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NON-ATTRIBUTING ACTIVE FIFs

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FLOWCHART 1: HOW TO GO ABOUT FINDING OUT IF A FIF IS A NON-ATTRIBUTING ACTIVE FIF

Is the FIF a non-attributing active FIF under s. 21B(1) & (2) by:

(a) Meeting the requirements <u>using financial accounting measures</u> of income and <u>applying the test in s. EX 21E based on applicable accounting standards</u> (refer to Flowchart 2 on page 12); or

(b) Meeting the requirements <u>using tax measures</u> of income and <u>applying the default test in s. EX 21D</u> (refer to Flowchart 2 on page 12).

YES

NO

Has the interest holder elected under s. EX 73 that the FIF is an elective attributing FIF?

i.e. <u>not</u> be a non-attributing active FIF for the interest holder for the accounting period?

YES

Calculate the net attributed FIF income or loss from the FIF.

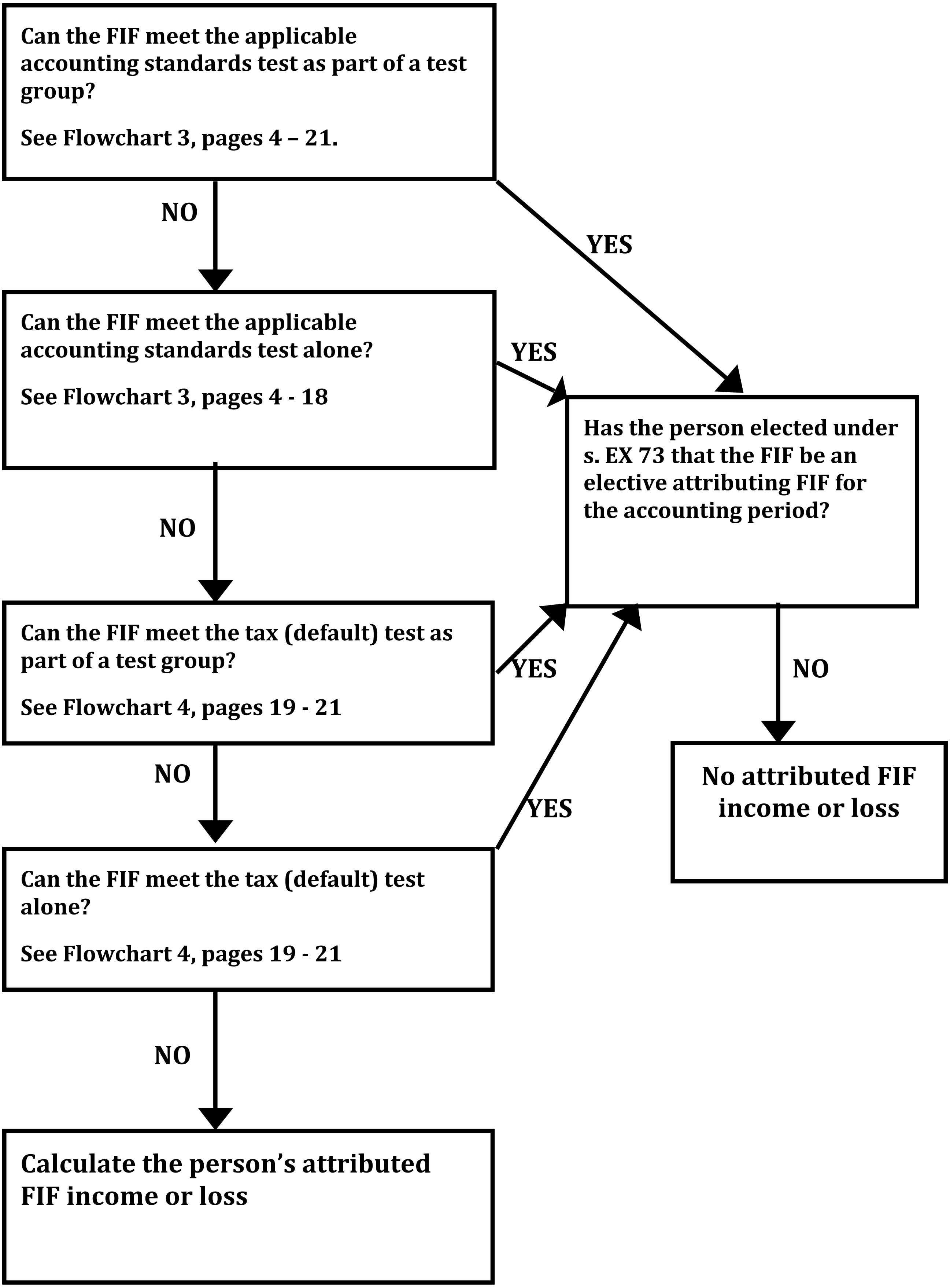
NO

No requirement to attribute CFC income or loss:

s. CQ 5(1)(c)(xv) and

s. DN 6(1)(c)(xv)

FLOWCHART 2: TESTS TO BE A NON-ATTRIBUTING ACTIVE FIF



FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST

1. What is the test based on using an applicable accounting standard?

A FIF, either alone, or as part of a test group of companies, meets the test based on using an applicable accounting standard in section EX 21E to be a non-attributing active FIF by:

(a) Meeting the requirements in section EX 21C for the use of an applicable accounting standard and choosing to use that accounting standard for the purposes of the formula calculation in section EX 21E.

