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VENTURE CAPITAL NZ TAX EXEMPTION FOR QUALIFYING FOREIGN EQUITY INVESTORS ("QFEI EXEMPTION")

1. A foreign investor that is a tax exempt entity in its country of residence, will be exempt from NZ income tax on the proceeds from a disposal of a share or option in a NZ company if all of the following requirements are satisfied:

   (a) The foreign investor's country of residence is an approved country.

   (b) The requirements to be a qualifying foreign equity investor (QFEI) are met.

   (c) The minimum holding period requirement has been met.

   (d) The NZ investee company satisfies the requirements for the exemption to apply.

Approved countries

2. The foreign investor must be a tax resident of an approved country under a double tax agreement between NZ and the approved country, or if there is no double tax agreement, under the laws of the approved country.

3. The approved countries, at the time of writing, are: Austria, Australia, Belgium, Canada, Chile, China, Denmark, Fiji, Finland, France, Germany, India, Indonesia, Ireland, Italy, Japan, Korea, Malaysia, Mexico, The Netherlands, Norway, The Philippines, Poland, Russia, Singapore, South Africa, Spain, Sweden, Taiwan, Thailand, United Arab Emirates, United Kingdom and United States of America.

4. Note: The initial list contained all the countries with which New Zealand had a double tax agreement except for Switzerland. Since then, New Zealand has negotiated double tax agreements with Hong Kong and Papua New Guinea (although the latter is not yet in force at the time of writing).

Qualifying foreign equity investor (QFEI)

5. In order to be treated as a QFEI, a foreign investor must meet all of the requirements set out in paragraphs 6 to 8 below.

6. The foreign investor must be one of the following:

   - A look-through entity.
   - A limited partnership.
   - A foreign resident legally entitled to the proceeds from the disposal of the share option, under the laws of its country of residence.

7. The foreign investor must be exempt from tax in their country of residence on the proceeds from the disposal of the share or option. The foreign investor should not be able to claim a tax credit or some type of similar compensation if tax had been paid in New Zealand on the proceeds.

8. The foreign investor cannot be a NZ resident, or have NZ residents as its members or partners. In addition, the foreign investor must not have any association with a NZ resident such that that the aggregated ownership interests in the foreign investor of persons associated with the NZ resident, would amount to 10% or more of the ownership interest in the foreign investor.

Minimum Holding Period Requirement

9. The share, option or convertible note must have been bought at least 12 months before the date of sale or other disposal.

10. The exemption from income tax applies only to the proceeds from a share or an option, so it follows that a convertible note must be converted into a share or option before it is disposed of.

Requirements For the NZ Investee Company

11. The NZ investee company must satisfy all of the following requirements in order for the QFEI exemption to apply.

12. At some point in the first 12-month period following the purchase of the share or option (or convertible note) by the foreign investor, the shares of the NZ company must *not* be listed on any stock exchange.

13. The NZ investee company is allowed to fund another company, but in that case, there must be some point in time, during the period the share or option is held by the foreign investor, that the NZ company and each company that is directly or indirectly funded by it, are both *not* listed on any stock exchange.

14. <u>The following requirements must be met for the entire period during which the share or option (or convertible note) is held by the foreign investor</u>:

    (a) The NZ investee company cannot have any of the following activities (<u>the prohibited activities</u>) as its main activity:

        (i) Land development or land ownership.

        (ii) Mining.

        (iii) Provision of financial services.

        (iv) Insurance.

        (v) Construction or acquisition of public infrastructure assets.

        (vi) Investing to derive interest, dividends, rent, or personal property lease payments that are not royalties.

(b) Notwithstanding the above, the NZ investee company can provide funding, in the form of debt or equity funding, to another company provided that:

(i) If the funded company is a NZ company, it does not have any of the prohibited activities as its main activity.

(ii) If the funded company is itself a NZ funding company that funds other companies, the other funded companies that are NZ companies:

- Do not have any of the prohibited activities as their main activity; or
- Do not themselves fund any other NZ companies with prohibited activities as their main activities.

(iii) If the funded company is not a NZ resident, it does not fund a NZ company that has any of the prohibited activities as its main activity.

