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THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

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THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION I: INTRODUCTION TO THE NEW LAWS

(1) Introduction to the new thin capitalisation rules	**(1) Introduction to the new thin capitalisation rules** 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. [Amendments to **subpart FE** inserted by **s. 105 to s. 115** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER

(1) Thin capitalisation rules apply to a group of entities who act together	**(1) Thin capitalisation rules apply to a group of entities who act together** This subpart applies to adjust the effective level of interest deductions for a New Zealand taxpayer by treating the taxpayer as deriving income: (a) If the taxpayer is not a foreign-owned bank and 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, either by comparison with the total level of debt worldwide of the taxpayer's worldwide group (identified in *sections FE 31 to FE 32*) or, in some situations, by comparison with the level of the taxpayer's debt in New Zealand arising from debt funding provided by third parties, and the taxpayer: (i) Is controlled by a single non-resident; (ii) Is controlled by a non-resident owning body; (iii) Is controlled by a group of entities, including non-residents and entities controlled by non-residents, that act together; (iv) Is a person (an **outbound entity**) with an income interest in a CFC or with an interest in a FIF that satisfies the requirements of section EX 35 (Exemption for FIF resident in Australia) or for which the person uses the attributable FIF income method; (v) Is a New Zealand entity who controls an outbound entity; and (b) If the taxpayer is a foreign-owned bank and the level of equity for the taxpayer's New Zealand banking group (identified in *sections FE 33 to FE 37*) is less than the acceptable threshold level." [**s. FE 1(1)** inserted by **s. 105** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]
(2) What are the changes in s. FE 1(1)?	**(2) What are the changes in s. FE 1(1)?** The new s. FE 1(1) applies from the 2015-16 income year and: (a) Clarifies that the purpose is to adjust interest deductions by treating the taxpayer as deriving income. (b) There are now 2 tests of whether debt is disproportionately high: (i) Comparison with worldwide debt of the taxpayer's worldwide group; and (ii) Comparison with the taxpayer's New Zealand debt funded by third parties. (c) There are two new categories of control that are affected by the rules: (i) Control by a **non-resident owning body**; or (ii) Control by a group of entities, including non-residents and entities controlled by non-residents that act together. (d) There is a clarification that the rules will apply when a NZ "entity" controls an outbound entity, as opposed to a NZ "resident". [**s. FE 1(1)** inserted by **s. 105** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(3) What is a non-resident owning body?	**(3) What is a non-resident owning body**? **Non-resident owning body** for a company and an income year, means a group consisting of 2 or more members who are each a non-resident or a person meeting the requirements of section FE 2(1)(cc), (d), or (db) and who each hold ownership interests in the company or have a linked trustee holding ownership interests in the company such that: (a) If the company, for each member of the group, owes money to the member (the **member debt**), or to the member's linked trustee (the **trustee debt**), or to a company (the **subsidiary**) in which the member or a linked trustee has ownership interests (the **subsidiary debt**): (i) 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; (ii) The requirements of subparagraph (i) would be met if each of 1 or more members of the group were treated as holding the ownership interests in the company held by the member, and by linked trustees, and were treated as being owed the member debt, the trustee debt, and an amount for a subsidiary debt equal to the product of the subsidiary debt and the ownership interest held in the subsidiary; (b) The company is not a widely-held company and 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 meeting the requirements of section FE 18(3B)(b)(i) to (iii) for the members; (c) The company has member-linked funding provided in a way recommended to, or implemented for, the members as a group by a person". **Linked trustee**, for a person, is a trustee to whom the person has provided money under a settlement or arrangement. For the purposes of the definition of **non-resident owning body**, in determining the relationship between the amount of a company's debt relating to a member and the level of the ownership interests in the company relating to the member, the level of each type of ownership interest in the company is considered, despite section FE 39 (which requires a person's ownership interest in a company to be the highest percentage of shares or rights the person holds in the categories listed in s. EX 5(1) under the CFC rules). [**s. FE 4** amended & **FE 4(2)** inserted by **s. 108** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(4) Whom the rules in subpart FE apply to	**(4) Whom the rules in subpart FE apply to** Section FE 2 sets out when subpart FE applies. Included in the list of persons to whom the rules apply in s. FE 2(1) are: 1. New paragraph (cb): A company that is resident in New Zealand if the company has members who make up a non-resident owning body for the company: (i) 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; (ii) Having control of the company by any other means; 2. New paragraph (cc): A company that is resident in New Zealand if a trustee who meets the requirements of paragraph (d) or (db): (i) Holds total ownership interests in the company of 50% or more; (ii) Has control of the company by any other means. 3. Replaced paragraph (d): The trustee of a trust if 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; (ii) A person who is described in paragraphs (a) to (cc) or would be described by this paragraph or paragraph (db) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored; (iii) A group of persons who act in concert, each of whom is described in paragraphs (a) to (cc) or would be described by this paragraph or paragraph (db) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored; 4. New paragraph (db): the trustee of a trust if a person described in paragraphs (a) to (cc), or would be described by this paragraph or paragraph (d) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored, has the power to appoint or remove a trustee of the trust other than for the purpose of protecting a security interest:”. 