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APPLYING THE AFI METHOD TO INDIRECT INTERESTS IN FOREIGN COMPANIES

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AFI METHOD FOR INDIRECT FIF INTERESTS

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<td>(1) Additional FIF income or loss when a FIF itself has an interest in a foreign company</td>
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<u>Additional FIF income or loss when a FIF itself has an interest in a foreign company</u>
If the FIF itself has an income interest calculated under s. EX 50(4) in a foreign company for the accounting period, <u>unless s. EX 50(7B) applies (see pages 2 - 4 below)</u> the person has additional FIF income or loss calculated using the following formula:
$$\left[\left(\textbf{Person's income interest}\right) \textbf{ x } \left(\textbf{FIF's FIF income or loss}\right)\right]$$
<u>Person's income interest</u>: is the person's income interest in the FIF for the period
<u>FIF's FIF income or loss</u>: is the FIF's income or loss under s. EX 58(4) & (5) as if:
(a) The FIF were the CFC referred to in s. EX 58(4) & (5); and
(b) The FIF's interest in the foreign company were an attributing interest, despite any application of s. EX 34 (FIF exemption for CFCs).
<u>Under s. EX 58(4)</u>, The person must:
(a) Choose, under s. EX 44 to EX 48 the calculation method for calculating the CFC's FIF income or loss; and
(b) Otherwise apply the calculation rules in s. EX 44 to EX 61 as if the person directly held the attributing interest; and
(c) Apply the FIF loss ring-fencing rules in s. DN 8 as if the person directly held the attributing interest.
<u>Under s. EX 58(5)</u>, the CFC's FIF income or loss does not include:
(a) Any amount actuarially determined to be attributable to policyholders in the CFC or another company as a result of applying s. EX 21(25) & (26) (which apply if the CFC or its parent company is a life insurer) to the CFC.
[S. EX 50(6) & (7) and s. EX 58(4) & (5) as amended by s. 39(2) & (3) of the Taxation (International Investment and Remedial Matters) Act 2012 and cl. 24C of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill, applying to income years beginning on or after 1 July 2011]
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<td>(2) Exclusion for certain additional FIF income or loss</td>
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<u>When a person does not have additional FIF income/loss under s. EX 50 (6)</u>

A person does not have additional FIF income or loss under s. EX 50(6) from a FIF with an interest in a foreign company if:

(a) <u>The foreign company meets the test for a non-attributing active CFC</u> under s. EX 21B(2) and the person:
(i) [Repealed by clause 24B(1) of the Annual Rates Tax Bill]
(ii) Is able to include the foreign company in the same test group as the FIF for the accounting standard test under s. EX 21E or the tax measures (default) test under s. EX 21D; or

(b) <u>The FIF would meet the accounting standard test</u> for a non-attributing active FIF under s. EX 21B(2)(b) if the items “added passive” and “reported revenue” under s. EX 21E(5), (8) & (10) for the FIF included the amounts given in (c) below:
(i) Relating to the FIF’s interests in each member of a grouping of one or more foreign companies including the foreign company; and
(ii) Reported in the accounts of the FIF, or in the consolidated accounts of the FIF’s test group under s. EX 21E.

(c) In determining whether a FIF would meet the requirements of (b) above for an accounting period, the amounts required to be included in “added passive” or “reported revenue” are:
(i) Amounts recognised in profit and loss under the equity method under whichever is appropriate of NZIAS 28, NZIAS 31, an equivalent IFRSE, and an equivalent standard or principle in the generally accepted accounting principles in the United States of America;
(ii) Amounts recognised in profit or loss under proportionate consolidation under whichever is appropriate of NZIAS 31, an equivalent IFRSE, and an equivalent standard or principle in the generally accepted accounting principles in the United States of America;
(iii) Dividends and net fair value changes recognised in profit or loss in relation to investments accounted for under whichever is appropriate of NZIAS 39, an equivalent IFRSE, and an equivalent standard or principle in the generally accepted accounting principles in the United States of America or

(d) In determining whether a FIF would meet the requirements of (b) above for an accounting period, an interest holder must not use the result of the test applied to the FIF and the foreign company as a member of a grouping of foreign companies if the interest holder uses for the period a result of the test applied to the FIF and a different grouping of foreign companies.

