New Zealand’s Thin Capitalization Rules

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PRÉCIS
Dans le cadre d’une réforme globale des règles d’imposition des investisseurs directs non résidents, la Nouvelle-Zélande a récemment promulgué des dispositions en matière de capitalisation restreinte. Les nouvelles dispositions en matière de capitalisation restreinte diffèrent de celles qui ont été adoptées en Australie et au Canada et elles semblent plus étoffées que les dispositions similaires qui ont été promulguées dans d’autres pays. Les dispositions adoptées par la Nouvelle-Zélande s’appliquent à tous les titres d’emprunt portant intérêt et non seulement aux titres d’emprunt émis par des parties liées. De plus, elles visent à éviter qu’un groupe multinational attribue un montant disproportionné de ses intérêts débiteurs à son exploitation de la Nouvelle-Zélande. Bien qu’un ratio d’endettement maximal soit prévu aux termes de ces dispositions, les contribuables dont le ratio d’endettement excède le ratio maximal, mais se rapproche du ratio d’endettement du groupe multinational pris dans son ensemble peuvent exercer des activités en Nouvelle-Zélande sans encourir de pénalité. Il semble qu’on ait ainsi voulu faire la distinction entre les cas où des raisons commerciales valables justifient un ratio d’endettement élevé et ceux où l’évitement fiscal est le principal ou l’unique objectif. Il est probable que peu d’investisseurs non résidents encourront des pénalités aux termes des dispositions applicables en Nouvelle-Zélande étant donné que le ratio maximal qui a été établi est élevé et que seuls les titres d’emprunt portant intérêt seront considérés comme une dette.

ABSTRACT
New Zealand has recently enacted thin capitalization rules as part of a comprehensive reform package addressing the taxation of non-resident direct investors. The new thin capitalization rules are different from those adopted in Australia and Canada and appear more robust than similar rules enacted in other countries. The New Zealand rules apply to all interest-bearing debt rather than just related-party debt, and they are designed to prevent the attribution of a disproportionate amount of interest expense of a multinational group to the group’s New Zealand

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operations. Although the rules provide for a safe-harbour debt-equity ratio, taxpayers can operate in New Zealand with a debt-equity ratio above the safe harbour without penalty if it is close to the debt-equity ratio of the multinational group as a whole. This feature appears to have been designed to delineate between cases where a high debt-equity ratio has been adopted for legitimate business reasons and cases where tax avoidance is the primary or sole objective. It is likely that few non-resident investors will suffer penalties under the New Zealand rules since the safe-harbour ratio has been set at a high level and only interest-bearing debt will count as debt under the rules.

INTRODUCTION

Over the past 12 years, New Zealand has undertaken an ambitious tax reform program which has attracted worldwide attention. A key part of this program is directed to the international tax area. Reform of the taxation of income earned by non-residents from New Zealand sources commenced in 1991 with the introduction of the “approved issuer levy,” which reduced taxes imposed on interest paid to non-residents.¹ In September 1993, taxes on dividends paid to non-resident portfolio investors were reduced² through the introduction of the foreign investor tax credit (FITC) regime.

In late 1995, a comprehensive package was enacted to reform the taxation of direct investment by non-residents. This package included a reduction in the tax imposed on New Zealand source profits distributed to non-resident direct investors, enhanced tax base protection against offshore profit shifting from revised transfer-pricing rules, and, for the first time, thin capitalization rules.³

This article explains and comments on New Zealand’s new thin capitalization rules.

THIN CAPITALIZATION AND TAX AVOIDANCE

“Thin capitalization” is a tax-avoidance technique that takes advantage of the schedular taxation of income earned by non-residents. As interest paid to non-residents is normally taxed at a lower rate than are business profits,

¹ Reforms were made to the taxation of the foreign source income of New Zealand residents in 1988-1992, with the introduction of the controlled foreign company and foreign investment fund regimes, revision of the trust taxation regime, and the introduction of dividend imputation.


³ The government announced in August 1996 that a conduit tax regime would be introduced which would allow foreign source profits to flow through a New Zealand resident company to non-resident shareholders with little additional New Zealand tax. These proposals are likely to affect the taxation of dividends paid to non-residents.

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non-resident investors can avoid tax by recharacterizing business profits as interest. Consequently, offshore subsidiaries of multinational enterprises may have high debt-equity ratios with most of the debt being provided either by the parent or by another related party. Because of the high debt-equity ratio, the source of the debt, and the accompanying increased financial risk, it can be argued that such debt bears the risks and has characteristics of equity financing.

While thin capitalization is conceptually a simple tax-avoidance arrangement, devising effective thin capitalization rules has proved difficult for legislators owing to a number of factors.

First, international norms for cross-border taxation have both created an environment that allows thin capitalization to be an effective avoidance arrangement and raised obstacles to the introduction by individual countries of measures to counter thin capitalization. It is established international practice for source countries to tax interest paid to non-residents lightly, because tax on such interest acts as a tariff on offshore borrowing and restricts the international flow of funds. Because of the fungibility of money, it is relatively difficult for source countries to tax interest paid to non-residents differentially according to whether the lender is a portfolio investor or a financial intermediary, or whether the borrower and lender are associated.

Second, double taxation treaties can constrain countries with respect to the steps that they can take unilaterally to attack thin capitalization arrangements. Treaties commonly limit the rate of tax on interest that can be imposed by source countries, usually specifying a rate that is considerably lower than the rate applying to business profits. Definitions that apply for treaty purposes may prevent reclassification, under domestic law, of interest paid as a dividend by a thinly capitalized company. Non-discrimination articles may raise obstacles to the denial of a tax deduction for interest paid to a related party. While the OECD tried to argue that its 1977 model tax convention accommodated domestic thin capitalization rules, many of

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4 If interest is taxed on a gross basis when paid to a financial intermediary, the tax will likely exceed the intermediary’s lending margin. Thus, the lender will be forced to pass the tax on to the borrower to protect its profitability.

5 Interest paid to non-residents is usually taxed on a gross basis, while business income is taxed on a net basis. The lower rate for interest under some tax treaties may not be available if the interest is paid to a related party. See, for example, article 9(3) of the Agreement Between the Government of New Zealand and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Singapore on August 21, 1973, as amended by the protocol signed on July 1, 1993.

6 As noted above, under some tax treaties, the reduced rate of tax on interest may not apply to interest paid to a related party, and hence reclassification under the domestic law of one contracting state could still occur.

its conclusions were tenuous and debatable. The release of the 1992 model tax convention, however, could reduce some of these obstacles, given the role of the commentary in the interpretation of treaties.

Third, it is difficult to draft justiciable rules that determine at what point a high debt-equity ratio can be regarded as a tax-avoidance arrangement, rather than a legitimate financing structure, and therefore where it is appropriate to impose a penalty. Virtually every country that has enacted thin capitalization rules has done so by using a fixed debt-equity ratio (safe-harbour ratio) beyond which a tax sanction applies. (This is known as the “fixed approach” to thin capitalization.) The safe-harbour ratio is usually set at a very high level. The disadvantage of a high safe-harbour ratio is that it may provide an incentive to thin capitalization since non-resident investors can raise debt up to this level without incurring a tax penalty.