5. New section FE 2(4) provides that: A resident of New Zealand and a relative who is a non-resident are not associated persons: (a) In relation to a company for the purposes of subsection (1)(b)(ii), if the non-resident does not have a direct or indirect ownership interest in the company; (b) In relation to a trust for the purposes of subsection (1)(d)(i), if the non-resident has not made a settlement on the trust. [**s. FE 2** amended by **s. 106** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(5) TIB/ Commentary/ Officials' Report explanation of hoe the rules will apply to shareholders acting together	**(5) TIB/Commentary/Officials' Report explanation of how the rules will apply to shareholders acting together** Section FE 2 provides that the thin capitalisation rules apply to a company where a *non-resident owning body* holds 50 percent or more of a company's ownership interests, or has control of a company by any other means. Section FE 1 has also been amended to reflect this. A *non-resident owning body* is a group of nonresidents or entities described in sections FE 2(1)(cc) to (db) (such as trusts settled by non-residents) that have one or more characteristics indicating they are acting together to debt-fund a New Zealand company. These characteristics are having: • Proportionate levels of debt and equity among the group; • An agreement that sets out how the company should be funded with member-linked funding if the company is not widely held (a term defined in s. YA 1); • Member-linked debt in the company in a way recommended by a person (such as a private equity manager), or implemented by a person on behalf of the members. 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. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014, page 51 & *Officials' Report to the Finance and Expenditure Committee on Submissions on the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* page 59 onwards]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(6) TIB/ Officials' Report explanation of the proportionality rule	**(6) TIB/Officials' Report explanation of the proportionality rule** Officials have clearly stated their view that proportionality is a characteristic of acting together as it generally requires a degree of coordination to achieve. More generally, proportionality is also a situation where shareholders are able to substitute debt for equity. This is because, where there is proportionality, the level of debt in a company does not change shareholders' exposure to the risk of holding equity in the company or shareholders' overall return. As debt levels increase, the makeup of the return will change (ie, fewer dividends and higher interest payments) but the sum of interest and dividends will be unchanged. 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." What is meant by proportionality: s. FE 4(a)(i) provides that the rule will apply if the company ultimately owes money to each member of the group and, for each member, the member's debt as a fraction of the total debt the company owes to all members (the *member debt*) is the same as the member's direct or indirect interests in the company as a fraction of direct or indirect ownership interests held by all members in the company. Subsection FE 4(a)(ii) provides that the rule also applies in relation to a member if the criteria of subsection FE 4(a)(i) would be met if the debt and equity held by the member's linked trustees, and the debt held by the member's subsidiaries, were held directly by the member. A *linked trustee* is a trust that a person has provided money to, whether through settlement or some other arrangement (such as a financial arrangement). This is to ensure a non-resident cannot avoid being included in a non-resident owning body by holding shares or debt in a New Zealand company through a trust. Under subsection (2) of the definition of *non-resident owning body*, 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 in the proportionality rule. The earlier 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). [*Tax Information Bulletin* Vol. 26 No. 7 August 2014, page 51 & *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* page 59 onwards]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(7) Officials' report: issues relating to acting as a group	**(7) Officials' report: issues relating to acting as a group** Section FE 2(1)(cc) as initially drafted referred to persons "acting together as a group". Officials noted that the section is intended to catch, among other things, companies that are controlled by a group comprising a trustee (or trustees) and other persons where both the trustee and the other persons are subject to the thin capitalisation rules. In defining whether a company controlled by a group of trustees and other persons should be subject to the rules, officials considered that the same concepts employed in the definition of a non-resident owning body could be used. This would mean, for example, the company would be subject to the rules if the group holds debt in proportion to equity in the company. As initially drafted, s. FE 2(1)(d)(iii) also referred to "a group of persons who act together as a group" to settle a trust. Officials' view is that in the case of settling a trust it is not possible to use the concepts used for a non-resident owning body. It does not make sense, for example, to refer to proportionality of settlements and debt lent to a trust as there is no link between settlements on a trust and entitlement to income from the trust. However, officials recommended that the specific wording in s. FE 2(1)(d)(iii) be changed to "acting in concert" on the basis that is is used elsewhere in New Zealand legislation. [*Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* pages 67-68]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(8) Agreement for member-linked funding and member-linked debt as recommended or implemented by a person	**(8) Agreement for member-linked funding and member-linked debt as recommended or implemented by a person** The other two characteristics of acting together – i.e. an agreement that sets out how the company should be funded with member-linked funding if the company is not widely held, and member-linked debt in the company in a way recommended by a person (e.g. a private equity manager) or implemented by a person on behalf of the members - only apply to member-linked debt. This is debt described in s. FE 18(3B)(b) where the member: (a) Is a party to the financial arrangement; (b) Guarantees or provides security for the arrangement (if the worldwide group is provided by sections FE 3(e) or FE 31D—this is described more in more detail in the section *Worldwide group debt test*); or (c) Has entered into a back-to-back arrangement with the person who has provided the funds to the company. 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)). 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. Officials noted that it is the intention of this section that all members of a non-resident owning body need to be taking recommendations from the same person in order for the provision apply. [*Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* pages 73-75]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(9) Example of the proportionality rule in the TIB	**(9) Example of the proportionality rule in the TIB** The TIB contains an example which shows: • 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 • How indirect ownership operates through a company; and • How indirect ownership operates through a *linked trustee*. **Facts:** 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). (b) Shareholder 2 holds 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). (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). **Conclusions:** (a) Shareholder 1 (together with its associate holding company), Shareholder 2 and Shareholder 3 are members of a non-resident owning body: (b) Each shareholder's share of total member debt is equal to their share of total member equity. (c) 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. (d) The thin capitalisation rules will apply to NZ Co because 60% of its shares are held by a non-resident owning body. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 52]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION II: COMPANIES CONTROLLED BY SHAREHOLDERS ACTING TOGETHER (continued)

