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WEEKLY COMMENT: FRIDAY 7 NOVEMBER 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 previously, 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 Worldwide Group of non-resident shareholders acting together.

New additional worldwide group test

3. Section FE 1(1)(a) as amended states that for a taxpayer (other than a foreign-owned bank), interest deductions will be adjusted by treating the taxpayer as deriving income if the level of debt in New Zealand of the taxpayer's New Zealand group (identified in sections FE 3 or FE 25 to FE 30) is disproportionately high:

   (a) By comparison with the total level of debt worldwide of the taxpayer's worldwide group (identified in sections FE 31 to FE 32); or

   (b) By comparison, in some situations, with the level of the taxpayer's debt in New Zealand arising from debt funding provided by third parties.

4. Therefore, there are now 2 tests of whether debt is disproportionately high:

   (a) The previous "standard" comparison with worldwide debt of the taxpayer's worldwide group; and

   (b) A new comparison with the taxpayer's New Zealand debt funded by third parties.

5. It is the latter test that applies to a taxpayer owned by a group of non-resident shareholders acting together.

Rule for determining worldwide group when owned by a non-resident owning body

6. New s. FE 31D states the worldwide group for:

   (a) An entity that would not have a New Zealand parent under the pre-existing New Zealand Group rules (i.e. without the amendments applying to determine the NZ group when owned by a non-resident owning body); and

(b) A company in which such an entity (i.e. an entity with no NZ parent under the pre-existing NZ Group rules) has an ownership interest of more than 50%.

7. The worldwide group, under s. FE 31D, for such an entity and a company that is owned by it, is made up of:

   (a) The entity; and

   (b) The entity's New Zealand group.

8. The above rules mean that the worldwide group of a New Zealand company owned by non-resident shareholders who are "acting together" will be just its New Zealand group.

Rules for determining the worldwide group debt percentage

9. Section FE 5(1) sets out the debt percentage tests. For an entity that is not an excess debt outbound entity (i.e. not a NZ company subject to the rules because of CFC or FIF interests), interest deductions will be adjusted and the taxpayer will be treated as deriving income if:

   (a) The NZ Group debt percentage exceeds 60%; and

   (b) The NZ Group debt percentage exceeds 110% of its worldwide group.

10. When the worldwide group is the New Zealand group, the second test above will allow unrestricted interest deductions, as the NZ group debt will never exceed 110% of itself.

11. However, a new restriction has been introduced, and this new restriction applies across the board to all companies, including a company controlled by a single non-resident (and already subject to the thin capitalisation rules). This new restriction involves removing shareholder-funded debt when calculating the worldwide group debt percentage. Consequently, the worldwide group debt percentage will fall when there are significant levels of shareholder-funded debt, and the allowable NZ group debt (being 110% of the worldwide group debt) will also fall.

12. This rule means that the NZ group debt percentage of a New Zealand company owned by non-residents who are acting together cannot exceed 110% of the NZ Group debt percentage calculated excluding all shareholder-funded debt as explained in paragraph 15 onwards below.

13. In effect, this means these companies will be unrestricted in how much they can borrow from genuine third-parties. This was apparently done for practical reasons. Officials stated that applying the standard worldwide group test to shareholders acting together is not feasible. It would be extremely difficult to meaningfully consolidate the debts and assets of the company's shareholders (who are presumably unrelated parties) to construct a worldwide group as it relates to their New Zealand investments.

14. There is also no default worldwide debt percentage when the worldwide group is the New Zealand group. Section FE 18(5)(a)(iii) has been amended so as to remove this restriction when the worldwide group of a company is its NZ group under s. FE 31D, or when a worldwide group of a trustee is the same as its NZ group under s. FE 3(1)(d) (which will be covered next week).

Excluding shareholder-funded debt from the worldwide group debt percentage

15. Section FE 18 sets out the rules for measuring the total group debt and the total group assets of the worldwide group of an excess debt entity. The general rule in s. FE 18(1) is that the total group debt and group assets of the worldwide group is calculated using an accounting standard that is equivalent to GAAP in accordance with the financial reporting standards of the country where the worldwide group accounts are prepared. Section FE 15 sets out the types of debt that are to be included for the purposes of this calculation.

16. Replacement s. FE 18(3) excludes certain types of debt from being included in this calculation. The excluded debt is described in new s. FE 18(3B), which states that a financial arrangement is removed from the measurement of total group debt for an excess debt entity that is not an excess debt outbound company if:

    (a) There is a person (the **owner**) who is not a member of the group who:

    (i) Has an ownership interest in a member of the group; or

    (ii) Is a settlor of a trust having a trustee who is a member of the group; and

    (b) The owner, or an associated person (excluding associates who are members of the group):

    (i) Is a party to the financial arrangement (for example, by a loan directly from the owner); or

    (ii) Guarantees, or provides security for, the performance of obligations under the financial arrangement, if the worldwide group is given by section FE 3(e) (typo: s/b FE 3(1)(d)) or FE 31D; or

    (iii) Provides, or undertakes to provide, funds for the use of a person who agrees to provide funds under the financial arrangement (for example, like a back-to-back loan); and

    (c) The owner has direct ownership interests in a member of the group of 5% or more; and

    (d) The financial arrangement is not traded on an exchange that would be a recognised exchange if paragraphs (c) to (e) of the definition of **recognised exchange** referred to financial arrangements as well as to shares and options over shares.

17. Let's consider these requirements in a little more detail. Firstly, the owner who provides the debt that is excluded must not be a member of the group. The owner must have an ownership interest in a group member, or be a settlor of a trust with a trustee who is a group member.