(The 3 applicable accounting standards and the requirements for their use are set out in **Flowchart 3 (3) to (6)** below)

(b) Applying the following formula using relevant items from the accounts, and the application rules in **Section II Flowchart 3 (9)** below, and meeting the three requirements below:

$$\frac{\textbf{Reported passive + Added passive - Removed passive}}{\textbf{Reported revenue + Added revenue - Removed revenue}}$$

Three requirements to be a non-attributing active FIF:

(i) The amount calculated using the above formula must be < 0.05

(ii) The numerator in the formula must sum to ≥ zero

(iii) The denominator in the formula must be > zero

(The items in the formula are explained in **Flowchart 3 (10) to (15)** below)

[s. EX 21B(2)(b) and s. EX 21E(3) & (5)]

2. What is the anti-avoidance rule for the accounting standards test?

Treating the FIF as if it were a CFC, the following anti-avoidance rules in section GB 15C must not apply:

1. A CFC is not a non-attributing active CFC under section GB 15C if a person ("a party") enters an arrangement having a purpose, that is more than incidental, of enabling a CFC to meet the requirements of the test in section EX 21E for accounts prepared under an applicable accounting standard, when the CFC would not meet the requirements of the default test in section EX 21D.

2. A party who is a CFC associated with the CFC is not a non-attributing active CFC if:

   (a) The arrangement (having a purpose, that is more than incidental, of enabling a CFC to meet the requirements of the test in section EX 21E for accounts prepared under an applicable accounting standard) involves a financial arrangement producing a foreign exchange loss for the CFC; and

   (b) The foreign exchange loss decreases for the CFC the amount of the numerator in the formula for the test in section EX 21E for accounts prepared under an applicable accounting standard.

[**Sections EX 21C(1)** & **GB 15C**]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

3. What are the applicable accounting standards?

There are four legislated applicable accounting standards, which may be used for a FIF alone, or for a FIF test group:

1. The GAAP with IFRS accounting standard

   The interest holder may use generally accepted accounting practice in New Zealand including IFRSs (*New Zealand Equivalents to International Financial Reporting Standards* approved by the Accounting Standards Review Board) and the *Framework for Differential Reporting for Entities Applying the New Zealand Equivalents to International Financial Reporting Standards Reporting Regime* (**GAAP with IFRS**) for a FIF if the requirements set out in **(4) on page 7** below are met, or for a FIF test group if the additional requirements in **(7) on page 10** below are met.

2. The IFRSE accounting standard

   An interest holder may use IFRSEs (International Financial Reporting Standards approved by the International Accounting Standards Board) for a FIF if the requirements set out in **(5) on page 8** below are met, or for a FIF test group if the additional requirements in **(7) on page 10** below are met.

3. United States generally accepted accounting principles (US GAAP)

   Section EX 21C is modified by s. EX 50(4B) to allow US GAAP accounts to be used for a FIF or for a FIF test group. US GAAP accounts can be used only when the AFI method applies. (US GAAP accounts cannot be used for interests of 10% or more in CFCs.)

   US GAAP can only be used if the interest holder or other person has accounts prepared under the GAAP with IFRS or the IFRSE accounting standards. The requirements are set out in **(4) & (5) on pages 7-8** below, and for a FIF test group the additional requirements in **(7) on page 10** below must be met.

4. The GAAP without IFRS accounting standard (**likely to be repealed – see Issues Paper**)

   The interest holder may use GAAP in NZ for persons not required to use IFRSs but required to comply with standards, other than IFRSs, approved by the Accounting Standards Review Board under the Financial Reporting Act 1993 (**GAAP without IFRS**) for a FIF if the requirements set out in **(6) on page 9** below are met, or for a FIF test group if the additional requirements in **(7) on page 10** are met.

   Note*:* *Tax Information Bulletin* Vol 24 No 6 July 2012 does not list, at page 25, the "GAAP without IFRS accounting standard" as being an accounting standard that can be used for FIFs.

   However, s. EX 50 (4B) does not contain a direction that this accounting standard cannot be used.

[**Sections EX 21C** & **EX 21E(1)]**

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

3A. What are the applicable accounting standards (continued): IRD explanation on pages 25 – 26 of TIB Vol 24 No 6 July 2012

Taxpayers should use the accounting standard that is most appropriate. For example, if the FIF prepares IFRSE accounts, it should use IFRSE accounting concepts as opposed to US GAAP concepts.

Certain conditions must be satisfied before any particular set of accounting standards can be used. This means the person may be unable to use any of the sets of accounting standards because the relevant conditions are not satisfied. A person may also choose not to use any of the sets of accounting standards, even if they are available.

<u>The main requirement is that the FIF's income appears in IFRS or IFRSE accounts</u>. This ensures that, whatever accounting standard might be used by the FIF itself, the resulting income—at least in aggregate—will be subject to an audit that checks for compliance with IFRS or IFRSE.

There are two ways that this requirement can be met.

The FIF's income could appear in IFRS / IFRSE accounts firstly because the FIF's accounts are fully or partially consolidated into the IFRS or IFRSE accounts.