(10) Members of a non-resident owning bodies are treated as associates	**(10) Members of a non-resident owning bodies are treated as associates** *Aggregating ownership interests* 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 ownership interests of a non-resident owning body. 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 41 (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)). Officials have stated that consistent with the amendment to s. FE 41 in the *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act*, a person's direct ownership interests do not include the interests of their associates. **Example in the TIB and the Commentary:** Resident company A Co has five non-resident shareholders who have an agreement that specifies how company A should be funded: Mr W (married to Mrs W), Mrs W, Mr X, Mr Y and Mr Z. Each holds 20 % of the issued shares. Mr W's ownership interest in A is 40 % (as his interests are aggregated with Mrs W under section FE 41). Mrs W's ownership interest is similarly 40 %. The other shareholders (who are not associated with each other or Mr and Mrs W) have an ownership of 20 % each. The ownership interests are added together, but with 40 % removed to correct for double-counting of Mr and Mrs W's interests. The non-resident owning body made up of Mr W, Mrs W, Mr X, Mr Y and Mr Z therefore has 100 % of the ownership interests in A Co. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 52]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY

(1) Determining members of the NZ group of a non-resident owning body	**(1) Determining members of the NZ group of a non-resident owning body** 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. 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. [**s. FE 25** amended by **s. 113** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]
(2) New grouping rules apply only if the pre-existing rules do not apply	**(2) New grouping rules apply only if the pre-existing rules do not apply** 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 changes, even if the company is also controlled by a non-resident owning body. Its New Zealand group will, by extension, also be unaffected. **Example** 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 Co has three resident subsidiaries. Z also owns 100% of an Australian company. Under the pre-existing 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, Co Z and the Australian company. 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. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 54 and *Commentary* on the Bill page 33-34]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(3) When the excess debt entity itself is treated as the New Zealand parent	**(3) When the excess debt entity itself is treated as the New Zealand parent** Section FE 26 sets out the rules for identifying the New Zealand parent. There are now some additional rules in s. FE 26(2) for determining when the excess debt entity is treated as the New Zealand parent: (a) 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**): (i) Carrying on business in New Zealand through a fixed establishment in New Zealand; or (ii) 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. (b) New s. FE 26(2)(bc): The entity itself is the New Zealand parent if the entity is a non-resident owning body. 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 **page 19** below. [**s. FE 26** amended by **s. 114** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(4) Explanation in the TIB and *Commentary* to the Bill of when the excess debt entity itself is the New Zealand parent	**(4) Explanation in the TIB and *Commentary* to the Bill of when the excess debt entity itself is the New Zealand parent** Under the new rules, the New Zealand group of a company controlled by a non-resident owning group will be determined much in the same way as companies controlled by a single non-resident. New section FE 26(2)(bb) will generally provide that a New Zealand company is a New Zealand parent company if a non-resident owning body has direct ownership interests of 50 percent or more in the company. A similar amendment to section FE 26(3)(d) – discussed on **page 18** below - generally defines a parent of an excess debt entity as the company where the non-resident owning body directly holds 50 percent or more of its ownership interests. There are two exceptions to these rules. The first is 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 will be the New Zealand parent as provided by subsection (2)(bc) or (4C) – discussed on **page 19** below - as appropriate. The second exception is 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 on the next page). Accordingly, section FE 26(6) – discussed on **page xx** below - 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 section FE 26(3). Each holding company will also have a New Zealand group that is just the company. **Example of operation of s. FE 26(2)(bb)** 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. The New Zealand parent for A Co can only be determined under section 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 section FE 26(3)(d)(ii). A Co's New Zealand group will comprise A Co and its three subsidiaries. **Note:** as discussed later on **page 24**, as A Co's group could only be determined under sections FE 26(2)(bb) and (3)(d)(ii), section FE 31D applies to deem the worldwide group of A Co to be its New Zealand group. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 pages 52-53 and *Commentary* on the Bill page 32]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(5) The top tier NZ resident company is the parent company if it is not the excess debt entity	**(5) The top tier NZ resident company is the parent company if it is not the excess debt entity** 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: (a) Replaced s. FE 26(3)(c) states that if the company identified as the NZ parent is a non-resident, a non-resident must have direct ownership of the NZ parent; or (b) Replaced s. FE 26(3)(d) states that if the 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) are not met and 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. Note that this rule in s. FE 26(3)(d) is similar to the rule in s. FE 26(2)(bb) discussed in **page 16** above. Remember also, as set out in **page 17** above, if the non-resident owning body has a tax return member, the non-resident owning body itself will be the New Zealand parent. (c) 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. [**s. FE 26** amended by **s. 114** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(6) Control of the company by any other means	**(6) Control of the company by any other means** 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". If the thin capitalisation rules apply only because a non-resident has "control of the company by any other means", s. FE 26(4)(c) is amended to allow the non-resident to be a "non-resident or non-resident owning body": (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. 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. [**s. FE 26** amended by **s. 114** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]
(7) When a non-resident owning body is the New Zealand parent	**(7) When a non-resident owning body is the New Zealand parent** 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. This rule is essentially the same as s. FE 26(2)(bc) discussed in **page 16** above [**s. FE 26** amended by **s. 114** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(8) Rule for inclusion of ownership interests of associated persons	**(8) Rule for inclusion of ownership interests of associated persons** When the excess debt entity itself is not the NZ parent, the rules for determining the NZ parent in s. FE 26(3) to (4C) require the ownership interests to be determined under sections FE 38 to FE 41 (which set out the rules for measuring ownership interests for the purposes of the thin capitalisation rules), but adjusted as follows for the purposes of identifying a New Zealand parent: (a) The ownership interests of a person associated with another person are not included with the ownership interests of the other person, except if the persons are associated under paragraph (b) below (i.e. a trustee acting in concert with another trustee); (b) A trustee who acts in concert with another trustee is treated as being associated with the other trustee." [**s. FE 26** amended by **s. 114** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]
(9) Controlling trustee is the New Zealand parent	**(9) Controlling trustee is the New Zealand parent** New s. FE 26(4D) states that if an excess debt entity meets the requirements of section FE 2(1)(cc) (i.e. controlled by a trustee of a trust with a non-resident settlor or a non-resident with the power to appoint trustees) and the New Zealand parent of the entity cannot be determined (in the absence of this s. FE 26(4D) and in the absence of the last resort rule in s, FE 26(6) that the excess debt entity is the NZ parent), the New Zealand parent of the entity is the trustee referred to in section FE 2(1)(cc) – i.e. the controlling trustee. [**s. FE 26** amended by **s. 114** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]
(10) Rule of last resort: excess debt entity as the New Zealand parent	**(10) Rule of last resort: excess debt entity as the New Zealand parent** Section FE 26(6) states that if none of the above rules apply, the excess debt entity is the New Zealand parent. 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. [**s. FE 26** amended by **s. 114** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(11) Explanation in the TIB and the Commentary of a non-resident owning body investing in NZ through holding companies

(11) Explanation in the TIB and the Commentary of a non-resident owning body investing in NZ through holding companies

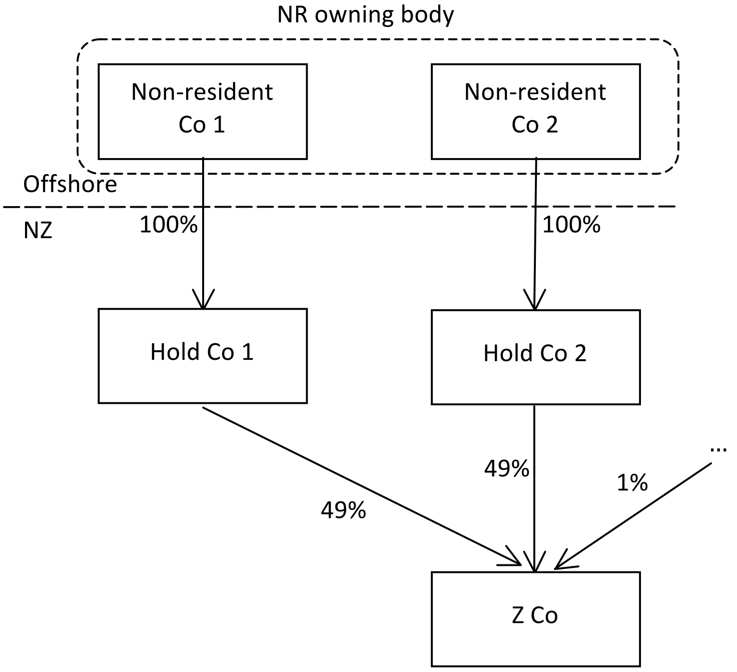
The rule of last resort referred to on the previous page applies if some members of a non-resident owning body invest into New Zealand through holding companies. The grouping rules will not be able to identify a New Zealand parent for the top-level operating company in New Zealand (Z Co in the example below).

Accordingly, section 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 section FE 26(3). Each holding company will also have a New Zealand group that is just the company.

Example

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).

Say the non-residents meet the criteria for being a non-resident owning body. Z Co is therefore also subject to the thin capitalisation rules under section FE 2(1)(bb).



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 it in its group under s. FE 26). Hold Co 2's New Zealand group is similarly just Hold Co 2.

