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WEEKLY COMMENT: FRIDAY 31 OCTOBER 2014

1. This week I continue 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. As noted last week, the changes were initially proposed in *Review of the thin capitalisation rules - An officials' issues paper* released in January 2013 and discussed further in *Thin capitalisation review: technical issues* in June 2013. I discussed these documents in *Weekly Comment* 1 March and 2 August 2013. This week I take a look at the rules for determining the New Zealand Group of non-resident shareholders acting together.

The New Zealand Group of a non-resident owning body

3. Section FE 25 set out the steps that are used to determine the membership of the New Zealand group of an excess debt entity that is a company. Section FE 25, as amended, now states that the rules in sections FE 26 to FE 30 will apply to a non-resident owning body, as well as an excess debt entity that is a company.

4. These new grouping rules will only apply if the thin capitalisation rules as they currently stand do not apply – that is, to a company not controlled directly or indirectly by a single non-resident. This means the New Zealand parent of a company controlled by a single non-resident will be unaffected by the proposed changes, even if the company is also controlled by a non-resident owning body. Its New Zealand group will, by extension, also be unaffected.

5. The following example to show this is provided in *Tax Information Bulletin* Vol. 26, No. 7, August 2014 (the "TIB item") on page 54:

   Non-resident companies Z, X and Y own 51, 25 and 24 %, respectively, of New Zealand-resident company A Co. Companies Z, X and Y have funded A Co with related-party debt as instructed by a private equity manager. Companies Z, X and Y therefore form a non-resident owning body.

   (a) A Co has three resident subsidiaries. Z also owns 100% of an Australian company.

   (b) Under the current thin capitalisation rules, the New Zealand group of A Co comprises A Co and its three New Zealand subsidiaries. The worldwide group is the New Zealand group, Company Z and the Australian company.

   (c) There will be no change to the New Zealand or worldwide group of A Co as a single non-resident (Company Z) owns 51 % of its shares – even though a non-resident owning body also holds 50 % or more of A Co's shares.

When the excess debt entity itself is treated as the New Zealand parent

6. Section FE 26 sets out the rules for identifying the New Zealand parent.

7. Under new s. FE 26(2)(bb), the entity itself is the New Zealand parent if the entity is resident in New Zealand, and meets the requirements of none of the other paragraphs (in s. FE 26), and has a non-resident owning body having a direct ownership interest of 50% or more in the entity and not having a member (a **tax-return member**):

   (a) Carrying on business in New Zealand through a fixed establishment in New Zealand; or

   (b) Deriving income, other than non-resident passive income, that has a source in New Zealand and for which relief from New Zealand tax is unavailable under all relevant double tax agreements.

8. Under new s. FE 26(2)(bc), the entity itself is the New Zealand parent if the entity is a non-resident owning body.

9. The general rule set down here is that a New Zealand company is the New Zealand parent company if a non-resident owning body has direct ownership interests of 50 percent or more in the company. The exception in s. FE 26(2)(bb) applies when a non-resident owning body has members that have operations in New Zealand (for example, if some of the members of the group operate through a branch in New Zealand). In this case, the non-resident owning body itself will be the New Zealand parent as provided by s. FE 26(2)(bc) or S. FE 26(4C), as discussed in paragraph 16 below.

10. The following example of the operation of s. FE 26(2)(bb) is provided in the TIB item on pages 52-53:

    Non-residents X Co, Y Co and Z Co (who are not associated persons) each own 33 percent of NZ resident company A Co and have proportionate debt and equity. They therefore will form a non-resident owning body. A Co has three NZ resident subsidiaries.

    (a) The New Zealand parent for A Co can only be determined under s. FE 26(2)(bb), under which A Co will be treated as the New Zealand parent (the non-resident owning body has direct interests of 100 percent in A Co). Similarly, A Co's subsidiaries will only be able to determine their New Zealand parent (A Co) under s. FE 26(3)(d)(ii) (as discussed in paragraph 11 below).

    (b) A Co's New Zealand group will comprise A Co and its three subsidiaries.

    (c) **Note:** as will be discussed next week, as A Co's group could only be determined under sections FE 26(2)(bb) and (3)(d)(ii), s. FE 31D applies to deem the worldwide group of A Co to be its New Zealand group.

The top tier NZ resident company is the parent company if it is not the excess debt entity

11. Section FE 26(3) sets out the rules for determining the New Zealand parent when the top tier New Zealand resident company in the group is not the excess debt entity itself. In that case, the New Zealand parent is a company that has an ownership interest in the excess debt entity and is a company that is carrying on business in New Zealand through a fixed establishment in New Zealand or deriving income, other than non-resident passive income,

that has a source in New Zealand and for which relief from New Zealand tax is unavailable under all relevant double tax agreements, and:

- Under s. FE 26(3)(c), if that company identified as the New Zealand parent is a non-resident, a non-resident must have direct ownership of the NZ parent; or
- Under s. FE 26(3)(d), if that company identified as the NZ parent is resident in New Zealand:

  (i) A non-resident must have a direct ownership interest in the NZ parent and also ownership interests of 50% or more in both the excess debt entity and the NZ parent; or

  (ii) If the requirements of subparagraph (i) above are not met, a group of non-residents is a non-resident owning body for the excess debt entity and for the NZ parent, and has ownership interests of 50% or more in the excess debt entity and the NZ parent, and no such non-resident owning body for the excess debt entity and for the NZ parent has a tax-return member.