Alternatively, it could appear if the FIF's income is included in the IFRS or IFRSE accounts using the equity method in IAS 28 or IAS 31, or by inclusion of dividends and fair value changes under IAS 39. If the FIF's income is included under one of those standards, the FIF itself must also produce accounts under an acceptable standard, including US GAAP.

<u>Once it has been determined that there is an acceptable set of accounts, information used to prepare those accounts, including underlying information, may be used</u> as long as it is consistent with the relevant standard (see existing section EX 21E(4)(b))

<u>For instance, if a FIF's income was recognised in the IFRS accounts of the New Zealand investor under IAS 28, and the FIF itself used US GAAP, it would be possible to take the detailed US GAAP information and use this in the active business test calculation in most cases</u>. However, there would be an exception if the associate's profit appearing in the IFRS accounts was not the same as the US GAAP profit because of an adjustment made to ensure compliance with IFRS. In such a case, it would be necessary to adjust the detailed US GAAP information to ensure consistency.

For example:

NZ Co has a 30% shareholding in a US FIF that prepares US GAAP accounts. The US GAAP accounts report a $20m profit. NZ Co has IFRS accounts that include a line item for income from associates. This item displays $6m from the US FIF.

The 30% share of the US FIF's income - $6m – is consistently reported in the IFRS accounts. So NZ Co can use the information underlying the FIF's US GAAP accounts for the purpose of applying the active business test in s. EX 21E to the US GAAP.

There are 2 audit requirements:

First, the accounts must be audited by a chartered accountant (Or foreign equivalent) who is independent of the FIF and the person.

Second, the auditor must give an "unqualified audit opinion" (or foreign equivalent).

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

4. What is required for use of the GAAP with NZ IFRS accounting standard?

The interest holder may use generally accepted accounting practice in New Zealand including IFRSs (*New Zealand Equivalents to International Financial Reporting Standards* approved by the Accounting Standards Review Board) and the *Framework for Differential Reporting for Entities Applying the New Zealand Equivalents to International Financial Reporting Standards Reporting Regime* (**GAAP with IFRS**) for the FIF, or for a FIF test group if the requirements in **(7) on page 10** below are met, if the interest holder or another person has accounts that:

1. Include:
   (a) The accounts of the FIF, or the accounts of the members of the test group, as appropriate <u>including by proportionate consolidation under NZIAS 31; or</u>

   (b) <u>Dividends and net fair value changes in relation to the FIF under NZIAS 39; or Amounts recognised under the equity method in NZIAS 28 or NZIAS 31;</u>

   <u>And</u>

   <u>The FIF has accounts prepared under US GAAP that meet the audit requirements in (3) below for accounts prepared under US GAAP principles in the US.</u>

2. Comply with GAAP with IFRS by:
   (a) Stating that they comply with GAAP with IFRS; and
   (b) The Commissioner not having reasonable grounds to suspect:
      (i) Fraudulent activity by the interest holder, the FIF, a <u>company</u> in the FIF test group or the auditor; or
      (ii) Preparation of the accounts with an intent to mislead; or
      (iii) Incompetence of the auditor; and

3. Meet the following audit requirements:
   (a) The accounts are audited by an accountant who is:
      (i) A chartered accountant or an accountant of equivalent professional standard in the country in which the accounts are prepared; and
      (ii) Independent of the FIF and the person; and
   (b) The accounts are given an unqualified opinion or an opinion of equivalent standard in the country in which the accounts are prepared.

[**S. EX 50(4B)(e) & (f)** modifications (as inserted by **s. 35(4)** of the Taxation (International Investment and Remedial Matters) Act 2012) to **s. EX 21C(1), (2), (3), (8) & (9)** (and **s. 25** of the same Act replacing <u>CFC</u> with <u>company</u> in the reference to fraudulent activity in **section EX 21C(9)(c)(i))**, from the first income year beginning on or after 1 July 2011]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

5. What is required for the use of the IFRSEs accounting standard?

An interest holder may use IFRSEs (International Financial Reporting Standards approved by the International Accounting Standards Board) for a FIF, or for a FIF test group if the requirements in **(7)** below are met, if the interest holder or another person has accounts that:

1. Include:

   (a) The accounts of the FIF, or the accounts of the members of the test group, as appropriate <u>including by proportionate consolidation under the IFRSE corresponding to NZIAS 31; or</u>

   (b) <u>Dividends and net fair value changes in relation to the FIF under the IFRSE corresponding to NZIAS 39; or</u>
   <u>Amounts recognised under the equity method in the IFRSE corresponding to NZIAS 28 or NZIAS 31;</u>

   <u>And</u>

   <u>The FIF has accounts prepared under US GAAP that meet the audit requirements in (3) below for accounts prepared under US GAAP principles in the US.</u>

2. Comply with IFRSEs by:

   (a) Stating that they comply with IFRSEs; and

   (b) The Commissioner not having reasonable grounds to suspect:

      (i) Fraudulent activity by the interest holder, the FIF, a <u>company</u> in the FIF test group or the auditor; or

      (ii) Preparation of the accounts with an intent to mislead; or

      (iii) Incompetence of the auditor; and

3. Meet the following audit requirements:

   (a) The accounts are audited by an accountant who is:

      (i) A chartered accountant or an accountant of equivalent professional standard in the country in which the accounts are prepared; and

      (ii) Independent of the FIF and the person; and

   (b) The accounts are given an unqualified opinion or an opinion of equivalent standard in the country in which the accounts are prepared.