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 New Zealand parent. As Z Co has no subsidiaries, its New Zealand group comprises only itself.

[*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 53 and *Commentary* on the Bill page 33]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(12) Rules to ensure matching New Zealand Groups	**(12) Rules to ensure matching New Zealand Groups** Officials have stated that under the thin capitalisation rules it is important that New Zealand groups of different entities are the same. That is, if Company A includes Company B in its New Zealand group, then Company B should include Company A in its group. It is also important that an entity cannot be included in multiple groups. This is to prevent the double-counting of the entity's debt and assets. Section FE 3(1)(d) (refer to **page 37**) excludes a company from a group of a trust if the company does not include the trust (or body) in its own group – i.e. the trust is not found to be the company's New Zealand parent under s. FE 26(4D). This rule would apply, for example, when a trust owns a subsidiary company. Without the rule a trust could include a company in its group but the company may not include the trust in its group. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 54 and *Commentary* on the Bill page 34]
(13) Restriction of an entity's debt and assets to a single group	**(13) Restriction of an entity's debt and assets to a single group** A separate rule is contained in s. FE 14(3B) to ensure that an entity cannot include its debt and assets in more than one New Zealand and worldwide group. This might occur, for example, if it were possible to argue there are multiple different non-resident owning bodies that hold 50% or more of the ownership interests in a company. An ordering rule, in s. FE 14(3C), applies in some cases when an entity is determining what group it should include its debt and assets in: 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. If this is not the case then there will be no rule for determining what group the debt and assets should be included in. The legislation relating to these rules is set out on the next page. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 54 and *Commentary* on the Bill page 34]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION III: THE NEW ZEALAND GROUP OF A NON-RESIDENT OWNING BODY (continued)

(14) Including debt and assets in only one NZ and Worldwide Group: legislation

(14) Including debt and assets in only one NZ and Worldwide Group: legislation

Section FE 14 sets out the rules for consolidation of debt and assets for the purpose of calculating the debt percentage of the New Zealand group. There are some new rules introduced to ensure matching NZ Groups, as discussed above.

1. Restriction of entity to a single group

   New s. FE 14(3B) states that:

   If an entity (the **common member**) is, under sections FE 3 and FE 26 to FE 29, a member or part of a member of different New Zealand groups, the debts and assets of the common member are included under this subpart 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.

2. Rule for determining which single NZ group

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

   For the purposes of subsection (3B), the debts and assets of the common member referred to in subsection (3B) are included with the debts and assets of the other members of the New Zealand group:

   (a) Given by section FE 26, in the absence of section FE 26(2)(bb) and (bc), (3)(d), (4D), and (6), for the common member; or

   (b) If paragraph (a) does not specify 1 New Zealand group, chosen by the excess debt entity to which the interest apportionment rules are being applied for the common member and the excess debt entity.

3. Rule for determining which worldwide group

   New s. FE 14(3D) provides the rule for determining the worldwide group of the common member as follows:

   For the purposes of subsection (3B), the debts and assets of the common member referred to in subsection (3B) are included with the debts and assets of the other members of the worldwide group given by sections FE 31 to FE 36B for the common member and the common member's New Zealand group under subsection (3C).”

[**s. FE 14** amended by **s. 110** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST

(1) New additional worldwide group test	**(1) New additional worldwide group test** 1. 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 (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. 2. 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. 3. It is the latter test that applies to a taxpayer owend by a group of non-resident shareholders acting together. [**s. FE 1(1)** inserted by **s. 105** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]
(2) Rule for determining worldwide group when owned by a non-resident owning body	**(2) Rule for determining worldwide group when owned by a non-resident owning body** 1. 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%. 2. New s. FE 31D states that: a worldwide group for an entity that would not have a New Zealand parent under section FE 26(2) and (3) in the absence of section FE 26(2)(bb), (3)(d)(ii), and (4C), and for a company in which such an entity has an ownership interest of more than 50%, is made up of: (a) The entity; and (b) The entity's New Zealand group. 3. 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. [**s. FE 31D** inserted by **s. 115** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST (continued)

(3) Rules for determining the worldwide group debt percentage	**(3) Rules for determining the worldwide group debt percentage** 1. 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%; (b) The NZ Group debt percentage exceeds 110% of its worldwide group. 2. 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. 3. 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 – see **pages 27-28** below. 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. 4. In effect, this means these companies will be unrestricted in how much they can borrow from genuine third-parties. [**s. FE 18** amended by **s. 112** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST (continued)

(4) Explanation in the Commentary of the Worldwide Group being the same as the NZ Group	**(4) Explanation in the Commentary of the Worldwide Group being the same as the NZ Group** Officials noted that the changes will deem the worldwide group of a New Zealand company owned by non-resident shareholders who are "acting together" to be just its New Zealand group. 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. 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. Companies controlled by single non-residents do not face this problem. They can use the worldwide group debt test as it currently stands. This means if the parent company's worldwide operations are highly geared, the New Zealand operation can use the worldwide group debt test to justify a high level of gearing in New Zealand. Officials did not support changing the worldwide group debt test for companies controlled by single non-residents because that would provide companies controlled by a single non-resident with two methods for applying the worldwide group debt test: the existing test (based on the debt-to-asset ratio of the worldwide debt), and the new modified test for those "acting together" (that allows unlimited borrowing from third-parties). The companies could pick and choose the method that would best suit them. [*Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* page 62]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST

(5) Worldwide group debt adjusted for loans from owners and associates

(5) Worldwide group debt adjusted for loans from owners and associates

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.

1. Replacement s. FE 18(3) states that despite s. FE 18(1), an excess debt entity must measure the amount of total group debt using the rules in s. FE 15 as if:

   (a) Section FE 15(1)(a) excluded from the measurement a financial arrangement meeting the requirements of new s. FE 18(3B); and

   (b) Section FE 15(1)(a)(ii) required the financial arrangement to give rise to an amount that would be allowed as a deduction to the natural person or to the entity, or another group member, if the entity or group member were resident in New Zealand.

2. New s. FE 18(3B) 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 and:

      (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 other than a member of the group:

      (i) Is a party to the financial arrangement; 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 31) 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; 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."

3. Under new s. FE 18(5)(a)(iii), the default debt percentage of the worldwide group of 54.5454% (i.e. 110% = 60%) does not apply if the entity's worldwide group is determined under either s. FE 3(1)(d) (i.e. worldwide group = trustee's NZ group) or new s. FE 31D (see **page 24** above). Therefore, there is no restriction on worldwide group debt for such an entity.