Inland Revenue has published the following explanation of the QFEI exemption at the following website address:

http://www.ird.govt.nz/technical-tax/legislation/2005/2005-111/2005-111-policy-issues/pi-new-rules/

Policy Issues - New rules for international venture capital

Section CB 2(1) and CB 2(4) of the Income Tax Act 1994 and section CW 11B of the Income Tax Act 2004

Introduction

1. Amendments to the Income Tax Act remove a tax barrier to unlisted New Zealand companies gaining access to offshore private equity and venture capital. The changes target non-resident institutional investors such as foreign pension funds that are tax-exempt in their own jurisdictions and are established or resident in a number of approved countries. Tax-exempt institutional investors, such as foreign pension funds, account for a substantial proportion of international venture capital. These changes are similar to those enacted in Australia in 2001.

Background

2. The term "venture capital" is used typically to describe a variety of private equity investments, from funding of new companies and early stage expansion capital to management buy-in and buy-out transactions for established companies. As a rule, venture capital investment concerns investments into unlisted companies.

3. Before the amendments, there were no special tax rules for venture capital investment. Therefore a venture capital investor that purchased shares in an unlisted New Zealand company would be taxed on any gains according to ordinary tax concepts.

4. Under these principles, dividends are taxed as gross income when they are derived, and profits derived on the sale of shares are taxed if the shares are held on revenue account. Broadly, shares are held on revenue account if they are purchased with the dominant purpose of resale, or if the profits from sale form part of the investor's business income.

5. The application of these rules to non-resident investors is subject to the provisions of a double tax agreement (DTA) if the non-resident is resident in a country with which New Zealand has a DTA. In the context of venture capital investment, our DTAs will not generally remove New Zealand's ability to tax revenue account share profits. In other words, before these amendments, non-resident venture capital investors investing in New Zealand would be taxed on realised share profits if they held the shares on revenue account.

6. The nature of venture capital investing, combined with the capital/revenue distinction, resulted in complexity and uncertainty for non-residents contemplating venture capital investment in New Zealand.

7. The new rules target non-resident venture capital investors established or resident in an approved country that are sensitive to the imposition of New Zealand tax. Non-resident investors will generally be sensitive to such tax if they are tax-exempt in their own jurisdiction, since their tax-exempt status will mean that they will not be able to claim, or make use of, a credit for New Zealand tax paid. In the venture capital context this is an

important issue because a number of institutional investors that invest in venture capital internationally, such as United States pension funds, are tax-exempt in their home jurisdiction.

8. The new rules use the availability of a tax credit (or other similar compensation) for New Zealand tax paid as a proxy for whether an entity is sensitive to the imposition of New Zealand tax. This should ensure that foreign tax-exempt institutional investors can qualify for the exemption.

9. It is very common for tax-exempt institutional investors to invest in venture capital opportunities via a foreign fund. In a venture capital context, foreign funds pool capital from a number of different investors and invest the capital in a number of different local fund managers. Therefore, to be effective, the new rules also accommodate such foreign funds.

10. In addition, the tax rule that limited the ability of special partners in a special partnership to offset special partnership tax losses against their other income has been repealed. This is designed to facilitate New Zealand resident investors investing alongside non-resident investors in venture capital through a special partnership.

Key feature

11. The main provisions giving effect to the new venture capital tax rules are contained in section CB 2(1)(g) and section CB 2(4) of the Income Tax Act 1994 and section CW 11B of the 2004 Act. The main features of the new provisions are as follows:

    (a) Profits derived by a qualifying foreign equity investor (QFEI) on the sale of shares in unlisted New Zealand resident companies that do not engage in certain prohibited activities are exempt from income tax.

    (b) A QFEI can either be a direct non-resident investor, an investor in a foreign "flow-through" limited partnership or a foreign "flow-through" entity.

    (c) To qualify as a direct QFEI the non-resident must satisfy the following main criteria:

        (i) The person must be resident in a country with which New Zealand has a DTA (excluding Switzerland).

        (ii) The person must be unable to benefit from a tax credit in its own jurisdiction for any tax that New Zealand would have imposed if it were not for the exemption.

    (d) For a person to qualify as a QFEI in a foreign limited liability partnership the partnership must satisfy the following main criteria:

        (i) The partnership must be established under the laws of a country with which New Zealand has a DTA (excluding Switzerland).