[**S. EX 50(4B)(g) & (h)** modifications (as inserted by **s. 35(4)** of the Taxation (International Investment and Remedial Matters) Act 2012) to **s. EX 21C(1), (4), (5), (8) & (9)** (and **s. 25** of the same Act replacing <u>CFC</u> with <u>company</u> in the reference to fraudulent activity in **section EX 21C(9)(c)(i)**), from the first income year beginning on or after 1 July 2011]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

6. What is required for the use of the GAAP in NZ without IFRS accounting standard?

[Important note: TIB Vol 24 No 6 does not list this as an acceptable standard. An *Officials' Issues Paper* released on 8 August 2012 questioned the continuing *Use of old GAAP in the CFC rules* following changes to the financial reporting framework in the Financial Reporting Bill**]**

The interest holder may use GAAP in NZ for persons not required to use IFRSs but required to comply with standards, other than IFRSs, approved by the Accounting Standards Review Board under the Financial Reporting Act 1993 (**GAAP without IFRS**) for a FIF, or for a FIF test group, if the interest holder or another person is a company resident in NZ that:

1. Has no revenue under Financial Reporting Standard 34 and Financial Reporting Standard 35; and
2. Is not an issuer under section 4 of the Financial Reporting Act 1993 in the current or preceding accounting periods; and
3. Is not required by section 19 of the Financial Reporting Act 1993 to file its accounts with the Registrar of Companies; and
4. Is not a large company under section 19A(1)(b) of the Financial Reporting Act 1993; and
5. Does not have accounts that are prepared and audited under GAAP with IFRS; and
6. Is not a subsidiary of a company having accounts that:
   (a) Include the accounts of the subsidiary; and
   (b) Are prepared and audited or required to be prepared under GAAP with IFRS; and
7. Has accounts that:
   (a) Include the accounts of the FIF, or the accounts of the members of the test group, as appropriate; and
   (b) Comply with IFRSEs by:
      (i) Stating that they comply with IFRSEs; and
      (ii) The Commissioner not having reasonable grounds to suspect:
         a. Fraudulent activity by the interest holder, the FIF, a company in the FIF test group or the auditor; or
         b. Preparation of the accounts with an intent to mislead; or
         c. Incompetence of the auditor; and
   (c) Meet the following audit requirements:
      (i) The accounts are audited by an accountant who is:
         a. A chartered accountant or an accountant of equivalent professional standard in the country in which the accounts are prepared; and
         b. Independent of the CFC and the person; and
      (ii) The accounts are given an unqualified opinion or an opinion of equivalent standard in the country in which the accounts are prepared.

[**S. EX 21C(1), (6), (7), (8) & (9) & s. 25** of the Taxation (International Investment and Remedial Matters) Act 2012 replacing CFC with company in the reference to fraudulent activity in **s. EX 21C(9)(c)(i),** from the first income year beginning on or after 1 July 2011]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

7. Can a test group be used?

The test based on the use of an applicable accounting standard may be applied by an interest holder to a CFC as a member of a test group if:

1. The group consists of companies required under the applicable accounting standard to consolidate, whether or not with companies that are not in the group; and

2. None of the other companies in the test group is a CFC (i.e. an actual CFC and not a FIF treated as a CFC); however the other foreign companies can be in different jurisdictions; and

3. The FIF (for which the AFI method is used) holds an income interest of > 50% in each other company in the test group (i.e. the top tier FIF must hold a more than 50% interest in each of the underlying FIFs); and

4. The companies in the test group do not have to have the same functional currency; and

5. There are audited and consolidated financial statements that:

   (a) Include the accounts of the companies in the group, whether or not with accounts of companies that are not in the group; and

   (b) Comply with the applicable accounting standard by meeting the requirements in section EX 21C for the relevant accounting standard – see **Flowchart 3 (4) to (6) on pages 7-9.**

[**S. EX 21E(2) & (13)(a)** as modified – modifications underlined - by **s. EX 50(4B)(l), (m) & (n)** inserted by **s. 35(4)** of the Taxation (International Investment and Remedial Matters) Act 2012, applying to income years beginning on or after 1 July 2011]

Only a single test can be used for each FIF

An interest holder cannot use the result of a test applied to a test group that includes a FIF if:

(a) The interest holder uses, for the period, the result of the same or a different test for the FIF alone; or

(b) The interest holder uses, for the period, the result of the same or different test for the FIF as part of a different test group.

[**S. EX 21B(4)** as inserted by **s. 24** of the Taxation (International Investment and Remedial Matters) Act 2012, applying for income years beginning on or after 1 July 2009]

Extract from *Tax Information Bulletin* Vol 24 No 6 July 2012 page 49:

Subsection EX 21B(4) clarifies that a CFC may not be part of more than one test group, and may not apply the test on an individual basis if it is part of a test group

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

8. If a test group cannot be used, apply the formula to each FIF individually.

9. What are the formula application rules for the accounting standards test?

(a) Each item in the formula is:
   (i) Determined under the applicable accounting standard; and
   (ii) Adjusted so that no amount is included in the item more than once; and

(b) Each item in the formula is determined:
   (i) From amounts consolidated for the FIF test group under the applicable accounting standard, if the formula is applied to the test group; or
   (ii) From amounts for the FIF if the formula is applied to the FIF alone; and

(c) <u>Omitted – no requirement to remove minority interests – so amounts belonging to other investors are included in the calculations: this is a practical concession</u>.