[**s. FE 18** amended by **s. 112** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST (continued)

(6) Worldwide Group debt percentage excludes debt linked to an owner of the Worldwide Group	**(6) Worldwide Group debt percentage excludes debt linked to an owner of the Worldwide Group** Whether there is any interest denial under the thin capitalisation rules depends on the result of two tests. One of these tests is known as the "worldwide group debt test" and is designed to ensure the amount of debt in a New Zealand company is proportionate to the amount of genuine external debt of the ultimate non-resident parent of that New Zealand company. In some circumstances, however, the debt of the ultimate parent company may also include debt from the parent's shareholders or other owners of the group. In such cases the debt level of the worldwide group does not reflect the level of genuine external debt. To address this, proposed new section FE 18(3B) provides that, when an excess debt entity (other than an outbound excess debt entity) is calculating its worldwide group debt percentage, it must exclude debt that is linked to an owner of the worldwide group. An "owner" will be a person who has an ownership interest in a member of the group or is a settlor of a trust that is a member of the group. A financial arrangement will be treated as linked to an owner of the group if the owner, or an associate of the owner (excluding associates who are members of the group): (a) Is a party to the financial arrangement (for example, by a loan directly from the owner); (b) Has guaranteed or otherwise provided security for the financial agreement and the entity's worldwide group is deemed to be the same as its New Zealand group under s. FE 3(e) or FE 31D (discussed below); and (c) Has provided funds or will provide funds, directly or indirectly, to another person who is providing funds under the financial arrangement (such as a back-to-back loan). [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 54 and *Commentary* on the Bill page 35]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST (continued)

(7) Financial arrangement is linked to an owner through a guarantee only if the Worldwide Group is the same as the New Zealand Group	**(7) Financial arrangement is linked to an owner through a guarantee only if the Worldwide Group is the same as the New Zealand Group** When a company is owned by a group of non-residents who meet the definition of a "non-resident owning body", there is no test to determine whether they have allocated a fair amount of their worldwide debt to New Zealand. This test is proxied by the requirement that, in essence, any debt of the New Zealand company (in excess of 60 percent) must be from a third party. Officials are of the view that this demonstrates that the New Zealand business, on its own, is able to support that level of debt. This provides a reasonable indication that the debt in the New Zealand business is not attributable elsewhere. Having shareholder-guaranteed loans not counted as owner-linked would weaken this. It would mean 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. For the same reason, officials do not support removing on-lent debt from being counted as owner-linked. If a shareholder borrows an amount and on-lends that, the shareholder is implicitly acting as a guarantor. The issue of shareholder-guaranteed debt is less significant in the case of a company controlled by a single non-resident. In this case the worldwide group debt test can act to ensure only a reasonable amount of the worldwide group's debt is allocated to New Zealand. 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. On this basis, 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. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 55 and *Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* pages 82-83]

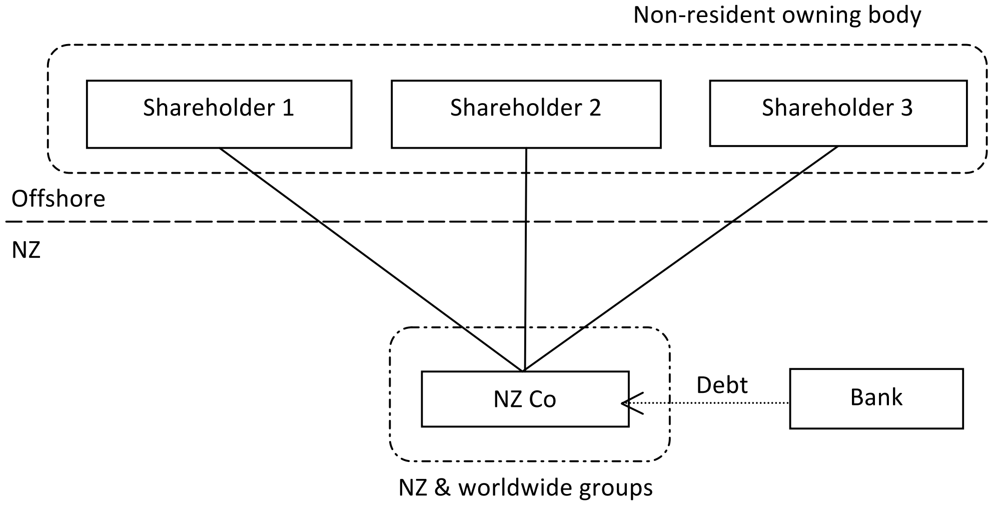
THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST (continued)

(8) TIB explanation of carve-out for public debt and minor shareholders	**(8) TIB explanation of carve-out for public debt and minor shareholders** New section FE 18(3B) also includes 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 percent 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). These carve-outs are designed to reduce compliance. 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. 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. The 5 percent 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. 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. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 55]
(9) Officials Report comments on the carve-outs	**(9) Officials Report comments on the carve-outs** The minority shareholder rule as initially introduced was a carve-out for 10% or less ownership, and there was no carve-out for publicly traded debt. Officials agreed that it would be difficult to manipulate a company's debt financing through publicly traded debt where the debt is widely traded. Officials also agreed that limiting the owner-linked rule to taxpayers with substantial interests reduces compliance costs, as it limits the number of shareholders that a company needs to investigate to determine if they hold owner-linked debt. Officials therefore recommended that the exemption be changed so it applies when a person owns less than 5 percent of a member of the worldwide group, *or* when the debt of the person is widely traded on a recognised exchange. The reduced ownership threshold was to counterbalance the removal of the recognised exchange requirement for minority shareholders. Officials noted that, with a 5 percent threshold, a maximum of 20 shareholders would need to be considered by the company to determine if they hold owner-linked debt. Officials noted that the general anti-avoidance provision could apply if owner-linked debt was spread across numerous associated entities. [*Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* page 83]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST (continued)

(10) Example of not including owner-linked debt in Worldwide Group debt	**(10) Example of not including owner-linked debt in Worldwide Group debt** Three shareholders collectively own NZ Co. As NZ Co is controlled by a non-resident owning body, its worldwide group is the same as its New Zealand group.  Non-resident owning body Shareholder 1 Shareholder 2 Shareholder 3 Offshore NZ NZ Co Debt Bank NZ & worldwide groups 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. Bank, however, will not be treated as an "owner" of NZ Co as it 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. *Effect of shareholders lending to NZ Co* The three shareholders lend a total of $500,000 to NZ Co, which has $800,000 of assets. The debt-to-asset ratio of NZ Co's New Zealand group is ($500k ÷ $800k) = 62.5 %. The debt-to-asset ratio of NZ Co's worldwide group is ($0 ÷ $800,000) = 0 % (as the debt from the owners is excluded). 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. *Effect of Bank lending to NZ Co* Instead of borrowing from its shareholders, NZ Co borrows the $500,000 from Bank. Again, NZ Co has $800,000 of assets. The debt-to-asset ratio of NZ Co's New Zealand group is ($500k ÷ $800k) = 62.5 %. The debt-to-asset ratio of NZ Co's worldwide group is ($500k ÷ $800k) = 62.5 %. 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. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 54 and *Commentary* on the Bill page 35]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION IV: WORLDWIDE GROUP TEST (continued)

(11) Deciding the worldwide group of a common member	**(11) Deciding the worldwide group of a common member** 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. 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. [**s. FE 14** amended by **s. 110** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION V: EXTENDING THE THIN CAPITALISATION RULES TO MORE TRUSTS

(1) Three new rules extending the application to trusts

(1) Three new rules extending the application to trusts

There are three new rules that define the application of the thin capitalisation rules to trusts. These rules are separate from, and in addition to, the existing "outbound" rules for New Zealand trusts in s. FE 2(1)(g).