        (ii) The partnership must have at least one limited partner.

        (iii) The general partner of the partnership must be resident in a country with which New Zealand has a DTA (excluding Switzerland).

        (iv) All partners with a greater than ten percent interest in the partnership must be:

            a. Resident in country with which New Zealand has a DTA (excluding Switzerland); and

            b. Unable to benefit from a tax credit in their own jurisdiction for any tax that New Zealand would have imposed if it were not for the exemption.

(v) For a foreign flow-through entity to qualify as a QFEI it must meet the following main criteria:

a. The entity must be established under the laws of a country with which New Zealand has a DTA (excluding Switzerland).

b. All members with a greater than ten percent interest in the entity must be:

- Resident in country with which New Zealand has a DTA (excluding Switzerland); and
- Unable to benefit from a tax credit in their own jurisdiction for any tax that New Zealand would have imposed if it were not for the exemption.

(e) Section HC 1 has been repealed. This provision prohibited the partners of special partnerships from offsetting special partnership tax losses against their other income.

Detailed analysis

12. The venture capital exemption is provided by the addition of new paragraphs (g) and (h) to section CB 2(1) of the Income Tax Act 1994 and the addition of CW 11B(1) to the 2004 Act. These provisions provide that the proceeds from the sale of shares by an eligible investor in certain unlisted New Zealand companies will be exempt from income tax if a number of criteria are met. The rules for determining which non-resident investors qualify are contained in the definition of "qualifying foreign equity investor" (QFEI) in section CB 2(4) of the 1994 Act and section CW 11B(4) of the 2004 Act. The new provisions do not change the current treatment of dividends that non-residents derive from the underlying companies.

Concept of eligible investment

13. New paragraphs (g) and (h) of section CB 2(1) and section CW 11B(1) list the criteria under which an amount may qualify as "non-residents' exempt income". Broadly, to be exempt, an amount must be derived by a QFEI from the sale of shares in an unlisted New Zealand resident company that does not have as a main activity one of the listed prohibited activities.

14. Venture capital investment can be made directly into a particular unlisted company (by purchasing shares directly in that company) or indirectly (by purchasing shares in a holding company that on-invests into the particular unlisted company). The new venture capital rules contemplate both scenarios. Section CB 2(1)(g) and section CW 11B(1)-(2) concern direct investment, while section CB 2(1)(h) and section CW 11B(1) and (3) concern indirect investment via a holding company.

15. Under both paragraphs, a number of criteria must be met in order for the investment to qualify for the exemption. Several of the criteria under each paragraph are very similar or the same - the main, common criteria will be discussed first. The criteria that are specific to investment directly and via a holding company will then be discussed.

Common criteria

Applies to shares and options to purchase shares

16. The exemptions in section CB 2(1)(g) and section CB 2(1)(h) of the 1994 Act and sections CW 11B(1) of the 2004 Act are limited to the sale of a share or an option to buy a share. The exemption is limited to shares and options to buy shares because a key characteristic of venture capital investment is that the venture capital investor's return is connected directly

with the performance of the company into which the investment is made. This is why a debt investment is not included in the exemption.

17. The current definition of "share" in section OB 1(a) encompasses investments that have both debt and equity characteristics. That is, in subparagraph (ii) of section OB 1(a) a debenture to which section FC1 applies is included in the definition of "share". A debenture of this type is one where the interest payable is determined by reference to the dividends payable or the company's profits. As the return from such a debenture is linked directly to the performance of the company, it is appropriate that such an investment is included in the new venture capital rules.

18. This definition would not encompass a share option because a share option is not a direct "interest in the capital of a company". However, the economic substance of a share option (the option to purchase shares in a company at a given price at some time in the future) is clearly akin to an equity interest in that company. Therefore the sale and purchase of an option to buy a share is included in the new rules (section CB 2(1)(g); section CB 2(1)(g)(i); section CB 2(1)(h); section CB 2(1)(h)(i) of the 1994 Act and section CW 11B(1)(b) of the 2004 Act).

19. The purchase of a note that is convertible into shares is also encompassed by the exemption, provided that the conversion occurs before the sale is made (section CB 2(1)(g)(i); section CB 2(1)(h)(i) of the 1994 Act and section CW 11B(1)(b) of the 2004 Act). This is consistent with the Australian approach and provides further flexibility when investing in venture capital.