(d) A reference to a company that is associated is treated as being a reference to a company that is:
   (i) Associated with a member of the FIF test group, although not a member of the FIF test group, if the formula is applied to the test group; or
   (ii) Associated with the FIF if the formula is applied to the FIF alone; and

(e) A reference to a company that is in the same group of companies is treated as being a reference to a company that is:
   (i) In the same group of companies as a member of the FIF test group, although not a member of the FIF test group, if the formula is applied to the test group; or
   (ii) In the same group of companies as the FIF if the formula is applied to the FIF alone; and

(f) Amounts determined for a FIF other than as part of a test group are:
   (i) Determined in the functional currency of the FIF; and
   (ii) Converted between currencies under the applicable accounting standard, but ignoring exchange differences arising on a monetary item that forms part of a net investment of the FIF in a foreign operation; and

(g) Amounts determined for a test group are:
   (i) Converted from the functional currency of the FIF to the presentation currency of the consolidated accounts for the test group using the average conversion rate for the accounting period; and
   (ii) Otherwise converted between currencies under the applicable accounting standard.

For the purposes of these application rules, amounts drawn from the accounts, or from information that is used to prepare the accounts and is consistent with them, are treated as complying with the relevant accounting standard if the Commissioner does not have reasonable grounds to suspect:
   (a) Fraudulent activity by the interest holder, the FIF, a foreign company in the FIF test group, or the auditor.
   (b) Preparation of the accounts with an intent to mislead.
   (c) Incompetence of the auditor.

[**S. EX 21E(4)** as modified by **s. EX 50(4B)(o)** – <u>modification underlined</u> - **& s EX (13)(b)**]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

10. What does the formula item "reported passive" mean?

<u>Reported passive</u> is the total amount of:

(a) Income from a dividend.

(b) Income from interest.

(c) Income from a royalty.

(d) Income from rent.

(e) Income, other than rent or interest, from a finance lease or operating lease.

(f) Income or loss from a financial asset other than: a share that is not revenue account property, or a derivative as defined in whichever is appropriate of NZIAS 39 **(see below)**, <u>an equivalent IFRSE, and an equivalent standard or principle included in US GAAP</u>, being income or loss in the form of:

  (i) A change in the reported fair value of the asset.

  (ii) A gain or loss on the derecognition of the asset, as defined in NZIAS 39 (<u>or the IFRSE or US GAAP equivalent</u>) – i.e. a gain or loss on the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position (for example, see the "Definitions" in paragraph 9 of NZIAS 39).

  (iii) A foreign exchange gain or loss on the asset.

(g) Income or loss from a derivative instrument, as defined in whichever is appropriate of NZIAS 39 **(see below)**, <u>an equivalent IFRSE, and an equivalent standard or principle included in US GAAP</u>, and included in the FIF's statement of income:

  (i) If the instrument is held in the course of a business of the FIF for the purpose of dealing with the derivative instrument.

  (ii) If the instrument is not entered in the ordinary course of business of the FIF.

  (iii) To the extent to which the income or loss is from a hedging relationship, of a type referred to in NZIAS 39 (<u>or the IFRSE or US GAAP equivalent</u>), with an amount that would change the numerator of the formula in section EX 21E(5) or with a transaction producing such an amount of income or gain.

(h) Income or gains from a business of insurance, including income or gains from a property used to back insurance assets.

<u>A derivative instrument as defined in NZIAS 39</u> is a financial instrument or other contract within the scope of NZIAS 39 (see paragraphs 2-7 of NZIAS 39) with all three of the following characteristics:

  (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying')

  (b) It requires no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

  (c) It is settled at a future date.

[**S. EX 21E(7)** modified by **s. EX 50(4B)(p)** (<u>modifications underlined</u>) & **NZIAS 39** 'Derivative']

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

11. What does the formula item "added passive" mean?

Added passive is the total of amounts not included in the item reported passive for the accounting period that are one or more of the following:

(a) Income from a life insurance policy that is included in the attributable CFC amount for the accounting period under section EX 20B(3)(g).

(b) Income from the disposal of revenue account property that is included in the attributable CFC amount for the accounting period under section EX 20B(3)(k) if the property is:

(i) Not a share, financial arrangement, or life insurance policy; and

(ii) Used by the FIF in a way that gives rise to income or gains that increase the numerator of the formula in section EX 20E(5).

(c) Income from a supply of services performed in New Zealand that is included in the attributable CFC amount for the accounting period under section EX 20B(3)(l).

(d) Income from a supply of telecommunications services that is included in the attributable CFC amount for the accounting period under section EX 20B(3)(m) or (n).

(e) Attributed portfolio investment entity (PIE) income that is included under section EX 20B(3)(o).