1. Replaced s. FE 2(1)(d) states that the interest apportionment rules apply to the trustee of a trust if 50% or more of the value of settlements made on the trust is from settlements made by:

   (a) A non-resident or an associated person of a non-resident - (note, however that, under s. FE 2(4)(b), a NZ resident and a non-resident relative are not associated persons for the purposes of this rule if the non-resident has not made a settlement on the trust); or

   (b) A person who is described in paragraphs (a) to (cc) or would be described by this paragraph (d) or paragraph (db) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored – in other words, any other person who the interest apportionment rules apply to, other than excess debt outbound entities (companies, trusts and individuals); or

   (c) A group of persons who "act in concert", each of whom is described in paragraphs (a) to (cc) or would be described by this paragraph (d) or paragraph (db) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored – in other words, any persons to whom the interest apportionment rules apply to, acting in concert, other than excess debt outbound entities (companies, trusts and individuals).

2. New s. FE 2(1)(db) states that the interest apportionment rules apply to the trustee of a trust if a person described in paragraphs (a) to (cc), or would be described by this paragraph (db) or paragraph (d) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored, has the power to appoint or remove a trustee of the trust other than for the purpose of protecting a security interest – in other words, any other person who the interest apportionment rules apply to, has the power to appoint or remove a trustee of the trust other than for the purpose of protecting a security interest, other than excess debt outbound entities (companies, trusts and individuals).

3. New s. FE 2(1)(cc) states that the interest apportionment rules apply to a company that is resident in New Zealand if a trustee who meets the requirements of s. FE 2(1)(d) or (db):

   (a) Holds total ownership interests in the company of 50% or more; or

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

[**s. FE 2** amended by **s. 106** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION V: EXTENDING THE THIN CAPITALISATION RULES TO MORE TRUSTS (continued)

(2) The legislation extending the rules to trusts

(2) The legislation extending the rules to trusts

Section FE 2 sets out when subpart FE applies. Included in the list of persons to whom the rules apply in s. FE 2(1) are:

1. New paragraph (cb): A company that is resident in New Zealand if the company has members who make up a non-resident owning body for the company:

   (i) 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;

   (ii) Having control of the company by any other means;

2. New paragraph (cc): A company that is resident in New Zealand if a trustee who meets the requirements of paragraph (d) or (db):

   (i) Holds total ownership interests in the company of 50% or more;

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

3. Replaced paragraph (d): **The trustee of a trust** if 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;

   (ii) A person who is described in paragraphs (a) to (cc) or would be described by this paragraph or paragraph (db) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored;

   (iii) A group of persons who act in concert, each of whom is described in paragraphs (a) to (cc) or would be described by this paragraph or paragraph (db) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored;

4. New paragraph (db): **the trustee of a trust** if a person described in paragraphs (a) to (cc), or would be described by this paragraph or paragraph (d) if settlements made by the trustee and powers of appointment or removal held by the trustee were ignored, has the power to appoint or remove a trustee of the trust other than for the purpose of protecting a security interest:".

5. New section FE 2(4) provides that:

   A resident of New Zealand and a relative who is a non-resident are not associated persons:

   (a) In relation to a company for the purposes of subsection (1)(b)(ii), if the non-resident does not have a direct or indirect ownership interest in the company;

   (b) In relation to a trust for the purposes of subsection (1)(d)(i), if the non-resident has not made a settlement on the trust.

[**s. FE 2** amended by **s. 106** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION V: EXTENDING THE THIN CAPITALISATION RULES TO MORE TRUSTS (continued)

(3) Explanation in the TIB of the new rules applying to trusts	**(3) Explanation in the TIB of the new rules applying to trusts** Amendments to s. FE 2(1)(d) extend the thin capitalisation rules to all types of trusts for tax purposes (complying trusts, non-complying trusts and foreign trusts). The new rules mean a trust is subject to the thin capitalisation rules if the majority of settlements on it come from non-residents or from persons who are subject to the thin capitalisation rules. A trust will be subject to the rules if 50 percent or more of the settlements are made by: (a) A non-resident or a person associated with the nonresident (however, an associate will not include a relative who has not made any settlements on the trust to prevent the rules applying to a trust settled by a NZ resident merely because the resident has a non-resident relation); (b) An entity subject to the inbound thin capitalisation rules (that is, an entity to which s. FE 2(a) to (cc) and (db) applies); or (c) A group of non-residents or entities subject to the thin capitalisation rules that act in concert. As with companies, the thin capitalisation rules apply to trusts settled by entities acting in concert. This is important to ensure the rules cannot be easily circumvented through the use of trusts. However, the rules for determining when a group of entities appear to be acting together used for companies (described in the section non-resident owning body) cannot be used for trusts. Instead, the rules apply to a trust settled by a group "acting in concert". This is because, for example, it is not sensible to refer to settlements made in proportion to debt extended to a trust because rights to income from a trust generally do not depend on the amount a person has settled on it. New s. FE 2(1)(db) also provides that a trust is subject to the thin capitalisation rules if a person subject to the thin capitalisation rules has the power to appoint or remove a trustee. This is designed as an anti-circumvention measure. It means trusts are subject to the rules if they have been settled by a New Zealand resident and then effective control of the trust is transferred to a non-resident by giving the non-resident power to appoint or remove the trustee. There is a carve-out from this rule if a person has the power to add or remove a trustee for the purpose of protecting a security interest. This type of security interest is commonly held by banks that have lent to a trust. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 56]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION V: EXTENDING THE THIN CAPITALISATION RULES TO MORE TRUSTS (continued)