12. Under s. FE 26(3)(e), no other company that meets the above requirements to be the New Zealand parent can have a direct ownership interest in the company identified under the above rules to be the NZ parent.

13. Note that the above rule in s. FE 26(3)(d) is similar to the rule in s. FE 26(2)(bb) discussed in paragraph 7 above. Remember also, as set out in paragraph 7 onwards above, if the non-resident owning body has a tax return member, the non-resident owning body itself will be the New Zealand parent.

Control of the company by any other means

14. Section FE 26(4) states the rules for determining the New Zealand parent when a non-resident has control of the excess debt entity "by any other means". This section mirrors the provisions of s. FE 26(3) discussed above, except that the control is by way of "any other means":

(a) The New Zealand parent is a company that has an ownership interest in the excess debt entity and is a company that is carrying on business in New Zealand through a fixed establishment in New Zealand or deriving income, other than non-resident passive income, that has a source in New Zealand and for which relief from New Zealand tax is unavailable under all relevant double tax agreements; and

(b) If the company identified as the New Zealand parent is resident in New Zealand, a non-resident or non-resident owning body that has control of the excess debt entity by any means has control of the company identified as the New Zealand parent by any means.

15. Again, under s. FE 26(4)(d), no other company that meets the above requirements to be the New Zealand parent can have a direct ownership interest in the company identified under the above rules to be the NZ parent.

When a non-resident owning body is the New Zealand parent

16. New s. FE 26(4C) provides that if the earlier sections FE 26(2) to (4B) do not apply and the excess debt entity is resident in New Zealand and has a non-resident owning body, the non-resident owning body is the entity's New Zealand parent if the non-resident owning body has:

    (a) A direct ownership interest of 50% or more in the entity; and

    (b) A tax-return member.

17. This is essentially the same as s. FE 26(2)(bc) discussed in paragraph 8 onwards above.

Rule of last resort: excess debt entity as the New Zealand parent

18. Section FE 26(6) states that if none of the above rules apply, the excess debt entity is the New Zealand parent.

19. This rule will apply if some members of a non-resident owning body invest into New Zealand through holding companies. The grouping rules will not be able to identify a New Zealand parent for the top-level operating company in New Zealand (Z Co in the example in paragraph 20 below). Accordingly, s. FE 26(6) will deem the top-level operating company as the New Zealand parent. A company controlled by the top-level operating company will identify the operating company as its parent under s. FE 26(3). Each holding company will also have a New Zealand group that is just the company.

20. The following example of the operation of s. FE 26(6) is provided in TIB item on page 53:

    Non-resident Co 1 owns 100 percent of Hold Co 1 and Non-resident Co 2 owns 100 percent of Hold Co 2. Hold Co 1 and Hold Co 2 are therefore subject to the thin capitalisation rules under section FE 2(1)(c) as they are each wholly owned by a single non-resident.

    (a) Hold Co 1 and Hold Co 2 each own 49% of Z Co, another New Zealand resident company. The remaining 2% of Z Co is owned by a third party.

    (b) The non-residents fulfil the requirements to be a non-resident owning body. Z Co is therefore also subject to the thin capitalisation rules under section FE 2(1)(bb).

    (c) Hold Co 1's New Zealand group is Hold Co 1 (as Hold Co does not hold 50 % or more of Z Co's ownership interests it does not include Z Co in its group under s. FE 26). Hold Co 2's New Zealand group is similarly just Hold Co 2.

    (d) Z Co's New Zealand group cannot be determined under s. FE 26 other than under s. FE 26(6). Z Co is therefore deemed to be its own New Zealand parent. Z Co has no subsidiaries, therefore, its New Zealand group comprises only itself.

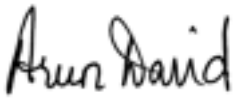
Restriction of an entity's debt and assets to a single group

21. If an entity is a "common member" – i.e. a member of more than one New Zealand group under any of sections FE 3 and FE 26 to FE 29, the debts and assets of the common member are included in the total group debt and total group assets of not more than 1 New Zealand group and in no worldwide group other than the worldwide group determined using that New Zealand group.

22. New s. FE 14(3C) provides a prioritisation rule for which NZ group the common member should be part of, as follows:

    (a) If the entity is a company that is controlled indirectly or directly by a single non-resident then it must include its debt and assets in the New Zealand group of the single non-resident.

    (b) If that is not the case, the single New Zealand group of the common member can be chosen by the excess debt entity to which the interest apportionment rules are being applied – i.e. there is no rule for determining which group the common member should belong to.



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