Fourth, where a country decides to adopt fixed thin capitalization rules, complex legislation is required to bring within the legislative net all permutations and combinations of arrangements that achieve thin capitalization. As a result, it is difficult to draft effective legislation, and the rules enacted by some countries have proved easy to circumvent. For example, the Australian and Canadian thin capitalization rules apply only to debt raised from associated parties, ignoring debt raised from arm’s-length parties that has been guaranteed or secured by an associated party. In addition, there is no provision to recharacterize subordinated debt raised from associated parties as equity when such debt is combined with first-ranking debt from arm’s-length sources. Owing to these difficulties, thin capitalization rules subsequently introduced in the United States, Japan, and New Zealand have focused on the overall debt-equity ratio of the taxpayer.


10 The role of the commentary on the OECD model convention in the interpretation of treaties was expressly recognized by the New Zealand Court of Appeal in CIR v. JFP Energy Incorporated (1990), 14 TRNZ 617.

11 A further complication is that even if article 9 (associated enterprises) of the OECD model convention is relevant to domestic thin capitalization rules, and such rules must be applied in a manner consistent with the arm’s-length principle, arm’s-length comparables will provide a wide range of debt-equity ratios, some of which will be quite high. Thus, little protection may be afforded against thin capitalization. See Andrew Smith, “Thin Capitalization and the Arm’s Length Principle” (June 1995), 2 International Transfer Pricing Journal 42-60.

12 The alternative, known as the “flexible approach,” involves a qualitative assessment based on a number of relevant factors and is thus more subjective in application.

13 Australia is a good example, with over 50 pages of CCH legislation covering the thin capitalization rules.

14 In the 1996 Australian budget, it was announced that the Australian thin capitalization rules would be amended to deem parent-guaranteed debt to be related-party debt.
Despite the difficulties outlined above, a number of OECD countries have introduced thin capitalization rules, almost invariably of a fixed nature.15 Interestingly, virtually no country has adopted a subjective or flexible approach to thin capitalization, despite the OECD’s recommendation of such an approach in its 1987 report.16

NEW ZEALAND’S INTERNATIONAL TAX DISCUSSION DOCUMENT

In early 1995, a discussion paper titled International Tax—A Discussion Document17 was released jointly by the New Zealand ministers of Finance and Inland Revenue as the first step in reforming the taxation of non-resident direct investors in New Zealand. The stated aim of the government’s policy was

[to] ensure that, whatever the location of investment or the source of finance, all investment decisions make the most efficient use of New Zealand’s resources. Policy that achieves this objective will make the greatest possible contribution to economic growth and consequently improving living standards for all New Zealanders.18

The proposals contained in the second part of the discussion document were designed to meet this objective by improving the climate for foreign investment in New Zealand, as well as providing a stable and sustainable tax regime for foreign investors,19 consistent with the wider business compliance cost reduction program announced in 1994.20

The proposed reforms comprised revised transfer-pricing rules, new thin capitalization rules, and tax reductions to non-resident direct investors through extension of the FITC regime. The document emphasized that these individual initiatives were key parts of an interlocking package that “would be mutually reinforcing” because tax reductions would reduce incentives for non-resident investors to shift profits through transfer pricing and thin capitalization.21

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15 These countries include Australia, Canada, Germany, Japan, Spain, the United Kingdom, and the United States.

16 Supra footnote 7, at paragraph 90. Of the OECD countries listed in footnote 15, supra, only Japan allows taxpayers to seek approval for a debt-equity ratio above the specified limit on a case-by-case basis.


18 Ibid., at 8.

19 Ibid., at 19-20.


21 Supra footnote 17, at 37.
The New Zealand government was particularly keen not to discourage non-resident investors, and this package was believed to be consistent with this goal owing to reduced taxes on distributed profits and enhanced certainty for investors flowing from balanced transfer-pricing and thin capitalization rules. For domestic political purposes, the package could be marketed as a “give-and-take,” allowing the government to argue that any revenue lost through the FITC regime would be recovered through the enhanced transfer-pricing and thin capitalization rules. Whether these reforms will prove to be revenue neutral in this way, however, is debatable.

**Objectives of Proposed Thin Capitalization Regime**

The discussion document recognized that even with reduced taxes imposed on non-residents under the FITC regime, there were still incentives to substitute debt for equity and that some form of thin capitalization provision appeared necessary to buttress the new transfer-pricing rules.\(^{22}\) In early 1995, however, the government was not convinced that thin capitalization rules should be introduced; it “would need to be satisfied that an effective and acceptable thin-capitalisation regime could be put into place that would not impose excessive compliance costs upon businesses.”\(^{23}\) Submissions were invited on the issue of thin capitalization—in particular, “whether a thin capitalisation regime is feasible and necessary,”\(^{24}\) and, if not, how thin capitalization should be dealt with.

This question was surprising because more stringent transfer-pricing rules would surely have encouraged non-resident investors to adopt thin capitalization arrangements. Media reports suggest that there was disagreement between the ministers of Finance and Inland Revenue about the need for thin capitalization rules and this question was raised as a compromise between them.\(^{25}\) Subsequently, after submissions on the discussion document had been received and considered, it was accepted that thin capitalization rules were necessary, and the government made no further comment on this issue.

The document outlined three major objectives that should be met by an efficient and effective thin capitalization regime:

1) The rules should determine the amount of interest expense properly attributable to New Zealand source income, in a manner that is flexible enough to have regard to the normal variation of commercial finance while recognizing and restricting the use of excessive debt finance.

2) The rules must be administered within the existing self-assessment system without the need for the commissioner’s discretion.

3) The rules must achieve the above objectives with minimal additional compliance costs to taxpayers.

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\(^{22}\) Ibid., at 53.

\(^{23}\) Ibid.

\(^{24}\) Ibid.

The discussion document contained a brief analysis of the thin capitalization rules enacted in Australia, Canada, Germany, Japan, Norway, Sweden, and the United States. It recognized that there was a major weakness in the rules of most of these countries in the adoption of a high safe-harbour debt-equity ratio and the fact that the rules took into account debt owing to related parties only.26

Specific criticism was directed at the Australian thin capitalization rules on the ground that debt raised from an arm’s-length lender and guaranteed by a foreign parent was not deemed to be related-party debt. Other grounds for criticism included the inability of the rules to determine accurately interest expense attributable to Australian source income, because of two factors:

1) The 3:1 debt-equity ratio was too high, especially when a parent company had a lower overall debt-equity ratio.27

2) Only related-party debt was taken into account, instead of all debt owing by the taxpayer.28

It was concluded that effective thin capitalization rules would require that all debt owing by a taxpayer be taken into account, rather than only related-party debt.

In July 1995, draft legislation was released together with an explanatory document inviting public submissions. Legislation enacting the reforms was passed in early December 1995 with effect from the income year beginning April 1, 1996.

THE FOREIGN INVESTOR TAX CREDIT REGIME

When dividend imputation was introduced in 1988, the double taxation of distributed company income for resident shareholders was reduced or eliminated. No provisions, however, were included to extend imputation benefits to non-residents, and non-resident withholding tax (NRWT) continued to be imposed on dividends paid to non-residents. While the effective tax rate on corporate income distributed to residents was reduced to 33 percent,29 the effective tax rate for non-residents was 43.1 percent.