(3) Explanation in the TIB of the new rules applying to trusts (continued)	**(3) Explanation in the TIB of the new rules applying to trusts (continued)** Section FE 2(1)(d) and (db) provides that settlements made by the trustee and powers of removal or appointment of the trustee must be ignored when applying the sections. This is to prevent circularity if two trusts make settlements on each other or each has the ability to appoint the other's trustee. To illustrate, say settlements on Trust A are made by a non-resident and Trust B. Settlements made on Trust B are made by Trust A. It is only possible to determine whether Trust B is subject to the thin capitalisation rules if the settlement it has made on Trust A is ignored. Ignoring the settlement means the sole settlor of Trust A is a non-resident. Trust B is therefore subject to the thin capitalisation rules as it has been settled by a trust that is itself subject to the rules. Once Trust B's status is determined, it is possible to determine that Trust A should also be subject to the rules as it has also been settled by entities that are subject to the rules (a non-resident and Trust B). [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 56]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION V: EXTENDING THE THIN CAPITALISATION RULES TO MORE TRUSTS (continued)

(4) New rules for determining the NZ Group and the Worldwide Group of a trustee	**(4) New rules for determining the NZ Group and the Worldwide Group of a trustee** The rule in s. FE 3(1)(a) is now limited to determining the New Zealand group of a natural person who is subject to the thin capitalisation rules other than by virtue of the "outbound" (ownership of a CFC or FIF for which the AFI method is used) rules (this rule previously also applied to the determination of the NZ group of a trustee of a non-complying trust settled by a non-resident where settlements by the non-resident and associates are 50% or more of the total settlements): • The NZ group of a natural person consists of the natural person and all associated persons who are NZ residents, or carrying on business through a fixed establishment in NZ, or derive NZ-sourced income that is not exempt under a tax treaty (other than non-resident passive income). Two new rules in s. FE 3(1)(c) and s. FE 3(1)(d) apply to the determination of the NZ group and worldwide group of a trustee described in s. FE 2(1)(d) or FE 2(1)(db) as set out on the previous page: (a) The New Zealand group of a trustee is made up of the trustee and all companies identified under s. FE 27 as being under the control of the trustee (i.e. using either the 50% or the 66% threshold), other than a company with a New Zealand parent not determined under s. FE 26(4D). **Note:** in s. FE 26(4D) the NZ parent is the trustee referred to in s. FE 2(1)(d) or FE 2(1)(db) – i.e. a company with a NZ parent that is not the trustee is not included in the trustee's NZ Group. (Until the 2015-16 income year, the trustee's NZ group includes all associated persons who are NZ residents, or carrying on business through a fixed establishment in NZ, or derive NZ-sourced income that is not exempt under a tax treaty, other than non-resident passive income.) (b) The worldwide group of the trustee is the trustee's NZ group (until the 2015-16 income year, the trustee's worldwide group includes all non-residents who are associated either with the trustee or with a member of the trustee's NZ group). [**s. FE 3** amended by **s. 107** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION V: EXTENDING THE THIN CAPITALISATION RULES TO MORE TRUSTS (continued)

(5) Explanation in the TIB of grouping rules for trusts	**(5) Explanation in the TIB of grouping rules for trusts** Amendments to section FE 3 define the New Zealand group of a trust as the trust and all companies controlled by the trust. Whether a trust controls a company is determined under section FE 27, based on the trust's choice of control threshold under that section. Similarly, the New Zealand group of a company that is controlled by a trust will be the trust and all other companies controlled by the trust. This is provided by new s. FE 26(4D), which defines the New Zealand parent of a company controlled by a trust to be the trust. The other members of the New Zealand group will then be determined under section FE 28. As with companies controlled by non-resident owning bodies, the worldwide group of a trust will be the same as its New Zealand group. This is provided by section FE 3(1)(d). [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 56]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION VI: EXTENSION OF ON-LENDING CONCESSION FOR TRUSTS

(1) The on-lending concession applying to trusts	**(1) The on-lending concession applying to trusts** The on-lending concession in s. FE 13 applies when: (a) A person enters into a financial arrangement with another person (**person A**); and (b) The person is a natural person, a member of a natural person's New Zealand group, an excess debt entity, or a member of an entity's New Zealand group or worldwide group; and (c) In the absence of s. FE 13, the financial arrangement would be included in the calculation of the debt percentage of the natural person, excess debt entity, New Zealand group, or worldwide group; and (d) The person: (i) Provides funds to person A under the financial arrangement; or (ii) Is **the trustee of a trust** with no trust property other than financial arrangements and property incidental to financial arrangements. Therefore, the on-lending concession will apply to all financial arrangements of a trustee if: (a) The trust property consists only of financial arrangements; and (b) The consideration for the financial arrangements are at arm's length and the requirements for **person A** are met – i.e.: (i) **Person A** is a non-resident not carrying on business through a fixed establishment in NZ and not deriving NZ-sourced income that is not exempt under a tax treaty other than non-resident passive income; or (ii) **Person A** is a person not associated with the trust; or (iii) **Person A** is associated with the trust, but is not a member of the trust's NZ group and is a person to whom the thin capitalisation rules separately apply. [**s. FE 13** amended by **s. 109** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION VI: EXTENSION OF ON-LENDING CONCESSION FOR TRUSTS (continued)

(2) TIB explanation of the on-lending concession applying to trusts	**(2) TIB explanation of the on-lending concession applying to trusts** Currently, section FE 13 provides what is commonly referred to as the "on-lending concession". It removes financial arrangements that provide funds to a person from the ambit of the thin capitalisation rules. Amendments to section FE 13 mean that, for a trust that holds only financial arrangements and property incidental to those financial arrangements, the on-lending concession will apply regardless of whether the arrangement provides funds. This amendment is designed for securitisation vehicles that hold only financial arrangements which will become subject to the rules because of the changes relating to trusts described above. This carve-out is on the basis that the on-lending concession would apply to most of the trust's debt in any event. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 57]

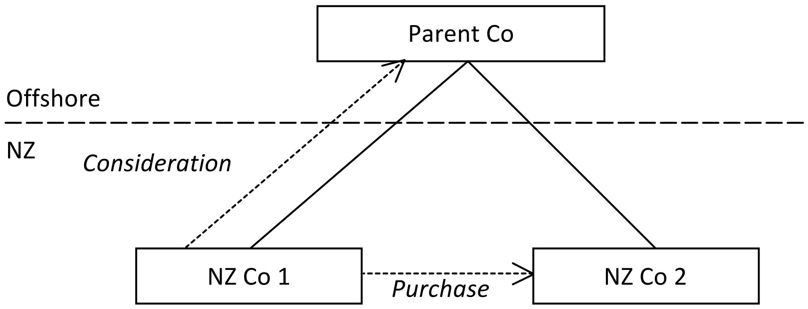
THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION VII: CHANGES IN ASSET VALUES FROM TRANSFERS BETWEEN ASSOCIATES

(1) Not recognising changes in asset values arising from transfers between associates	**(1) Not recognising changes in asset values arising from transfers between associates** 1. A change in value is excluded if the change arises from a transfer between associated persons by the new s. FE 16(1D) which states that the value of the total group assets does not include a change in the value of assets arising from a transfer of the assets or ownership interests between a member of the group and an associated person in or after the 2015–16 income year. 2. However, there are two exceptions to the rule in s. FE 16(1D), under s. FE 16(1E): a change in asset values can be included in group assets if: (a) The change would have been permitted under generally accepted accounting practice in the absence of the transfer; or (b) The change: (i) Arises for a company that, with other companies, has its ownership or control purchased by a person (the **purchaser**) who is not an associated person of the former owner and that is restructured on being included in the purchaser's group (the **group**); and (ii) Includes a change in value for the company's assets in NZ that is a reasonable proportion of the change in value of the group's total assets. In other words, a change in asset values arising from transfer between associated persons can be included if the change is equivalent to a revaluation or arises from a purchase by a non-associate. [**s. FE 16** amended by **s. 111** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION VII: CHANGES IN ASSET VALUES FROM TRANSFERS BETWEEN ASSOCIATES (cont.)

