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WEEKLY COMMENT: FRIDAY 14 NOVEMBER 2014

1. This week I complete looking at the changes to the thin capitalisation rules enacted in the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014*. The new laws apply from the 2014-15 income year.

2. The complete new rules, as discussed over the past three weeks and this week, are contained in the PDF attachment *Thin Capitalisation Rules: Changes Legislated in 2014*.

3. As noted previously, the changes were initially proposed in *Review of the thin capitalisation rules - An officials' issues paper* released in January 2013 and discussed further in *Thin capitalisation review: technical issues* in June 2013. I discussed these documents in *Weekly Comment* 1 March and 2 August 2013.

4. This week I take a look at the extension of the thin capitalisation rules so they apply to more trusts, the corresponding extension to the on-lending concession as it applies to trusts, and the tightening of the rules in respect of asset transfers between associated persons and indirect interests of individuals and trusts in CFCs and FIFs held through associated persons.

Three new rules extending the application to trusts

5. 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).

6. 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:

   (i) A non-resident or an associated person of a non-resident - (note, however that, under new 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

   (ii) 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

   (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 (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).

7. 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).

8. 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):

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

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

9. The 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). Any trust will be subject to the thin capitalisation rules if 50 percent or more of the settlements are made by:

   (a) A non-resident or a person associated with the nonresident (however as noted, an associate will not include a relative who has not made any settlements on the trust so that the rules will not apply to a trust settled by a NZ resident merely because the resident has a non-resident relative);

   (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: this rule is the equivalent of the "non-resident owning body" rule for companies. However, 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. Hence, the reference to a group of persons "acting in concert".

10. 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 apparently designed as an anti-avoidance rule. It will catch a trust that has been settled by a New Zealand resident following which, effective control of the trust is transferred to a non-resident by giving the non-resident power to appoint or remove the trustee.

11. There is a carve-out from this anti-avoidance rule if a person has the power to add or remove a trustee for the purpose of protecting a security interest. The explanation in *Tax Information Bulletin* Vol. 26 No. 7 August 2014 page 56 ("the TIB item") states that this type of security interest is commonly held by banks that have lent to a trust.

12. Both s. FE 2(1)(d) and (db) contain a rule to prevent circularity if two trusts make settlements on each other or each has the ability to appoint the other's trustee. The rule is that settlements made by the trustee and powers of removal or appointment of the trustee must be ignored when applying the sections.

13. The TIB item contains the following illustration on page 56:

    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).

New rules to determine the NZ Group and Worldwide Group of a trustee

14. 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 in paragraphs 6 and 7 above:

    (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).

    (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).

15. The amendments to s. FE 3 define the New Zealand group of a trust as the trust and all companies controlled by the trust, except a company for which the trustee is not identified as the NZ parent. Whether a trust controls a company is determined under s. FE 27, based on the trust's choice of control threshold under that section.

16. 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 s. FE 28.

17. 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 s. FE 3(1)(d).

Extension of the on-lending concession for trusts

18. The on-lending concession in s. FE 13 applies so as to remove certain financial arrangements from being counted as "debt". New 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.

19. 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.

20. The amendments to s. 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 or not the arrangement provides funds.

21. Apparently these amendments are 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. The carve-out is on the basis that the on-lending concession would apply to most of the trust's debt in any event.

Not recognising changes in asset values arising from transfers between associates

22. 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.

23. 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 the change is equivalent to a revaluation or arises from a purchase by a non-associate:

(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.

24. These new rules will mean 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.

25. The change applies only in relation to transfers that occur in or after the 2015–16 income year.

26. Apparently, 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.

27. Section FE 16(1E) provides two exceptions to the rule restricting asset value changes arising from transfers between associates. 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.

28. The intention behind the second exemption is apparently 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. According to the TIB item, 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).

29. The TIB item contains the following example on page 57: A New Zealand subsidiary of a foreign company buys a sister NZ company from the common foreign parent company. The buyer company will not be able to include any increase in asset values resulting from the purchase for thin capitalisation purposes unless that increase would have been allowed under generally accepted accounting practice in the absence of the purchase.

Excluding individuals' and trustees' interests in CFCs and FIFs held through associates

30. 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.

31. 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 paragraph (b) above 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.

32. Section FE 16(1B) applies to the investments excluded by s. FE 16(1BA).

33. This means that 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.

34. Officials noted that this 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.

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