26 Several writers highlight how the Canadian and/or Australian rules can be avoided or rendered ineffective because only related-party debt is taken into account or because the rules do not apply to subordinated debt from related parties that is combined with first-ranking debt raised from arm’s-length sources. See Andrew Smith, Tax Avoidance and Non-Resident Investors: The Case of Thin Capitalisation (Wellington: Victoria University of Wellington, Institute of Policy Studies, 1992), 118-24; Tim Edgar, “The Thin Capitalization Rules: Role and Reform” (1992), vol. 40, no. 1 Canadian Tax Journal 1-54, at 39-44; and R. Vann, Trans-Tasman Taxation of Equity Investment (Wellington: Victoria University of Wellington, Institute of Policy Studies, 1989), 96-98.

27 The Australian government announced in its August 1996 budget that the safe-harbour ratio will be reduced from 3:1 to 2:1.

28 This aspect of the rules also has been amended: see supra footnote 14.

29 New Zealand branches of non-resident companies were taxed at 38 percent, with the additional 5 percent compensating for the exemption from NRWT of remittances of profits to the head office. Under the 1995 reform package, such branches are now taxed at 33 percent, the rate applied to resident companies.
or 53.1 percent, depending on whether the non-resident was eligible for relief under a double taxation agreement.\textsuperscript{30}

In 1993, the FITC regime was introduced to provide tax relief to non-resident portfolio investors.\textsuperscript{31} This relief was extended to all non-resident shareholders from December 18, 1995 as part of the reform package. The FITC regime is contained in subpart LE of the New Zealand Income Tax Act and provides an income tax credit to New Zealand companies paying dividends to non-resident investors, conditional on the application of this credit to pay an extra dividend (known as a “supplementary dividend”) to the non-resident shareholder.\textsuperscript{32} NRWT is still imposed on both dividends at the normal rate. The amount of the credit (and hence the amount of the “supplementary dividend”) is calculated according to the imputation credits attached to the dividend.\textsuperscript{33} The following example shows how the FITC regime applies (assuming that all shareholders are non-residents).

\textit{Example 1 Effective New Zealand Tax Rates on Distributed Corporate Income Under the FITC Regime}

<table>
<thead>
<tr>
<th>New Zealand resident shareholder</th>
<th>Non-resident shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax income</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less company tax @ 33%</td>
<td>(330)</td>
</tr>
<tr>
<td>Net profit after tax</td>
<td>$ 670</td>
</tr>
<tr>
<td>Dividend paid to shareholder</td>
<td>$ 670</td>
</tr>
<tr>
<td>Plus imputation credit for residents</td>
<td>330</td>
</tr>
<tr>
<td>Plus supplementary dividend</td>
<td>na</td>
</tr>
<tr>
<td>Gross dividend</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less NZ income tax</td>
<td>(330)</td>
</tr>
<tr>
<td>Less NRWT @ 15%\textsuperscript{a}</td>
<td>na</td>
</tr>
<tr>
<td>Net return after NZ tax</td>
<td>$ 670</td>
</tr>
<tr>
<td>Effective NZ tax rate</td>
<td>33.0%</td>
</tr>
</tbody>
</table>

\textsuperscript{a} As the dividend is “fully imputed” under section NG2(3).


\textsuperscript{31} Investors with less than a 10 percent ownership interest in a New Zealand company.

\textsuperscript{32} New Zealand Income Tax Act 1994, as amended (herein referred to as “Income Tax Act 1994”). Unless otherwise stated, statutory references in this article are to this Act. The supplementary dividend requirement is contained in section OB1, not subpart LE. The definition of “supplementary dividend” requires that this dividend be paid in the same income year as the first dividend and with respect to that first dividend. Both dividends must be derived by the same non-resident shareholder. In addition, the supplementary dividend must be equal to the tax credit calculated under section LE2.

\textsuperscript{33} For a detailed explanation of how the FITC is to be calculated, see the appendix to this article.
The reason for providing tax relief to foreign investors by increasing the dividend payable to them through the supplementary dividend arising from the tax refund and the continued imposition of NRWT is to ensure a full tax credit overseas for NRWT. The risk of simply abolishing NRWT on fully imputed dividends (as was done in Australia from 1986) is that the NRWT forgone will be clawed back offshore, leaving the investor with little (if any) net gain. Example 2 shows this effect.

Example 2  FITC Regime with Foreign Tax Credits Offshore

Assumptions:
The non-resident investor’s marginal (foreign) tax rate is 40 percent. All shareholders are non-residents.

<table>
<thead>
<tr>
<th></th>
<th>NRWT and no tax relief (old New Zealand approach)</th>
<th>Removal of NRWT (Australian approach)</th>
<th>Supplementary dividend and NRWT (new New Zealand approach)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross dividend</td>
<td>$670</td>
<td>$670</td>
<td>$788</td>
</tr>
<tr>
<td>Less New Zealand NRWT</td>
<td>(101)</td>
<td>na</td>
<td>(118)</td>
</tr>
<tr>
<td>Foreign tax @ 40%</td>
<td>$268</td>
<td>$268</td>
<td>$315</td>
</tr>
<tr>
<td>Foreign tax credit</td>
<td>(101)</td>
<td>(nil)</td>
<td>(118)</td>
</tr>
<tr>
<td>Less net foreign tax</td>
<td>(167)</td>
<td>(268)</td>
<td>(197)</td>
</tr>
<tr>
<td>Net dividend</td>
<td>$402</td>
<td>$402</td>
<td>$473</td>
</tr>
<tr>
<td>Increase in after-tax income</td>
<td></td>
<td>17.7%</td>
<td></td>
</tr>
<tr>
<td>New Zealand corporate income tax</td>
<td>$330</td>
<td>$330</td>
<td>$212</td>
</tr>
<tr>
<td>New Zealand NRWT</td>
<td>101</td>
<td>na</td>
<td>118</td>
</tr>
<tr>
<td>Foreign tax (net of foreign tax credit)</td>
<td>167</td>
<td>268</td>
<td>197</td>
</tr>
<tr>
<td>Total tax paid</td>
<td>$598</td>
<td>$598</td>
<td>$527</td>
</tr>
</tbody>
</table>

\(^a\) When Australia introduced a similar dividend imputation regime in 1986, NRWT was removed from fully imputed (“franked”) dividends.

The relief provided by New Zealand is maintained in the hands of the non-resident shareholder. The foreign government also collects more tax (increased from $167 to $197). It is hoped that the additional tax paid offshore will dissuade foreign countries from enacting legislation to negate the New Zealand supplementary dividend approach. Where double taxation agreements exist, there may in any event be impediments against the enactment by foreign countries of legislation that aims to restrict such credits.\(^34\)

\(^34\) See Michael Rigby, “New Zealand Taxation of Interest and Dividend Income of Non-Residents” (March 1995), 1 New Zealand Journal of Taxation Law and Policy 160-92. Readers should note that Rigby’s discussion refers only to the availability of the FITC to non-resident portfolio shareholders, whereas the credit has subsequently been extended to all non-resident shareholders. The method for calculating the FITC also has changed slightly since Rigby’s article, but the principles remain the same.
BACKGROUND TO NEW ZEALAND’S THIN CAPITALIZATION RULES

Before the new thin capitalization rules are examined in detail, it is desirable to review the background to their introduction.