(2) TIB explanation of not recognising an asset uplift	**(2) TIB explanation of not recognising an asset uplift** New sections FE 16(1D) and (1E) provide that increases in a company's New Zealand group assets that arise from the sale or other transfer of assets between a member of the group and a person associated with the group must be ignored. This may or may not be another member of the group. This change applies only in relation to transfers that occur in or after the 2015–16 income year. The purpose of this change is to ensure that increases in asset values that are not recognised under generally accepted accounting practice in the consolidated worldwide accounts of a company cannot be recognised in the asset values of the company's New Zealand group. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 57]
(3) Example in the TIB of not recognising an asset uplift	**(3) Example in the TIB of not recognising an asset uplift** Parent Co owns two New Zealand subsidiaries, NZ Co 1 and NZ Co 2.  Parent Co Offshore NZ Consideration NZ Co 1 Purchase NZ Co 2 NZ Co 1 purchases the shares in NZ Co 2 from Parent Co. NZ Co 1 will not be able to include any increase in asset values resulting from this purchase for thin capitalisation purposes unless that increase would have been allowed under generally accepted accounting practice in the absence of the purchase. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 57]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION VII: CHANGES IN ASSET VALUES FROM TRANSFERS BETWEEN ASSOCIATES (cont.)

(4) Explanation in the TIB of when an asset uplift can be recognised	**(4) Explanation in the TIB of when an asset uplift can be recognised** Section FE 16(1E) will provide two exemptions to the rule above. These are when: (a) Generally accepted accounting practice would allow the increase in asset values in the absence of the transfer; or (b) The transfer is part of a restructure following the purchase of the group by a person not associated with the group and the change in the value of the New Zealand group's assets is a reasonable proportion of the change in the value of the group's total assets. The intention behind the second exemption is to allow uplifts to be recognised when a third party has, in essence, purchased a group of companies and part of that purchase price relates to the group's intangible property. Following this, the purchaser may restructure the group, in part to spread the value of the intangible property among all its subsidiaries. An increase in the assets of the New Zealand group following such a restructure is allowable, provided the increase is a reasonable considering the increase in the value of the entire group's assets (for example, having regard to the relative size of the New Zealand group). [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 57]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION VIII: EXCLUDING INDIVIDUALS & TRUSTEES INDIRECT INTERESTS IN A CFC

(1) Excluding individuals' and trustees' interest in CFCs and FIFs held through associated persons	**(1) Excluding individuals' and trustees' interest in CFCs and FIFs held through associated persons** Section FE 16 sets out the rules for measuring total group assets of a New Zealand group. Investments in a CFC, an exempt Australian FIF, or a FIF for which the AFI method is used, are excluded, under s. FE 16(1B), from being part of total group assets (except to the extent the investments are part of an on-lending concession or the CFC or FIF derives NZ-sourced income). This exclusion is being expanded so as to also apply to CFC and relevant FIF interest of associated persons. 1. New s. FE 16(1BA) specifies that the exclusion in s. FE 16(1B) applies to an investment of a person (the **relevant person**) who is either the excess debt entity or another member of the New Zealand group, and that is an investment: (a) In a CFC in which the relevant person has an income interest; or (b) In a FIF in which the relevant person has an interest meeting the requirements of section EX 35 – i.e. exempt Australian FIF or for which the relevant person uses the attributable FIF income method; or (c) Of a trustee or natural person in a CFC through an income interest in the CFC of an associated person, if the associated person would be a member of the New Zealand group but for being an excess debt outbound company or being included in the New Zealand group of an excess debt outbound company; or (d) Of a trustee or natural person in a FIF, through an income interest of an associated person that meets the requirements of subparagraph (ii) for the FIF and the associated person as a relevant person, if the associated person would be a member of the New Zealand group but for being an excess debt outbound company or being included in the New Zealand group of an excess debt outbound company. 2. Section FE 16(1B) applies to the investments excluded by s. FE 16(1BA). [**s. FE 16** amended by **s. 111** of the *Taxation (Annual Rates, employee Allowances, and Remedial Matters) Act 2014* applying for the 2015-16 and later income years.]

THIN CAPITALISATION RULES: CHANGES LEGISLATED IN 2014

SECTION VIII: EXCLUDING INDIVIDUALS & TRUSTEES INDIRECT INTERESTS IN A CFC (cont.)

(2) Explanation in the TIB of when CFC interests are excluded from assets	**(2) Explanation in the TIB of when CFC interests are excluded from assets** New s. FE 16(1BA) largely rewrites the previous s. FE 16(1B) but with a new provision. Individuals or trustees will be required to exclude certain interests in a controlled foreign company (CFC) or foreign investment fund (FIF) they hold indirectly through an associate that is outside their New Zealand group if the associate is outside their group by virtue of being an excess debt outbound company or included in the group of such a company. This provision is necessary as s. FE 3(2)(a) excludes from the New Zealand group of an individual or trustee who is an outbound investor, all companies that are excess debt outbound companies or included in the group of such a company. Despite this provision, the person or trustee's indirect interests in the CFC or FIF should be still be excluded from their group assets. [*Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 57]
(3) Explanation in the Officials' Report of when indirect CFC interests are excluded	**(3) Explanation in the Officials' Report of when indirect CFC interests are excluded** Proposed section FE 16(1BA) will bring the treatment of a person who has a significant indirect interest in a CFC in line with the treatment where they have a significant direct interest in a CFC. Officials consider the proposal should therefore proceed. The submitter is correct that the individual or trustee will be taxed on their CFC or FIF income when it is eventually distributed. However, until this distribution occurs the individual or trustee may gain significantly from deferral. Officials note this situation could be avoided by placing debt offshore (so thin capitalisation thresholds are not breached) or by placing debt in a company (where any interest denial will generate imputation credits, preventing double-taxation of the eventual distribution). [*Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill* page 88]