Investments held for at least 12 months

20. To qualify for the exemption, a QFEI must have purchased the share, share option or convertible note at least 12 months before the share or share option is sold (section CB 2(1)(g)(i); section CB 2(1)(h)(i) of the 1994 Act and section CW 11B(1)(b) of the 2004 Act). This requirement is designed to ensure that the investment is genuinely venture capital in nature. That is, one of the key factors that distinguish venture capital from other types of investment is that the stock is generally held for the medium to long term. (For this reason venture capital is often referred to as "patient equity".)

Direct investment

Listing requirements

21. To qualify for the exemption, the shares purchased by the QFEI must either be unlisted on a "recognised exchange" at the time of purchase or, if they are listed at the time of purchase, they are de-listed at some stage within a year following the purchase (section CB 2(1)(g)(iii)(A), (B) of the 1994 Act and section CW 11B(1)(d) of the 2004 Act). A recognised exchange is defined in section OB1. Broadly, it can be described as an exchange market established in New Zealand or anywhere else in the world that exhibits certain criteria that are likely to produce genuine market values for the stock that is traded.

Main activity cannot be a prohibited activity

22. To qualify for the exemption, the company into which the investment is made cannot, for the entire period of the investment, carry on as its main activity any of the activities listed in section CB 2(1)(g)(iv)(A)-(H) of the 1994 Act and section CW 11B(2)(a)-(h) of the 2004 Act). The prohibited activities include land development and ownership and the provision of financial services.

Investment into holding companies

23. Section CB 2(1)(h) of the 1994 Act and section CW 11B(3) of the 2004 Act ensure that a venture capital investment made via a company that on-invests (the holding company) into the ultimate investee company can still qualify for the exemption. The provisions are designed to ensure a level of commercial flexibility when making venture capital investment.

24. In a private equity context, holding companies typically engage as their main activity in the provision of funding to the ultimate investee companies. Given this main function, it is likely that an investment into such a holding company would not qualify under section CB2(1)(g). This is because the holding company would probably be considered to have as a main activity the provision of financial services or investing passively. (Both are prohibited activities under section CB 2(1)(g)(iv)(D) and (H) and section CW 11B(2)(a) to (h).) Section CB 2(1)(h) and section CW 11B(3) overcome this problem by providing that an investment into a holding company can qualify, provided a number of criteria are met. (These criteria are additional to the criteria that are common to direct investment and investment into a holding company that are discussed above.)

Listing requirements

25. To qualify for the exemption, there must be some time during the 12 months following purchase of the investment when the shares of the holding company that is invested into are not listed on the official list of a recognised exchange (section CB 2(1)(h)(iii) of the 1994 Act and section CW 11B(1)(d) of the 2004 Act). This is the same criterion as for direct investment.

26. In addition, there is a requirement that the companies that the holding company invests into (both New Zealand resident and non-resident companies) not be listed on a recognised exchange at some time during the period of the investment in the holding company. There is also a requirement that there be at least one point in time during the period of the investment when each of the ultimate investee companies and the holding company is not listed on a recognised exchange (section CB 2(h)(vii) and section CW 11B(3)(c)).

Activity of holding company

27. The holding company must have as its main activity the provision of capital, either as debt or equity, to other companies (section CB 2(1)(h)(iv) and section CW 11B(3)).

Activities of New Zealand resident companies invested into

28. The New Zealand resident companies that the holding company invests into do not have as their main activity any of the prohibited activities that apply to direct investments, unless the activity is the provision of financial services or passive investment (section CB2(1)(h)(v)(A) and section CW 11B(3)(a)(i)). This is to ensure that if the holding company investment route is taken, the companies that ultimately receive the benefit of the investment are in the same category as those that are targeted by the direct investment exemption.

29. The exception that is provided for New Zealand resident companies invested into that provide financial services or engage in passive activities is designed to accommodate an investment by a holding company into another holding company (second-tier holding company). This explains why there is a requirement that the second-tier holding company cannot have as a main activity the provision of financial services or passive investment activity unless the activity is the provision of capital to other companies (section CB 2(1)(h)(v)(B) and section CW 11B(3)(a)(ii)).