Incentives for International Investors To Avoid New Zealand Tax

While the New Zealand corporate tax rate of 33 percent is moderate by OECD standards, it does not necessarily follow that effective New Zealand tax rates on business income are particularly low. The New Zealand tax base is broadly defined,\(^{35}\) capital allowances are low, and virtually no incentives are offered. All these factors counteract the advantages of a moderate statutory tax rate.\(^{36}\)

Profits shifted out of New Zealand by non-resident investors may be exempt offshore or can be routed to no-tax or low-tax jurisdictions. Advantages can also arise through income shifting owing to such factors as the following:

- the ability to effect an offset of company losses between other subsidiary companies in different jurisdictions;
- the shifting of tax liabilities between jurisdictions to obtain tax advantages such as maximizing dividend imputation credits and avoiding minimum tax requirements; and
- maximization of foreign tax credits—for example, a full credit for New Zealand withholding tax on interest or royalties may be granted, whereas withholding tax on dividends may not be fully creditable.

The absence of any international consensus on company-shareholder tax integration and how such integration should apply to cross-border dividend flows creates further incentives for cross-border income shifting. Prohibitively high tax burdens may arise when corporate income is distributed down a chain of cross-border subsidiaries, making it critical for income to be transferred within multinational groups in a tax-efficient manner. Profits shifted in the form of interest are much more likely to receive symmetrical tax treatment in both the source and residence countries, with foreign tax credits eliminating or significantly reducing any double taxation.

\(^{35}\) New Zealand does not have a comprehensive capital gains tax; however, many gains of a capital nature are taxed as ordinary income (for example, capital gains on debt instruments and from portfolio equity holdings in foreign companies). Under current law, profits from certain land transactions are specifically exempt from tax and profits from some land and non-land transactions do not constitute income for income tax purposes. In very general terms, the property must not have been acquired for the purpose of resale, and it must have been owned for a reasonable length of time.

\(^{36}\) For an example of the gains to be enjoyed from thin capitalization in New Zealand, even with the extension of the FITC regime to direct investors, see table 1 in Andrew Smith, “Thin Capitalization Rules To Be Enacted” (August 1995), 1 Asia-Pacific Tax Bulletin 218-23, at 219.
Existing Provisions for Determining the Debt-Equity Boundary

From 1958 to 1988, New Zealand taxed companies on a “classical” basis, which gave rise to the double taxation of distributed corporate income. Despite the incentives created for both resident and non-resident taxpayers to substitute debt for equity, there were very few provisions in New Zealand tax law to deal with the debt-equity boundary.

While the government did have concerns about convertible notes, resulting in restrictions on the deductibility of interest payable on such notes, this policy was later liberalized when hybrid securities were perceived to be a legitimate financing option. Apart from this provision, there were two other anti-avoidance provisions, both of which remain in the current Act. Section FC1 denies a deduction for interest paid on debentures issued by a company where the interest rate is not specifically determined “but [is] determinable from time to time by reference to the dividend payable by the company or the company’s profits, however measured.” The purpose of this provision is to prevent the stripping of company income in the form of interest payable on debt where the interest on that debt represents a distribution of company profits rather than what can be reasonably regarded as interest. Section FC2 denies a deduction for interest paid on debentures issued in substitution for equity shares. For the purposes of the Act, debentures falling within either of these two sections are treated as equity shares in the issuing company.

There have never been any anti-avoidance provisions that apply on the basis of the debt-equity ratios of taxpayer companies, nor have New Zealand courts ever applied any common law doctrines reclassifying debt as equity.

It is sometimes argued that the introduction of comprehensive dividend imputation in 1988 removed incentives for equity to be disguised as debt. To some extent this is true, but not necessarily in all cases. Complex anti-streaming rules for imputation credits, the inability of tax-exempt investors (or those with tax losses) to use imputation credits, and the advantages for non-residents to derive interest instead of dividends mean that there can still be considerable tax advantages in disguising equity as debt.

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37 Restrictions on the deductibility of interest paid on convertible debentures were completely removed in 1986.

38 This denial of an interest deduction does not apply where the interest was set by a floating rate if “the rate of interest payable is determined by a fixed relationship to economic, commodity, industrial or financial indices, or banking rates or general commercial rates”: section FC1(3).

39 In C of T (WA) v. Boulder Perseverance Limited (1937), 58 CLR 223, the Supreme Court of Western Australia disallowed a deduction for the share of profits paid on certain profit-sharing notes that provided for a fixed interest rate and participation in the issuer’s profits, on the ground that the profits paid to note holders were a distribution of profits after taxation.
The boundary between debt and equity in the current Act is found in the “qualified accruals rules.” These rules specify the tax treatment of all debt instruments known as “financial arrangements.” Financial arrangements are defined very broadly, with “shares” and “share options” being specifically excluded from this definition.

Shares are defined as “any interest in the capital of a company” and any debentures falling within sections FC1 and FC2 (discussed earlier). Thus, equity in a company is a specific exclusion from the term “financial arrangement.” If a security does not meet the legal test of being “an interest in the capital of a company,” it is taxed as a debt security. Accordingly, the boundary between debt and equity is based purely on the legal form of a security without any consideration of its economic substance. Ironically, the nature of this debt-equity boundary tends to favour thin capitalization arrangements, because equity is a narrowly defined exclusion from the broadly defined term “financial arrangement” (that is, debt).

THE NEW RULES

The thin capitalization rules are contained in subpart FG of the Income Tax Act 1994. Consistent with the new style of drafting adopted in the 1994 Act, subpart FG contains a statement of purpose setting out the Legislature’s intention in enacting thin capitalization rules. This statement is intended to influence the statutory interpretation of the subpart.

The statement of purpose reads:

[T]he purpose of this Subpart is to ensure, in the case of a New Zealand taxpayer controlled by a single non-resident and which has a disproportionately high level of New Zealand group debt funding, an appropriate apportionment to the New Zealand taxpayer of the worldwide interest expenditure of the group of entities of which the New Zealand taxpayer is a part.

Application of the Rules

The thin capitalization rules are effectively applied in a two-stage process. First, the taxpayer must fall within one of three ownership categories specified in section FG2(1). Second, only if the “New Zealand group debt percentage” of the taxpayer exceeds certain levels can an apportionment of a taxpayer’s deductible interest expense be made. If the taxpayer meets only one of these two tests, no apportionment of deductible interest expense will occur.

40 In section OB1.
41 Known as “excepted financial arrangements.”
42 Also in section OB1.
43 Section FG1.
The Ownership Tests
The first stage in applying the thin capitalization rules is to determine whether, at any time during the income year, a taxpayer is one of the following:

1) A non-resident\(^{44}\) (subject to certain provisos).\(^{45}\) Thus, branches of non-resident companies, non-resident individuals, and non-resident partners are brought within the first limb.

2) A New Zealand resident company in which a non-resident person has a 50 percent or greater “ownership interest” or otherwise holds control “by any other means whatsoever.”\(^{46}\) This limb brings New Zealand resident companies with non-resident shareholders within the ambit of the thin capitalization rules. The concept of “ownership interest” is discussed in the next section.

3) A trustee of a non-qualifying trust\(^{47}\) 50 percent or more settled by a single non-resident person.\(^{48}\) A trust will be considered 50 percent or more settled if the total value of all settlements by one non-resident person (including those of associated persons) exceeds 50 percent of all settlements on the trust.\(^{49}\)

The effect of these three limbs is that the thin capitalization rules can have a very wide application and are not limited solely to non-resident-controlled New Zealand companies.