[**S. EX 21E(8)** including **s. EX 21E(8)(e)** as inserted by **s. 36(1)** of the Tax Administration Act 2011 applying from 29 August 2011, the date on which the Act received the Royal assent]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

12. What does the formula item "removed passive" mean?

Removed passive is:

1. Zero if the interest holder does not choose to include an amount for this item; or
2. The total of amounts that are included in the item 'reported passive' or added passive for the accounting period and are in a category included in categories chosen by the interest holder from the following:

   (a) A dividend that is

   (i) Not included in the attributable CFC amount for the accounting period under section EX 20B(3)(a) to (c); and

   (ii) Paid by a company other than 1 from which the person does not have additional FIF income or loss under s. EX 50(6) because of the application of s. EX 50(7B)(b) (i.e. paid by a company other than an underlying FIF for which there is no "look-through" because the top tier FIF would pass the accounting standards test to be a non-attributing active FIF if certain amounts from the underlying FIF were included in "added passive" and "reported revenue" of the top tier FIF – **see Section I (10) on page 8**).

   (b) A royalty that would be included in the attributable CFC amount for the accounting period but for section EX 20B(5)(a) to (d).

   (c) Rent that would be included in the attributable CFC amount for the accounting period but for section EX 20B(7)(a) to (c).

   (d) A gain or loss from a financial asset that is a financial arrangement or agreement referred to in section EX 20B(12) – see the IRD explanation in *Tax Information Bulletin* Vol 24 No 6 July 2012 set out in **(12A) on page 15** below.

   (e) The cost of revenue account property producing an amount ('the included amount') included in the attributable CFC amount under section EX 20B(3)(k) to the extent, not exceeding 'the included amount', to which:

   (i) The cost would be a deduction of the FIF in the accounting period if the FIF were a resident of New Zealand; and

   (ii) The deduction would exceed the amount of any income arising under subpart CH (Adjustments) relating to the deduction.

[**S. EX 21E(9)** including **s. EX 21E(9)(cb)** (shown as paragraph (d) above) inserted by **s. 27(2)** of the Taxation (International Investment and Remedial Matters) Act 2012 effective from income years commencing on or after 1 July 2009, as modified by **s. EX 50(4B)(q)** – modification underlined – inserted by **s. 35(4)** of that Act effective from income years beginning on or after 1 July 2011]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

12A. IRD explanation: amendment to "removed passive" in s. EX 21E(9)(cb)

Excerpt from pages 48 – 49 of Tax Information Bulletin Vol 24 No 6 July 2012

Paragraph EX 21E(9)(cb)

Reported passive in section EX 21E(7) is the measure of passive income that is used in the active business test using accounting concepts. One component of reported passive is income or loss from a financial asset, other than a derivative or a share on capital account. Accounts receivable can be financial assets. This means that gains or losses on accounts receivable—for example, due to exchange rate fluctuations—may be included in the measure of passive income. However, accounts receivable may relate to active businesses so including them is not necessarily appropriate.

Reported passive income also includes interest received from associated non-attributing CFCs. Such interest may not be ignored even though other forms of passive income from such CFCs can be (see paragraphs EX 21E(9)(a) to (c)).

The Act changes the measure of passive income to address these problems. The change allows gains or losses on financial assets (including interest income) to be excluded from the measure of passive income if:

- They are included in the measure to begin with (see the existing provision at the beginning of subsection EX 21E(9)); and
- They could be excluded under the active business test that uses tax rules ((see subsection EX 20B(12), but subject to the modification described below).

This allows the exclusion of amounts that are, broadly speaking, payments from related active entities and gains or losses relating to accounts receivable.

The exclusions in subsection EX 20B(12) are exclusions from financial arrangement income. The subsection does not apply to financial arrangement expenditure.

However, in the context of section EX 21E, it would be inappropriate not to exclude expenditure if income was being excluded; section EX 21E refers to gains *or losses* from financial assets. Therefore, paragraph EX 21E(9)(cb) (**paragraph (d) on page 14**) refers to any gain or loss on a financial asset that is a financial arrangement or agreement referred to in subsection EX 20B(12), *whether or not it actually generates income under that subsection*. That is, a person may exclude gains under paragraph EX 21E(9)(cb), but only if they also exclude similar losses. (emphasis added)

[IRD TIB Vol 24 No 6 July 2012 pp 48-49]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

13. What does the formula item "reported revenue" mean?

Reported revenue is the total amount that is:

(a) Included under the applicable accounting standard in:

(i) Operating revenue, if the applicable accounting standard is GAAP without IFRS (see **(5) on page 8** above); or

(ii) Revenue, otherwise.

(b) Income from rent. (See the explanation in *Tax Information Bulletin* Vol 24 No 6 July 2012 **set out below**).

(c) Income, other than rent, from a finance lease or operating lease.

(d) A gain or loss on a financial asset, other than: a share not on revenue account, or a derivative as defined in whichever is appropriate of NZIAS 39 (see **(10) on p. 12** above), an equivalent IFRSE, and an equivalent standard or principle included in US GAAP, being a gain or loss in the form of:

(i) A change in the reported fair value of the asset;

(ii) A gain or loss on the derecognition, as defined in NZIAS 39 (or an IFRSE or US GAAP equivalent), of the asset (see **(10) on page 12** above);

(iii) A foreign exchange gain or loss on the asset.