18. Secondly, the debt could be "provided" merely by way of a guarantee from a shareholder. This requirement stems from officials' view that the New Zealand business, on its own, must be able to support the level of third party debt, or the rule will be undermined.

19. Officials view is that a shareholder guarantee indicates that the New Zealand business may not actually be able to commercially support its level of debt – the guarantee may have been required in order for the loan to proceed. This provides an indication that debt that should be allocated elsewhere in the world has been put in New Zealand – since the loan is implicitly supported by assets outside of New Zealand.

20. For the same reason, officials did not support removing on-lent debt (i.e. debt borrowed from a third party by a shareholder and on-lent to the group) from being counted as owner-

linked. If a shareholder borrows an amount and on-lends that, the shareholder is implicitly acting as a guarantor.

21. The issue of shareholder-guaranteed debt is less significant in the case of a company controlled by a single non-resident. Shareholder guarantees could nonetheless be used to excessively gear the worldwide group. However, officials understand the concerns raised by submitters that a New Zealand company may struggle to get information about guarantees provided by shareholders of the ultimate parent company. On this basis, officials recommended that shareholder-guaranteed debt not be treated as "owner-linked" in relation to a company controlled by a single non-resident. Officials stated they will reconsider this position if evidence arises that guaranteed debt is being used to excessively gear a company's worldwide group.

22. Therefore, the rule that excludes shareholder-guaranteed debt in s. FE 18(3B)(b)(ii) applies only in relation to entities with a worldwide group deemed to be the same as their New Zealand group under s. FE 3(1)(d) or FE 31D.

23. Thirdly, debt from third parties that are the result of back-to-back funding arrangements are also excluded. Therefore, it is not possible for a shareholder to circumvent the rules by placing a deposit with a third party lender.

24. Fourthly, new s. FE 18(3B) contains a carve-out for minor shareholders and publicly traded debt. An owner's financial arrangement will not be excluded from the worldwide group debt test if:

    (a) The owner has a 5% or less direct ownership interest in the group; or

    (b) The financial arrangement held by the owner is traded on a **recognised exchange** (if the definition of recognised exchange in section YA 1 was read to include a reference to an exchange for trading financial arrangements).

25. These carve-outs are apparently designed to reduce compliance:

    (a) It would be difficult to manipulate a company's debt financing through publicly traded debt where the debt is widely traded. Excluding such debt reduces compliance costs.

    (b) Limiting the rule to shareholders with a direct ownership interest of 5 percent or more limits the number of shareholders that a company needs to investigate to determine if they hold owner-linked debt.

    (c) The 5% ownership threshold does not refer to indirect interests or interests held by associates. This is intentional. Otherwise the exemption's purpose as a compliance reduction measure would be defeated.

    (d) However, it is not intended to provide an opportunity for a non-resident with a significant interest in a company to avoid the application of the owner-linked debt rules by spreading their interests across numerous associated entities. Officials expressed the view that the general anti-avoidance rule could apply in such a case.

Example in the TIB and the Commentary

26. *Tax Information Bulletin* Vol. 26, No. 7, August 2014 (the "TIB item") contains the following example on on page 54:

    (a) Three shareholders collectively own NZ Co, and they constitute a non-resident owning body. Therefore, NZ Co's worldwide group is the same as its New Zealand group.

    (b) The three non-resident shareholders will be treated as "owners" of NZ Co as they each have an ownership interest in NZ Co and are outside of its worldwide group. Any debt they extend to NZ Co will not be treated as debt in NZ Co's worldwide group debt test.

    (c) Alternatively, NZ Co could borrow from "Bank" a third party lender, which has no ownership interest in NZ Co and is not associated with any of the shareholders. A loan from Bank will therefore be included as debt in NZ Co's worldwide group debt test.

    (d) Say the three shareholders lend a total of $500,000 to NZ Co, which has $800,000 of assets:

        (i) The debt-to-asset ratio of NZ Co's New Zealand group is ($500k ÷ $800k) = 62.5%.

        (ii) The debt-to-asset ratio of NZ Co's worldwide group is ($0 ÷ $800,000) = 0% (as the debt from the owners is excluded).

        (iii) The debt-to-asset ratio of NZ Co's New Zealand group exceeds both the 60 percent safe harbour and worldwide group debt test. NZ Co will therefore have income under s. CH 9 to cancel out some of its interest deductions.

    (e) If instead of borrowing from its shareholders, NZ Co borrows the $500,000 from Bank:

        (i) The debt-to-asset ratio of NZ Co's New Zealand group is ($500k ÷ $800k) = 62.5%.

        (ii) The debt-to-asset ratio of NZ Co's worldwide group is ($500k ÷ $800k) = 62.5%.

        (iii) While the debt-to-asset ratio of NZ Co's New Zealand group exceeds the 60 % safe harbour, it does not exceed the worldwide group debt test. NZ Co will not have any income under s. CH 9.

Deciding the worldwide group of a common member

27. When a New Zealand group member is a "common member" i.e. a member of more than one New Zealand group, new s. FE 14(3B) states the rule for ensuring that its debt and assets are included in only a single New Zealand group and also only a single worldwide group.

28. For determining the worldwide group of the common member, new s. FE 14(3D) provides that the debt and assets of the common member are to be included only in the worldwide group of the common member's New Zealand group – which, in the case of a non-resident owning body is the single New Zealand group chosen by the excess debt entity to which the interest apportionment rules are being applied.

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