 30% in NZ Co; Shareholder 2 has lent $50m to a trustee who is a *linked trustee* (because Shareholder 2 has provided money to the trustee), who has in turn lent the $50m to NZ Co.

    (c) Shareholder 3 has a direct shareholding of 10% in NZ Co and has lent NZ Co $16.67m.

    (d) Shareholder 4 has a 40% shareholding in NZ Co and has not provided any debt funding.

Analysis: The shareholders who funded the debt hold 60% of the shares, and the total debt is $100m:

(a) Shareholder 1 holds one-third of the 60% of the shares held by the 3 shareholders who funded the debt; Shareholder 1 has also funded one-third of the debt ($33.33m). Alternatively, Shareholder 1's proportion of debt to equity is 33.33% debt to 20% equity or 1:0.6.

(b) Shareholder 2 holds one-half (i.e. 30%) of the 60% of the shares held by the 3 shareholders who funded the debt; Shareholder 2 has also funded half of the debt ($50m). Alternatively, Shareholder 2's proportion of debt to equity is 50% debt to 30% equity or 1:0.6.

(c) Shareholder 3 holds one-sixth (i.e. 10%) of the 60% of the shares held by the 3 shareholders who funded the debt; Shareholder 3 has also funded one-sixth of the debt ($16.67m). Alternatively, Shareholder 3's proportion of debt to equity is 16.67% debt to 10% equity or 1:0.6.

Conclusions in the TIB example: Shareholder 1 (together with its associate holding company), Shareholder 2 and Shareholder 3 are members of a non-resident owning body:

(a) Each shareholder's share of total member debt is equal to their share of total member equity.

(b) They therefore have proportionate levels of debt and equity in the ratio 1:0.6 or their equity percentage is 60% of each shareholder's debt percentage.

(c) The thin capitalisation rules will apply to NZ Co because 60% of its shares are held by a non-resident owning body.

13. The following points are worth noting:

(a) Arrangements on how to fund the company are only counted as a characteristic of acting together if the arrangement applies to the current income year. That is, shareholders who have agreed how to fund an entity in the event of a specified event that is yet to occur (such as insolvency) are not a non-resident owning body by virtue of that agreement.

(b) Where non-residents are partners in a limited partnership, each non-resident partner is considered a single non-resident controller of a New Zealand investment. Limited partnerships are transparent for New Zealand tax purposes. Therefore, the partnership is disregarded and the partners are treated as carrying on the business of the partnership.

(c) There will be no grandparenting: if the non-resident owning body rules apply to a company, the thin capitalisation rules will apply from the 2015-16 income year.

(d) Officials did not agree that the residence of a settlor should only be tested at the time of settlement. If a resident owner of a New Zealand company moves offshore, the thin capitalisation rules will begin applying to the company. Settlors of a trust are to be treated in a similar manner.

14. The new proportionality rule will capture both direct and indirect proportionality, including debt or equity that is routed through a trust (a *linked trustee*, explained below). Officials noted that:

    "The reference to both ownership interests and direct ownership interests is intentional. The provision is intended to catch situations when, for example, a non-resident has debt and equity in the same proportion as other shareholders when considering their direct ownership interests, but not their indirect ownership interests. This might arise if, say, the non-resident also had a minor shareholding through a subsidiary."

15. Sections FE 38 to FE 41 deal with measuring ownership interests in companies and aggregating ownership interest of associated persons. These rules will apply to the determination of the ownership interests of a non-resident owning body.

16. The ownership interests of a non-resident owning body will be determined as if the members of the body are associates. This means that, as per s. FE 38 (which requires aggregation of the ownership interests of associated persons), the ownership interests of the owning body will be calculated by aggregating the ownership interests of the body's members, except to the extent the aggregation would result in double-counting (as per the exception in s. FE 41(2)).

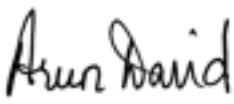
17. Officials have stated that consistent with the amendment to s. FE 41 in the *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014*, a person's direct ownership interests do not include the interests of their associates.

Issues relating to arrangements for member-linked funding

18. Officials agreed that an agreement between shareholders should create a non-resident owning body only if the agreement sets out how a company will be funded with owner-linked debt (as defined by s. FE 18(3B) – to be covered more fully when Worldwide Group debt is considered week-after-next).

19. Officials also agreed that the provisions relating to shareholders exercising their rights on the recommendations of a person, or a person acting on shareholders' behalf, should only apply in relation to owner-linked debt. This would also ensure that an investment manager managing their fund will not be misconstrued as managing an underlying business they own, unless the investment manager directs their members on how to debt-fund the underlying business.

20. Officials noted that it is the intention of this section that <u>all</u> members of a non-resident owning body need to be taking recommendations from the <u>same</u> person in order for the provision apply.



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