(e) A gain or loss from a derivative instrument, as defined in NZIAS 39 (or an IFRSE or US GAAP equivalent) (see **(10) on page 12** above), and included in the FIF's statement of income:

(i) If the derivative instrument is held in the course of a business of the FIF for the purpose of dealing with the derivative instrument;

(ii) If the derivative instrument is not entered in in the ordinary course of business of the FIF;

(iii) To the extent to which the gain or loss is from a hedging relationship, of a type referred to in NZIAS 39 (or an IFRSE or US GAAP equivalent), with an amount that would change the denominator of the formula in section EX 20E(5) or with a transaction producing such an amount of income or gain.

(f) Income or a gain from a business of insurance, including from property used to back insurance assets, if the applicable accounting standard is not GAAP without IFRS.

[**S. EX 21E(10)** including **s. EX 21E(10)(ab)** (shown as paragraph (b) above) inserted by **s. 27(3)** of the Taxation (International Investment and Remedial Matters) Act 2012 from income years beginning on or after 1 July 2009 as modified by **s. EX 50(4B)(r)** – modifications underlined – of that Act effective from income years beginning on or after 1 July 2011]

Excerpt from page 48 of *Tax Information Bulletin* Vol 24 No 6 July 2012

Paragraph EX 21E(10)(ab)

Reported revenue in section EX 21E(10) is the measure of total income for the purposes of the active business test using accounting concepts. Reported revenue includes "revenue" if IFRS is used, a term which is defined by International Accounting Standard 18. Lease income is generally excluded from the definition of "revenue" under that standard. Lease income is brought in under another item that is part of reported revenue, but only if it is income other than rent from finance or operating leases. This means that rental income may not be able to be included in the measure of total income. This is not intended. This Act amends the definition of reported revenue so that rent may be included.

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

14. What does the formula item "added revenue" mean?

Added revenue is:

1. Zero if the interest holder does not choose to include an amount for this item; or
2. The total of amounts that are not included in the item 'reported revenue' for the accounting period and are either or both of the following:
   - (f) Income from a life insurance policy that is included in the attributable CFC amount for the accounting period under section EX 20B(3)(g).
   - (g) Income from the disposal of revenue account property that is included in the attributable CFC amount for the accounting period under section EX 20B(3)(k) if the property is:
     - (i) Not a share, financial arrangement, or life insurance policy; and
     - (ii) Used by the FIF in a way that gives rise to income or gains that increase the numerator of the formula in section EX 20E(5).

[**S. EX 21E(11)**]

FLOWCHART 3: THE APPLICABLE ACCOUNTING STANDARDS TEST (CONTINUED)

15. What does the formula item "removed revenue" mean?

<u>Removed revenue</u> is the total of amounts that are included under the applicable accounting standard in the item 'reported revenue' or 'added revenue' for the accounting period and are 1 or more of the following:

(a) An amount included in the item 'removed passive' under section EX 21E(9)(d) – see paragraph 2(e) in **(12) on pages 14-15** above.

(b) A dividend to the extent to which it is included in the item 'removed passive' under section 21E(9)(a) – see paragraph 2(a) in **(12) on page 14-15** above.

(c) Income from a supply of personal services that is included in the item reported 'reported revenue', and in the attributable CFC amount for the accounting period under section EX 20B(3)(h).

(d) Income or loss from a share that is not revenue account property under the Income Tax Act 2007 in the form of:

- (i) A change in the reported fair value of the share.
- (ii) Income or loss on the derecognition, as defined in whichever is appropriate of NZIAS 39, <u>an equivalent IFRSE, and an equivalent standard or principle included in US GAAP</u>, – see **(10) on page 12** above – of the share.
- (iii) A foreign exchange gain or loss on the share.

(e) Income derived from another CFC **(FIF?)** that:

- (i) Is subject to the laws of the country or territory under which the FIF is liable to income tax on the FIF's income because of the FIF's domicile, residence, place of incorporation, or centre of management; and
- (ii) Is liable to tax on its income in that country or territory because of its domicile, residence, place of incorporation, or centre of management; and
- (iii) Could be consolidated with the FIF for the purposes of this section if appropriate audited accounts were prepared.

(f) If the applicable standard is GAAP without IFRS (see **(5) on page 8** above), income from a liability, other than income derived in the normal course of business from a sale or supply of services, in the form of:

- (i) A reduction in the liability;
- (ii) A gain on the disposal or other derecognition of the liability;
- (iii) A foreign exchange gain on the liability.

(g) If the applicable standard is GAAP without IFRS (see **(6) on page 9** above), income from an asset that is not a financial asset under whichever is appropriate of NZIAS 32, <u>an equivalent IFRSE, and an equivalent standard or principle included in US GAAP</u>, and not revenue account property as defined in section YA 1 (Definitions) in the form of:

- (i) An increase in the fair value of the asset.
- (ii) A gain on the disposal of the asset.
- (iii) A foreign exchange gain on the asset.