**Determination of “Ownership Interests” in Companies**
For the purposes of the rules, the ownership of companies is determined using a concept of “ownership interest.” This concept is unique to the thin capitalization rules, although it is very similar to the “control interest” tests used in the New Zealand controlled foreign company regime.\(^{50}\)

A taxpayer’s “ownership interest” is defined\(^{51}\) as the sum of all direct and indirect ownership interests held by a person in a company, plus the direct and indirect ownership interests held by persons associated\(^{52}\) with

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\(^{44}\) Section FG2(1)(a).

\(^{45}\) Unless the taxpayer is a company in which a New Zealand resident person has a 50 percent or greater ownership interest and no non-resident (when aggregated with associated persons) has a 50 percent or greater interest in the taxpayer: ibid.

\(^{46}\) Section FG2(1)(b).

\(^{47}\) Defined in section OB1.

\(^{48}\) Section FG2(1)(c).

\(^{49}\) Section FG2(7).

\(^{50}\) See subpart CG.

\(^{51}\) Section FG2(2).

\(^{52}\) As defined in section OD7. Under section FG2(6), if a non-resident has no direct or indirect ownership interest in the company, any relative of that person who is resident in New Zealand is not an associated person in respect of the company.
that person. Generally, a taxpayer’s “direct ownership interest” is determined by reference to the taxpayer’s highest percentage share of the following:

1) interest in the capital of the company; or

2) rights to vote or to participate in certain decision making with regard to the management or operation of the company; or

3) entitlement to company income; or

4) entitlement to the company’s net assets on winding up.

Where a chain of companies exists, special rules apply. If a taxpayer’s direct ownership interest (along with the direct ownership interests of associated persons) is below 50 percent, the taxpayer’s ownership interest in the lower-tier company is obtained by multiplying the interest in the top-tier company and the top-tier company’s interest in the lower-tier company. However, where the ownership interest in the top-tier company is 50 percent or more, the ownership interest in the lower-tier company is deemed to be the top-tier company’s ownership interest in the lower-tier company. In other words, the taxpayer’s interest in the top-tier company is effectively deemed to be 100 percent, as shown in figure 1.

The “Debt Percentage” Test

Even if a taxpayer falls within one of the three ownership categories in section FG2(1), the amount of deductible interest can be subject to apportionment only if a taxpayer’s “New Zealand group debt percentage” exceeds either the safe-harbour limit of 75 percent or 110 percent of the “worldwide group debt percentage” of the group to which the taxpayer belongs, whichever is greater.

The safe-harbour 75 percent debt percentage is equivalent to a 3:1 debt-equity ratio and, to reduce compliance costs, is designed to exclude most taxpayers that operate with a commercially realistic debt-equity ratio. While this 75 percent safe-harbour limit appears comparable to the safe-harbour debt-equity ratios adopted under the thin capitalization rules enacted in Australia, Canada, and Germany, the New Zealand ratio is effectively lower because the other countries’ ratios take into account

53 Section FG2(3).
54 Sections CG4(4)(a) to (d).
55 Under section FG2(4).
56 Section FG3. The 110 percent limit applies only to companies and trusts, and not to individuals: section FG3(b).
57 While Australia, Canada, Germany, and Japan all use a 3:1 safe-harbour ratio, the ratios are not strictly the same. Owing to more conservative accounting policies adopted in Germany and Japan, the ratio is effectively lower than that in Australia or Canada. Moreover, in Australia, Canada, and Germany, the ratio refers to related-party debt to equity (which in practice would allow a much higher overall debt-equity ratio), while the Japanese ratio takes all debt into account.
only related-party interest-bearing debt, while the New Zealand ratio takes into account all interest-bearing debt.\footnote{The US safe-harbour ratio is 1.5:1 and is calculated taking all debt into account.}

**Figure 1** Determination of Ownership Interests down a Chain of Companies

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-resident individual</td>
<td>Non-resident individual</td>
</tr>
<tr>
<td>60%</td>
<td>49%</td>
</tr>
<tr>
<td>New Zealand company 1</td>
<td>New Zealand company 1</td>
</tr>
<tr>
<td>50%</td>
<td>60%</td>
</tr>
<tr>
<td>New Zealand company 2</td>
<td>New Zealand company 2</td>
</tr>
</tbody>
</table>

Economic interest in NZ company 2 . . . 30% 29.4%
Ownership interest in NZ company 2 . . 50% 29.4%
NZ company 1 . . . . . . . . . . . . . . . . . . . . Within section FG2(1)(b) Outside section FG2(1)(b)
NZ company 2 . . . . . . . . . . . . . . . . . . . . Within section FG2(1)(b) Outside section FG2(1)(b)

**Determination of Taxpayer’s “New Zealand Group Debt Percentage”**

A taxpayer’s “New Zealand group debt percentage” is defined as the proportion of total debt over the total assets of the taxpayer’s New Zealand group for the income year.\footnote{Section FG4(1).}

**Calculation of “Total Debt”**

Total debt is defined as “financial arrangements”\footnote{Supra footnote 40.} that provide capital to the taxpayer (or another group member) and for which interest deductions have been permitted other than those relating solely to foreign-exchange variations.\footnote{Section FG4(2).} Thus, interest-free loans (including those denominated in foreign currencies) will be excluded and essentially treated as equity, as will accrual accounting provisions, deferred tax, and other similar liabilities or provisions.
As noted earlier, the existing definition of “financial arrangement” (used in the domestic interest accruals regime contained in subpart EH) is extremely broad and robust, and encompasses all types of securities that are closely substitutable for debt. While “specified leases” 62 (that is, financial leases) are excluded from the definition of financial arrangement, such leases are deemed to provide funds from a financial arrangement and expenditures incurred from such leases are deemed to give rise to interest for the purposes of the thin capitalization rules. 63 Because the definition of financial arrangement has been adopted, instruments such as swaps, options, and futures contracts, while not usually recognized as interest-bearing liabilities on a balance sheet, could be regarded as debt under the rules. Such instruments will effectively be disregarded in the determination of a taxpayer’s debt percentage because of the qualification that financial arrangements must also provide funds to the issuer.

A deduction is allowed from the amount of total debt for any funds loaned (at interest) by the taxpayer to all unassociated persons and associated non-resident persons. 64 As a result, financial institutions and financing subsidiaries with high debt-equity ratios are unlikely to be subject to penalties under the thin capitalization rules. For this reason, a special safe-harbour debt-equity ratio for financial institutions (such as that provided under the Australian thin capitalization rules) is not necessary.

Calculation of “Total Assets”
Taxpayers are provided with four options for calculating the value of their (or another group member’s) total assets. 65 They can elect to use either

1) the values shown in the financial accounts of the New Zealand group; or

2) the net current value of the assets; or

3) for trading stock that is valued at market selling value in calculating the taxpayer’s income, the market selling value; or

4) if permitted under generally accepted accounting principles (GAAP) in New Zealand, a combination of financial accounting and market values.

If there is a group of companies, taxpayers are required to determine the amount of total debt and assets on a New Zealand consolidated basis with intercompany balances eliminated. 66 These options will provide taxpayers

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62 Sections FC5 to FC8.
63 Section FG9. Also, under the interest accrual rules, financial arrangements involving deferred settlements for real estate transactions or extended trade credits can give rise to imputed interest expense. Under Determinations G16A and G20, if a trade credit is granted for a period of more than 63 days, an interest component arises from the transaction, resulting in an interest deduction for the issuer.
64 Section FG6.
65 Sections FG4(3)(a) to (d).
66 Section FG4(9).
with considerable incentives to regularly revalue assets (consistent with New Zealand GAAP) and are likely to give the commissioner problems where market values for specialized assets\(^{67}\) cannot be easily ascertained. It appears that taxpayers need not adopt asset revaluations used for calculations under the thin capitalization rules also for financial reporting purposes.