30. The rules have also been designed to accommodate chains of New Zealand resident holding companies. This is achieved by allowing the second-tier holding company to provide capital to companies that are similar in nature to the second-tier holding company (third-tier holding companies) or are the target investee companies (section CB 2(1)(h)(v)(C) and (D) and section CW 11B(3)(a)(iii) and (iv)). The inclusion of the words "directly or indirectly" in these provisions is designed to ensure that multiple tiers of holding companies are accommodated by the rules.

Activities of non-New Zealand resident companies invested into

31. A non-New Zealand resident company cannot provide capital to a New Zealand resident company, either directly or indirectly, that has as a main activity any of the prohibited activities listed in section CB 2(1)(g)(iv)(A) to (H), section CB 2(1)(h)(vi), section CW 11B(2)(a)-(h) and section CW 11B(3)(b)). This rule is designed to ensure that the new rules cannot be used to direct investment into ineligible activities via an offshore holding company.

Concept of eligible investor

32. The automatic venture capital exemption in paragraphs (g) and (h) of section CB 2(1) and section CW 11B(1) is available only to certain non-resident investors. A qualifying investor is defined as a "qualifying foreign equity investor" (QFEI), of which there are three categories (section CB 2(4) and section CW 11B(4)). The first category targets non-residents that invest directly into New Zealand venture capital opportunities, while the other two categories target indirect investment via foreign limited liability partnerships and foreign flow-through entities.

Investment directly into New Zealand

33. This category is aimed at non-resident venture capital investors that provide the capital to the ultimate investee company directly. The rules that determine whether a person qualifies as a QFEI under this category are contained in section CB 2(4)(a) and the definition of "foreign exempt person" in section CW 11B(4). The main criteria that must be satisfied in order to qualify under this category are discussed below.

Resident in an approved country

34. To qualify as a QFEI under this category, the person must be non-New Zealand resident and resident in a country that is approved for the purpose of the definition of QFEI (section CB 2(4)(a)(i) and section CW 11B(4), paragraph (a) of the definition of "foreign exempt person"). With the exception of Switzerland, this list contains all countries with which New Zealand currently has a DTA in force. These countries are:

- Australia
- Belgium
- Canada
- China
- Denmark
- Fiji
- Finland
- France

- Germany
- India
- Indonesia
- Ireland
- Italy
- Japan
- Korea
- Malaysia
- Netherlands
- Norway
- Philippines
- Russia
- Singapore
- South Africa
- Sweden
- Taiwan [1]
- Thailand
- United Arab Emirates
- United Kingdom
- United States of America

35. The new rules in section CB 2(7) and section CW 11B(6) contain the provisions for including and withdrawing countries. This list is amendable by Order in Council.

36. The presence of a DTA will allow Inland Revenue to invoke the exchange-of-information Article of the DTA in order to receive information on particular investors and transactions. This will assist in the administration of the new rules.

37. To be included on the list it is necessary for the DTA country to engage in effective exchange-of-information. For this reason Switzerland is not included on the list. It is recognised that effective information exchange agreements may be negotiated in the future outside the context of a full DTA. If this occurs there may be some scope to extend the list of eligible countries beyond those with which there is a DTA.

Inability to make use of a credit for New Zealand tax paid

38. To qualify for the exemption, the non-resident investor must be unable to claim a tax credit or other compensation for any income tax that New Zealand tax laws may, but for the exemption in the new section CB2(1)(g) and (h) and section CW 11B(1), have levied on the income (section CB 2(4)(a)(v) and section CW11B(4), paragraph (e) of the definition of "foreign exempt person"). This inability must result from the investor's special status under the tax laws of its home jurisdiction. The formulation targets investors that are tax-exempt in their

own jurisdiction owing to their special status under the tax laws there, rather than their particular circumstances at any point in time. For example, a non-resident that is unable to utilise a credit because it is in a tax loss position for the year would not qualify as a QFEI.

The inability to make use of a credit cannot arise from flow-through status

39. The non-resident must also be treated by the tax laws of the country in which it is resident as the person who derives the proceeds from the sale of the shares (section CB 2(4)(iv) and section CW 11B(4), paragraph (d) of the definition of "foreign exempt person"). This is designed to exclude from this category of QFEI foreign vehicles that are treated by the tax laws of their countries as flow-through for tax purpose. Broadly, a flow-through vehicle is not taxed as an entity. Instead the income flows through to the vehicle's investors and is taxed according to those investors' individual tax status.