[**S. EX 21E(12)** as modified by **s. EX 50(4B)(s) & (t)** – <u>modifications underlined</u> – effective 1/7/11]

FLOWCHART 4: THE TAX MEASURES (DEFAULT) TEST

1. If the test based on applicable accounting standards cannot be used, or it is failed, the test based on tax measures (the default test) can be used:

A FIF, either alone, or as part of a test group of companies, meets the default test in section EX 21D to be a non-attributing active FIF, for an accounting period and a person, by:

Applying the following formula, using the application rules set out in **(4) on page 21** below, and meeting the two requirements below:

$$\frac{\textbf{Attributable CFC amount - Attributable adjustments}}{\textbf{Annual gross income ignoring income under subpart CQ - Gross adjustments}}$$

Two requirements to be a non-attributing active FIF:

(i) The amount calculated using the above formula must be < 0.05

(ii) The denominator – i.e. annual gross income – must not be zero.

Attributable CFC amount is the amount determined under section EX 20B.

Attributable adjustments is the total of amounts included in 'attributable CFC amount' that are:

(a) If the interest holder so chooses, income derived from the supply of personal services:
  (i) Included in an attributable CFC amount under section EX 20B(3)(h); and
  (ii) Not included in an attributable CFC amount under another paragraph of section EX 20B(3) and (4) – i.e. not otherwise included as part of "gross" or "arrangement .

(b) If the interest holder so chooses, the cost of revenue account property producing an amount ('the included amount') included in the attributable CFC amount under section EX 20B(3)(k) to the extent, not exceeding 'the included amount', to which:
  (i) The cost is a deduction of the FIF in the accounting period; and
  (ii) The deduction exceeds the amount of any income arising under subpart CH (Adjustments) relating to the deduction.

Annual gross income is the annual gross income for the accounting period in the absence of income under subpart CQ (i.e. income from CFCs and FIFs).

Gross adjustments is the total of the following amounts for the accounting period:

(a) The amount of the item 'Attributable adjustments' in the formula.

(b) Expenditure or loss that is included in the calculation of the attributable CFC amount under section EX 20B.

(c) Income derived from a company that would meet the requirements to be a member of the FIF test group.

(d) Income from a supply that meets the requirements of section GB 15B (Anti-avoidance rule for supplies made to a non-test group FIF for the purpose of increasing the amount of the denominator in the formula).

[**S. EX 21D & GB 15B**]

FLOWCHART 4: THE TAX MEASURES (DEFAULT) TEST (CONTINUED)

2. Can the tax measures (default) test be used for a test group?

A person (the 'interest holder') with an interest in a FIF may choose to apply the default test for the FIF as a member of a test group if the group consists of companies:

1. None of which is a CFC (but they can be in different jurisdictions); and
2. In each of which the FIF holds a voting interest of more than 50% (i.e. the top tier FIF must hold a more than 50% in each of the underlying FIFs); and
3. Each of which is required to use the same currency under section EX 21(4) – see **(3)** in the separate PDF attachment on the **Calculation Rules: Attributable CFC amount And Net Attributable CFC income/(Loss)**; and
4. That are consolidated for the purposes of applying the default test:
   (a) Using like tax treatments for like transactions and for other events in similar circumstances; and
   (b) Eliminating in full all balances, transactions, income, and expenses arising between members of the test group.

[**S. EX 21D(1)** as modified by **s. EX 50(4B)(i) & (j)** – modifications underlined – inserted by **s. 35(4)** of the Taxation (International Investment and Remedial Matters) Act 2012 applying from income years beginning on or after 1 July 2011]

Only a single test can be used for each CFC

An interest holder cannot use the result of a test applied to a test group that includes a FIF if:

(c) The interest holder uses, for the period, the result of the same or a different test for the FIF alone; or

(d) The interest holder uses, for the period, the result of the same or different test for the FIF as part of a different test group.

[**S. EX 21B(4)** as inserted by **s. 24** of the Taxation (International Investment and Remedial Matters) Act 2012, applying for income years beginning on or after 1 July 2009]

Extract from *Tax Information Bulletin* Vol 24 No 6 July 2012 page 49:

Subsection EX 21B(4) clarifies that a CFC may not be part of more than one test group, and may not apply the test on an individual basis if it is part of a test group.

FLOWCHART 4: THE TAX MEASURES (DEFAULT) TEST (CONTINUED)

3. If a test group cannot be used, apply the formula to each FIF individually

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4. The formula application rules for the tax measures (default) test are:

(a) Each item in the formula is determined:

(i) For the FIF's consolidated test group, if the interest holder chooses to apply the formula to the test group; or

(ii) For the FIF if the formula is applied to the FIF alone; and

(b) <u>No adjustment is made to remove amounts corresponding to income interests not held by the interest holder</u>; and

(c) A reference to a company that is associated is treated as being a reference to a company that is:

(i) Associated with a member of the FIF test group, although not a member of the FIF test group, if the formula is applied to the test group; or

(ii) Associated with the FIF if the formula is applied to the FIF alone; and

(d) A reference to a company that is in the same group of companies is treated as being a reference to a company that is:

(i) In the same group of companies as a member of the FIF test group, although not a member of the FIF test group, if the formula is applied to the test group; or

(ii) In the same group of companies as the FIF if the formula is applied to the FIF alone; and

(e) A numerator or denominator that is a negative number is treated as being zero; and

(f) The amount calculated using the formula is zero if the denominator is zero.

[**S. EX 21D(3)** as modified by **s. EX 50(4B)(k)** – <u>modifications underlined</u> – inserted by **s. 35(4)** of the Taxation (International Investment and Remedial Matters) Act 2012 applying from income years beginning on or after 1 July 2011.]