Any temporary reduction in the balance of a financial arrangement or an increase in the value of an asset must be excluded from the calculations if the reduction or increase has the purpose or effect of defeating the intent and application of the thin capitalization rules.\(^ {68}\)

Taxpayers are offered three options for the time at which their debt and total assets are calculated.\(^ {69}\) They can choose either

1) the average of total debt and total assets calculated at the end of each day of the income year; or

2) the average of the total debt at the end of each three-month period; or

3) the total debt and assets at the end of the income year.

Where debt or assets are valued in a foreign currency, taxpayers must convert them to New Zealand dollars at the spot rate on the date the calculation was made.\(^ {70}\) Taxpayers can also elect to use a forward exchange rate applicable on the first day of the income year.\(^ {71}\) This rate can be selectively applied to foreign currency amounts by the taxpayer. In practice, exchange-rate fluctuations could have a substantial effect on a taxpayer’s debt percentage from year to year. This may encourage taxpayers to value their fixed assets for financial reporting purposes in a foreign currency, so that there is a natural hedge between the fixed asset and the foreign currency liability.\(^ {72}\)

**Calculation of Taxpayer’s “Worldwide Group Debt Percentage”**

A taxpayer’s “worldwide group debt percentage” is to be calculated at the end of the accounting year that is closest to the beginning of the taxpayer’s income year.\(^ {73}\) Taxpayers have two options with respect to the calculation of the percentage. They can use amounts taken from the

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\(^{67}\) For example, oil drilling equipment.

\(^{68}\) Section FG4(8).

\(^{69}\) Section FG4(5).

\(^{70}\) Section FG4(7).

\(^{71}\) Section FG7.

\(^{72}\) The New Zealand Statement of Standard Accounting Practice (SSAP) 28 (Accounting for Fixed Assets) is silent on such an approach, as is SSAP 21 (Accounting for the Effects of Changes in Foreign Currency Exchange Rates). Air New Zealand values its aircraft fleet for financial reporting purposes in US dollars.

\(^{73}\) Section FG5(1).
financial statements of the taxpayer’s worldwide group, provided that the debt and assets are calculated under a financial reporting standard in a consistent and non-distorting manner that is generally equivalent to New Zealand GAAP, and in accordance with the financial reporting standards of the country that are applied in the preparation of the group’s consolidated financial accounts.

Alternatively, taxpayers can elect to use either of the bases specified in sections FG4(2) and (5) for calculating total debt and assets of the New Zealand group. If the worldwide group is a company, the values of debt and assets are required to be determined on a consolidated basis, using methods similar to those for consolidated entities in New Zealand, with elimination of intercompany balances. Similar provisions are specified for joint ventures and trusts. A concession is also made for on-lending by the worldwide group similar to that made for the calculation of the New Zealand group debt percentage.

If it is impractical for a taxpayer to calculate its worldwide group debt percentage because of an inability to comply with the requirements of sections FG5(1) to (11), the taxpayer can elect that the commissioner estimate the percentage.

In cases where the commissioner is not asked to or cannot reasonably make an estimate, the taxpayer’s worldwide debt percentage is set at 68.1818 percent. This default rate provides a safe-harbour percentage of 75 percent using the 110 percent rule (68.1818% × 110% = 75%). If every person in the taxpayer’s worldwide group, apart from the taxpayer, is resident in New Zealand, the taxpayer’s worldwide group debt percentage is deemed to be 68.1818 percent notwithstanding the other provisions of section FG5.

Calculation of “Debt Percentage” for Trusts and Individuals
The above rules apply to trusts in a similar manner. The “New Zealand group” of a trust will include all persons associated with the trust who are either residents of New Zealand or non-residents carrying on business in

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74 Section FG5(2).
75 Section FG5(4).
76 Section FG5(8).
77 Section FG5(10).
78 Sections FG5(9) and (11).
79 Section FG6(2).
80 Section FG5(12)(a).
81 Section FG5(12)(b).
82 Section FG5(13).
New Zealand through a fixed establishment. The worldwide group of a trust also will include all persons associated with the trust resident in New Zealand or elsewhere.

Because of practical difficulties in applying the above regime to individuals, the debt percentage of an individual taxpayer is calculated on a slightly different basis. The requirement to consolidate the assets and liabilities of associated persons (such as relatives) when determining the New Zealand group and worldwide debt percentages is obviously impractical and is not required for individuals. Instead, the debt percentage is calculated with reference to the individual’s New Zealand assets and liabilities, excluding any private or domestic assets in New Zealand. Effectively, no worldwide group debt percentage is required to be calculated for non-resident individuals because that rule applies when the New Zealand group debt percentage exceeds 75 percent. Individuals cannot take advantage of the 110 percent worldwide group debt percentage rule, which is available only to companies and trusts.

**Apportionment of Deductible Interest**

If a taxpayer falls within one of the three ownership categories in section FG2(1) and has a New Zealand group debt percentage in excess of the greater of 75 percent and 110 percent of the worldwide group debt percentage, any interest expense claimed under section DD(1)(b) as a deduction for tax purposes is reduced by the amount calculated under the following formula:

\[
(I - GI - IFD) \times \frac{TNZD - NZDA}{TNZD} \times \frac{NZDP - TDP}{NZDP}
\]

where

- \( I \) = interest that would be otherwise deductible (including foreign exchange gains/losses);
- \( GI \) = interest payable on intercompany balances excluded under consolidation accounting;
- \( IFD \) = deductible foreign exchange gains/losses arising on non-interest-bearing debt excluded under section FG4(2);
- \( TNZD \) = total New Zealand group debt before exclusion of funds on-loaned under section FG6;

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83 Section FG4(15).
84 Section FG4(16)(a).
85 Ibid.
86 Section FG4(16)(b).
87 Section FG3(a).
88 Section FG3(b).
89 This provision specifies the rules for interest deductibility.
90 Section FG8(1).
NZDA = amount of funds on-loaned under section FG6;

NZDP = taxpayer’s New Zealand group debt percentage for the income year, being the percentage of total debt over total assets; and

TDP = for companies and trusts, the greater of 75 percent and 110 percent of the taxpayer’s worldwide group debt percentage; in all other cases, 75 percent.

The above formula is applied to all members of the New Zealand group. As the formula is an averaging one, taxpayers are not required to identify specific borrowings of any taxpayer in their group. However, there is scope for companies that are members of a wholly owned group to elect to transfer the disallowed interest deduction between them. Such a transfer may have consequences for future tax loss carryforwards. Example 3 shows how this formula applies.