40. If foreign flow-through vehicles were not excluded from this category of QFEI it would be possible that such vehicles that New Zealand may treat as being resident in an approved country would qualify under this category. This is because such vehicles could maintain successfully that the fact that they are not taxed as an entity automatically means that they are unable to benefit from a credit for New Zealand tax that would otherwise be imposed. This would not necessarily be the correct result because the determination of whether a foreign flow-through vehicle should benefit from the exemption should depend on whether the main investors in the vehicle can benefit from a tax credit for any New Zealand tax imposed. The rules concerning the other two categories of QFEI (paragraphs (b) and (c) of section CB2(4) and paragraphs and section CW 11B(4) ("foreign exempt partnership" and "foreign exempt entity") have been designed to ensure that this determination is made appropriately.

Foreign limited liability partnerships

41. This category of QFEI is designed to accommodate non-resident venture capital investors in foreign limited liability partnerships (FLLPs) that New Zealand treats as transparent for tax purposes. In this context "transparent" means that, instead of taxing the foreign vehicle as an entity, New Zealand tax rules would tax the investors in the vehicle directly, based on their interest in the vehicle. The rules are designed to provide the exemption to the non-resident person investing in the vehicle, provided that the vehicle meets a number of criteria. The rules are contained in section CB 2(4)(b) and the definition of "foreign exempt partnership" in section CW 11B(4), and the main criteria are discussed below.

Established under the laws of an approved country

42. To qualify as a QFEI under this category, the non-resident person must be an investor in an unincorporated body that is established under the laws of an approved country (section CB 2(4)(b)(i) and section CW 11B(4), paragraph (a) of the definition of "foreign exempt partnership"). It is also necessary to accommodate FLLPs that are established under these State laws of an approved country. This is because in a number of countries that have federal systems, it is a particular state law rather than the federal law that establish these vehicles. Therefore the subparagraphs also provide for bodies that are "established under the laws of part of such a territory".

Must have the main characteristics of a limited partnership

43. The unincorporated body must exhibit the main characteristics of a limited partnership (section CB 2(4)(b)(ii)-(v) and section CW 11B(4), paragraphs (b)-(e) of the definition of "foreign exempt partnership"). Therefore the body must be one that:

    (a) Consists of persons (section CB 2(4)(b)(ii) and section CW 11B(4), paragraph (b) of the definition of "foreign exempt partnership");

    (b) Is treated by the tax rules of the other country as flow-through body (section CB 2(4)(b)(iii) and section CW 11B(4), paragraph (c) of the definition of "foreign exempt partnership");

    (c) Has at least one general partner who is involved in the running of the body, has a controlling interest in the body and is liable for all the debts of the body (section CB 2(4)(b)(iv) and section CW 11B(4), paragraph (d) of the definition of "foreign exempt partnership"); and

    (d) Has at least one limited partner who has a limited involvement in the running of the body, does not control the body and has limited liability for the debts of the body (section CB 2(4)(b)(v) and section CW 11B(4), paragraph (e) of the definition of "foreign exempt partnership").

General partners resident in approved territory

44. The unincorporated body's general partners must all be resident in an approved territory (section CB 2(4)(b)(vi) and section CW 11B(4), paragraph (f) of the definition of "foreign exempt partnership"). The general partners are the people in the body that are responsible for the business activities of the body. Therefore it is likely that they will have access to the necessary information concerning investors and investments. Requiring general partners to be resident in an approved country (that is also a country with which New Zealand has a DTA with an effective exchange-of-information Article) should ensure that Inland Revenue is able to administer the rules effectively.

Substantial investors are resident in an approved territory

45. To qualify as a QFEI under this category, the non-resident person must be an investor in an unincorporated body where all the investors that own ten percent or more of the capital of the body are resident in an approved territory (section CB 2(4)(b)(vii) and section CW 11B(4), paragraph (g) of the definition of "foreign exempt partnership"). This provision will ensure that the significant investors in the body are resident in a country with which New Zealand has a DTA with an effective exchange-of-information Article. This should ensure that Inland Revenue is able to administer the rules effectively.