[S. EX 50(7B) & (7C) inserted by s. 35(6) of the Taxation (International Investment and Remedial Matters) Act 2012 and cl. 24B of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill, applying to income years beginning on or after 1 July 2011]
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<td>(3) IRD TIB explanation</td>
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<u>Summary of IRD explanation of s. EX 50(7B) in TIB Vol 24 No 6 July 2012</u>
If the AFI method is used for a foreign company, the default position is to “look-through” this foreign company and apply the FIF rules to any shares that the company holds in other foreign companies. However, several important exceptions to the “look-through” rule in s. EX 50(6) are listed in s. EX 50(7B).
[The first exception in s. EX 50(7b)(a)(i) is when the person can demonstrate that the second foreign company is able to pass the requirements for applying both the AFI method and pass the active business test: <u>Repealed by cl. 24B(1) of the Annual Rates Tax Bill</u>]
Under s. EX 50(7B)(a)(ii), a person will not need to apply a FIF attribution method to a second-tier company if that company has been included in the same test group as another FIF that has applied and passed the active business test on a test group basis. In order to be part of the same test group the FIF would have to have a more than 50% voting interest in the second foreign company as well as meet several other requirements (see pages 26-27 of the TIB).
S. EX 50(7B)(b) applies where a FIF has less than a 50% voting interest and the second foreign company cannot be included in the FIF’s test group. Certain additional amounts, <u>relating to the FIF’s shareholding</u> in the second foreign company, and reported in the accounts of the FIF or in the consolidated accounts of the FIF’s test group under s. EX 21E, are included in a modified version of the active business test for the FIF. But the FIF must pass the active business test twice: first, excluding the additional amounts from the lower-tier company (the ordinary active business test) and second, including the additional amounts from the lower-tier company (the modified test). Then the second foreign company can be ignored. <u>The modified version test can only be applied to a FIF and a single other group of foreign companies</u>. (<u>Amendments in cl. 24B of the Bill.)</u>
After the FIF passes the “ordinary active business test”, it performs the accounting-based active test in s. EX 21E a second time, this time including the additional amounts that are reported in the FIF’s accounts and that relate to the FIF’s non-controlling interests in other foreign companies. For the second test, the following amounts are included in “added passive” and “reported revenue”:
(a) Amounts recognised in the FIF’s P&L under the equity method in accordance with NZIAS 28 or an equivalent IFRSE, or an equivalent US GAAP standard or principle. These amounts should show up as the share of the associate’s profit.
(b) Amounts recognised in the FIF’s P&L under proportionate consolidation in accordance with NZIAS 31 or an equivalent IFRSE, or an equivalent US GAAP standard or principle. These standards may apply when the FIF has income from a joint venture investment.
(c) Any dividends and net fair value changes are recorded under NZIAS 39 or an equivalent IFRSE, or equivalent US GAAP standard or principle. Because the definition of NZIAS 39 includes an equivalent standard issued in its place, this reference will include NZIFRS 9 when it replaces NZIAS 39. When a taxpayer includes a dividend as part of the “added passive” item, this dividend cannot also be included in the “removed passive” item. (Normally, most dividends can be included in the removed passive item and therefore ignored for the purpose of the active business test.) This is achieved by section EX 50(4B)(l).
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(4) IRD TIB example	**Summary of IRD explanation of s. EX 50(7B) in TIB Vol 24 No 6 (continued)** The above amounts will be net amounts (so they could be negative). The active business test usually only considers gross amounts. **Example** For example, say NZ Co owns 50% of Ireland FIF. Ireland FIF has $1,000 of (active) sales income and $20 of passive interest income. • Ireland FIF owns 50% of UK FIF, whose profit/(loss) is $70. Ireland FIF's share of associate's profit under the equity method is $35. • Ireland FIF owns 20% of US FIF, whose profit/(loss) is ($100). Ireland FIF's share of associate's loss under the equity method is ($20). • Ireland FIF owns 10% of German FIF, whose profit/(loss) is $100. Ireland FIF's share is $10: it receives a dividend of $2 and records a change in net fair value of investments of $8. Ireland FIF's "reported passive" is $20 (its interest income). Ireland FIF's "added passive" is $25 = ($35 - $20 + $2 + $8) Ireland FIF's "total revenue" is $1,045 = $1,000 + $20 + $25 This results in a passive income to revenue ratio of 4.31%, so the underlying FIFs can be ignored.