Example 3 Application of Deductible Interest Apportionment Formula

NZ Co is a wholly owned subsidiary of US Co. US Co has no other interests in New Zealand, and NZ Co has no other subsidiaries. NZ Co has elected to calculate its debt percentage on an annual basis. The balance sheets of both companies are as follows:

<table>
<thead>
<tr>
<th>NZ Co March 31, 1996</th>
<th>US Co March 31, 1995 (consolidated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>$100</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>400</td>
</tr>
<tr>
<td>Notes receivable</td>
<td>100</td>
</tr>
<tr>
<td>Inventory</td>
<td>400</td>
</tr>
<tr>
<td>Fixed assets (net)</td>
<td>1,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$2,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$100</td>
</tr>
<tr>
<td>Provision for income tax</td>
<td>100</td>
</tr>
<tr>
<td>Financial lease obligations</td>
<td>400</td>
</tr>
<tr>
<td>Loan from US Co, at interest</td>
<td>700</td>
</tr>
<tr>
<td>Term loan from bank</td>
<td>500</td>
</tr>
<tr>
<td>Loan from US Co, interest-free</td>
<td>100</td>
</tr>
<tr>
<td>Shareholders’ funds</td>
<td>100</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

91 Section FG8(2).
Calculation of Debt Percentages

<table>
<thead>
<tr>
<th></th>
<th>NZ group</th>
<th>Worldwide group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total debt</td>
<td>$1,900</td>
<td>$12,000</td>
</tr>
<tr>
<td>Less non-interest-bearing debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>(100)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Provisions for income tax</td>
<td>(100)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Loan from US Co, interest-free</td>
<td>(100)</td>
<td></td>
</tr>
<tr>
<td>Adjusted debt</td>
<td>$1,600</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$2,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>On-lending concession</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank</td>
<td>$ 100</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Notes receivable</td>
<td>100</td>
<td>1,000</td>
</tr>
<tr>
<td>Total on-loaned amounts</td>
<td>$ 200</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>

1) NZ group debt percentage:
   \[
   \frac{\text{Adjusted debt less amounts on-loaned}}{\text{Total assets less amounts on-loaned}} = \frac{1,600 - 200}{2,000 - 200} = \frac{1,400}{1,800} = 77.8\%.
   \]

2) Worldwide group percentage:
   \[
   \frac{\text{Adjusted debt less amounts on-loaned}}{\text{Total assets less amounts on-loaned}} = \frac{8,000 - 2,000}{20,000 - 2,000} = \frac{6,000}{18,000} = 33.3\%.
   \]

Calculation of interest deduction apportionment for NZ Co

\[
(I - GI - IFD) \times \frac{TNZD - NZDA}{TNZD} \times \frac{NZDP - TDP}{NZDP}
\]

\[
I = $160
\]
\[
GI = \text{nil}
\]
\[
IFD = \text{nil}
\]
\[
TNZD = $1,600
\]
\[
NZDA = $200
\]
\[
NZDP = 77.78\%
\]
\[
TDP = 75\%
\]

\[
($160 - \text{nil} - \text{nil}) \times \frac{1,600 - 200}{1,600} \times \frac{77.78\% - 75\%}{77.78\%} = 5.00 \text{ interest not deductible.}
\]

Therefore, the amount of deductible interest expense is $155.00 ($160.00 - $5.00).

(1996), Vol. 44, No. 6 / no 6
Any interest deduction disallowed under the above formula is not reclassified as a dividend. Nor can any amount disallowed be carried forward and deducted in a subsequent year if the taxpayer’s debt percentage falls below the specified safe-harbour levels. There is also no adjustment allowed under the above formula for any minority interests held by New Zealand residents.

COMMENTARY ON THE RULES

It is a common feature of most tax regimes that no direct restrictions are imposed on a firm’s choice of debt and equity finance raised from arm’s-length sources, on the ground that it is best left to the firm’s management to determine the optimal mix of debt and equity. The New Zealand thin capitalization rules attempt to delineate between thinly capitalized financing structures adopted primarily for tax-avoidance reasons and those adopted for legitimate business reasons. This delineation is made by allowing non-resident-controlled New Zealand taxpayers with high debt-equity ratios to avoid any penalty under the new rules where the overseas parent or shareholder has a high overall debt-equity ratio. In cases where the New Zealand taxpayer has a high debt-equity ratio but the overseas parent or shareholder has a low overall debt-equity ratio, a penalty is more appropriate because it can be inferred that a disproportionate amount of debt has been borrowed by the New Zealand entity to avoid tax. The rules catch situations where the type of financing is converted within a group—for example, where equity is raised from outsiders and then on-loaned at interest to offshore subsidiaries.

Thus, the New Zealand rules address the deficiencies inherent in the rules of other countries where only related-party debt is taken into account. The New Zealand rules also address the situation where parent-guaranteed debt raised from unrelated sources or subordinated debt raised from associated parties is disregarded. They eliminate the need to identify back-to-back loans, guarantee arrangements, or subordinated debt, which can give rise to enforcement difficulties for tax authorities. In this respect, the New Zealand legislation is better classified as an interest allocation provision rather than an anti-avoidance provision against income shifting.

The New Zealand rules apply when the ownership interest of a single non-resident in a New Zealand company is 50 percent or more. This percentage is much higher than the thresholds adopted elsewhere (for example, 15 percent in Australia and 25 percent in Canada). The higher percentage reflects the fact that thin capitalization is less likely to occur when there are other minority owners or shareholders unrelated to the main non-resident owners. It also lessens the possibility that tax penalties will arise where a minority non-resident investor lends money to the New Zealand enterprise. However, it must be remembered that, because of the manner in which ownership interests in tiers of companies are calculated, the New Zealand rules could still apply even where the non-resident’s economic interest is less than 50 percent.
In practice, the New Zealand thin capitalization rules will affect few taxpayers. This is because the safe-harbour debt-equity ratio has been set at a very high level. First, the specified ratio is high when compared with arm’s-length debt-equity ratios. Second, under the method used to calculate the taxpayer’s debt for the purposes of the rules, the amount of debt will be much less than the taxpayer’s total debt for financial reporting purposes. Non-interest-bearing debt is effectively treated as equity when the debt percentage is calculated, and certain monetary assets are deducted from both total debt and total assets for the purposes of the rules. These features significantly favour taxpayers, even though a very broad definition of debt has been adopted for the application of the rules. The ability to use current asset values will also encourage taxpayers to regularly revalue assets upward in their accounts.

The treatment of non-interest-bearing debt essentially as equity under the rules may be a major weakness. As non-interest-bearing debt is often provided by a related party, taxpayers can manipulate such debt from year to year so that their debt percentage is just within the safe-harbour or worldwide debt percentage limit. Another potential weakness is the opportunity for non-resident related parties to charge a high interest rate on a small amount of the related-party debt, leaving the balance non-interest-bearing and thereby achieving a reduction of the taxpayer’s debt percentage.

Ironically, instead of discouraging thin capitalization, the rules may encourage non-residents to thinly capitalize their New Zealand interests up to the safe-harbour limit. As the safe-harbour ratio has been set at a high level, the rules may encourage income shifting out of New Zealand through intercompany interest payments, rather than the reverse. The Australian thin capitalization rules contain provisions against “debt creation” for this reason.

The rules can be criticized on the ground that they are essentially an interest allocation provision, and it is possible that interest paid to New Zealand resident lenders could be denied a deduction even though the interest was assessable to the lender in New Zealand. In addition, the rules could disallow a deduction for interest paid to arm’s-length lenders.

While this is true, because New Zealand has open capital markets and funds can flow freely across international borders, it is difficult to distinguish effectively between New Zealand and non-resident lenders. Moreover, because of the many different ways funds can be routed through a multinational enterprise, it would not be effective to impose sanctions

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taking into account only related-party debt. Experience in Australia and Canada has demonstrated that such narrow rules are easily circumvented. 93

A further criticism is that new investments in New Zealand that are financed at the margin by debt could suffer a penalty. This also is true, but it is debatable whether non-resident investors should be free to allocate interest expense to jurisdictions as they please. Provided that there is an adequate capital base, no penalties will arise. If penalties could arise, the group can organize the debt financing so that some interest expense will be incurred offshore and more equity contributed to the New Zealand group.