Substantial investors in the body are not able to benefit from a tax credit

46. To qualify as a QFEI under this category, the non-resident person must be an investor in an unincorporated body where all the investors that own ten percent or more of the capital of the body are unable to benefit from a tax credit for New Zealand tax that would, in the absence of the exemption, be payable (section CB 2(4)(b)(viii) and section CW 11B(4), paragraph (h) of the definition of "foreign exempt partnership"). This criterion is designed to ensure that the main ultimate investors are sensitive to the imposition of New Zealand tax.

Foreign flow-through entities

47. This category of QFEI is designed to accommodate non-resident venture capital investors that invest through a foreign flow-through entity that is established as a separate legal entity in the country in which it has been established. The criteria that will determine whether the foreign flow-through entity will qualify as a QFEI under this category are very similar to those that apply to the FLLP category. The following explains the main qualification criteria for foreign flow-through entities where they are different from the FLLP QFEI category. (The rules are contained in section CB 2(4)(c) and the definition of "foreign exempt entity" in section CW 11B(4).)

Established as a legal entity under the laws of an approved country

48. To qualify under this category, the foreign hybrid must be established as a legal entity under the federal or state laws of the country in which it is established and must be established under the laws of an approved country (section CB 2(4)(c)(i) and section CW 11B(4), paragraph (a) of the definition of "foreign exempt entity").

Membership

49. The foreign flow-through entity must have members that hold interests in the capital of the entity and are entitled to shares of the entity's income (section CB 2(4)(c)(ii) and section CW 11B(4), paragraph (b) of the definition of "foreign exempt entity"). In order to ensure commercial flexibility and accommodate current structures, it is not necessary that the members' entitlement to income is in direct proportion to their interest in the capital of the entity.

Not resident in a country that taxes the foreign hybrid as an entity

50. To qualify under this category, the foreign flow-through entity cannot be resident in a country that has laws that tax the foreign flow-through entity as an entity on its income (section CB 2(4)(c)(iii) and section CW 11B(4), paragraph (d) of the definition of "foreign exempt entity"). This provision ensures that a foreign flow-through entity that is taxed as an entity in the country in which it may be resident for tax purposes does not qualify for the exemption. Such entities should not qualify because their taxable status in their country of residence will make it unlikely that they are sensitive to the imposition of New Zealand tax.

Tax treatment of venture capital not covered by the exemption

51. The new tax rules for venture capital are not intended to affect the current tax treatment of venture capital investment that is not covered by the new exemptions. Under the current tax rules, profits from the sale of shares will be taxable only if, broadly, the shares were purchased with the dominant purpose of resale or the profits form part of the investor's business income. The new exemption is designed to remove a risk that certain foreign investors could be caught by these rules. In this sense the new rules should be viewed as a "safe harbour" for the investments of a certain category of non-resident investors.

Application date

52. The new venture capital rules apply from 1 April 2004.

Special partnerships

53. The preferred method of venture capital investment internationally is through the use of limited liability vehicles that are "flow-through" for tax purposes. This means that any income of the entity is borne by the partners and not taxed at the entity level.

54. To properly facilitate the flow of international venture capital into New Zealand it is necessary to ensure that the special partnership rules that provide limited liability and flow-through treatment properly reflect the way international venture capital is carried out. Section HC 1 has been repealed to remove a tax barrier to the operation of the special partnership rules. Section HC 1 is the provision that prevented special partners of a special partnership from offsetting their special partnership tax losses against their other income.

55. The rule was introduced to counter a number of aggressive tax schemes that occurred in the 1980s. It has been repealed because the deferred deduction rules (contained in sections ES 1 to ES 3 and sections GC 29 to GS 31) should provide the necessary protection against abusive tax schemes. The removal of section HC 1 will be helpful for venture capital investment into New Zealand because it will remove a barrier to local entities investing alongside international venture capital investors.

Application date

56. The repeal of section HC 1 applies to special partnership gross income and allowable deductions for the 2004-05 and subsequent income years.

[1] Under our "One China" policy, Taiwan is not recognised as a sovereign state. Therefore this DTA was entered as an agreement between the New Zealand Commerce and Industry Office and the Taipei Economic and Cultural Office in New Zealand.

Date published: 04 Aug 2008