Double Taxation Agreements and the New Rules

The discussion and consultative documents contained no discussion of the relationship between the proposed thin capitalization rules and existing double taxation agreements. The OECD in its 1987 report on thin capitalization 94 recognized that there is considerable potential for conflict to arise between domestic thin capitalization rules and treaties. Controversial areas include the ability to reclassify excess interest expense as a dividend, whether thin capitalization rules are consistent with the arm’s-length principle, and whether such rules give rise to discrimination against non-residents. Such conflicts may result in the overruling of thin capitalization rules by treaties or, alternatively, in their being upheld through treaty overrides 95 which may undermine relationships between treaty partners.

New Zealand’s thin capitalization rules are vulnerable on two grounds. First, they may contravene the associated enterprise articles of New Zealand tax agreements because they apply to all loans, not just those raised from associated parties. Second, the rules may conflict with non-discrimination articles of tax agreements (although relatively few of New Zealand’s existing agreements contain such an article). 96 This is because the rules impose tax requirements on enterprises controlled by non-residents that similar enterprises controlled by New Zealand residents do not face. 97

93 The US earnings-stripping rules also impose sanctions only on related-party debt, but they are bolstered by other anti-avoidance provisions covering back-to-back loans, parent-guaranteed debt, and related-party subordinated debt.

94 Supra footnote 7, at paragraphs 26 to 69.

95 As New Zealand is a jurisdiction where the doctrine of parliamentary sovereignty applies, foreign treaties are not necessarily paramount. See Michael Rigby, “A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism” (1991), vol. 8, no. 3 Australian Tax Forum 301-427, at 314-17.

96 Of the 24 tax agreements currently in force between New Zealand and other countries, only 7 contain a non-discrimination article. Another 9 have protocols attached that allow the other signing party to request the addition of a non-discrimination article to the existing agreement should New Zealand include such an article in subsequent agreements with other countries. The 9 countries concerned have not yet exercised this option.

97 Most of the New Zealand tax agreements that do contain a non-discrimination article use wording that is different from that of the non-discrimination article in the OECD (The footnote is continued on the next page.)
The New Zealand rules also could be criticized on the ground that they introduce some aspects of a unitary tax, since they allocate interest expense between New Zealand and foreign countries according to a set formula, rather than by reference to arm’s-length criteria. The use of unitary taxes to apportion the income of multinational enterprises has been condemned in international circles, and in particular by the OECD.

OTHER OPTIONS TO ADDRESS THIN CAPITALIZATION
It is debatable whether similar protection could be provided to the New Zealand revenue base by enacting an equity-equivalence provision along the lines of section 385 of the US Internal Revenue Code. This provision allows the US commissioner to reclassify debt as equity when it is evident that the debt has the characteristics and bears the economic risks of debt, based on several qualitative criteria that apply to both residents and non-residents. Such an approach is flexible but increases taxpayer uncertainty. However, if binding rulings were offered on a timely basis, uncertainty could easily be reduced.

CONCLUSION
New Zealand has adopted a novel and unique approach to dealing with thin capitalization. Considerable thought has gone into the regime, particularly to overcome some of the problems and weaknesses found in the rules of other countries, such as Australia and Canada.

It is regrettable that neither the discussion document nor any of the other documents issued before the enactment of the rules made any mention of the relationship between these rules and New Zealand’s double taxation agreements. Possibly the omission indicates that officials were nervous of this issue and aware of potential problems. While the revised commentary on the OECD model convention issued in 1992 may better accommodate domestic thin capitalization rules, it is far from certain that a conflict will not arise. Thus, the rules may be vulnerable to challenge by a non-resident investor in the New Zealand courts.

The effectiveness of the New Zealand thin capitalization rules is dependent on the level of the safe-harbour ratio. Since the ratio is high, few non-resident investors are likely to be affected by the new rules, except to the extent that foreign-exchange fluctuations will have an impact. The rules may actually encourage thin capitalization by non-residents, particularly given the provisions of the recently introduced Companies Act 1993, which now permits share buybacks and cancellations that were...
previously prohibited or difficult to undertake. It is now much easier for non-resident investors to remove equity and replace it with debt under the Companies Act 1993. Furthermore, the tax regime applying to such transactions is unlikely to provide any major disincentives to substitutions of debt for equity by non-resident investors.

There has been muted comment on the rules from the professional and business communities, and this may suggest that few regard them as a problem. To date, only non-resident owners of New Zealand real estate financed substantially with debt\(^99\) have been identified as being likely to face reduced interest deductions under the rules, although individuals travelling overseas and leaving a domestic dwelling rented out in New Zealand may be similarly affected.\(^{100}\)

APPENDIX TECHNICAL ANALYSIS OF THE FOREIGN INVESTOR TAX CREDIT REGIME IN SUBPART LE

New Zealand operates a variable imputation regime under which it is discretionary whether or not imputation credits are attached to dividends. Credits can be attached at a rate from nil up to 49.25 percent\(^{101}\) of the dividend paid. The relationship between company income tax paid and imputation credits attached to dividends is monitored through a memorandum account known as the "imputation credit account." This account must be filed along with the company tax return.

Because the imputation regime is variable, there are complex anti-streaming rules to prevent the diversion of credits away from tax-exempt and non-resident persons. Thus, all dividends paid during a year must normally bear imputation credits at the same rate.

The interface between the FITC regime and these anti-streaming rules is complex. First, the supplementary dividend is ignored for the purposes of these anti-avoidance rules and (by implication) has no imputation credits attached to it. Second, for the purposes of determining the imputation ratio in respect of the anti-avoidance rules, the tax credit arising under section LE2(2) is treated as if it were an imputation credit. The effect of this provision is that where dividends are paid to non-resident shareholders and a supplementary dividend also is paid, imputation credits are attached to these dividends at a different rate than that applied to dividends paid to resident shareholders. The relationship between the two is as follows:


\[^{100}\text{See A. Richardson, “Thin Capitalisation Rules Need Scrutiny,” National Business Review, March 8, 1996, 45. Many New Zealand banks will finance up to 75 to 80 percent of a property’s value, while some will lend as high as 90 percent.}\]

\[^{101}\text{See section ME8(1). The rate of 49.25 percent is the “gross-up” of the company tax rate of 33 percent; that is, }\]

\[
\frac{33}{100\% - 33\%} = 49.25\%.
\]

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\[ IC_{nr} = \frac{120}{187} \times IC_r \]

where

\[ IC_{nr} = \text{the amount of imputation credits attached to dividends paid to non-resident shareholders who also receive a supplementary dividend; and} \]

\[ IC_r = \text{the amount of imputation credits attached to dividends paid to resident shareholders.} \]

Thus, where a supplementary dividend is paid in respect of an ordinary dividend to a non-resident shareholder, the main dividend will have a lesser amount of imputation credits attached than will the same dividend paid to resident shareholders.

The amount of the tax credit (and hence the supplementary dividend) is determined according to the formula in section LE2(2):

\[ TC \text{ (and } SD) = \frac{67}{120} \times IC_{nr} \]

where:

\[ TC = \text{the tax credit accruing to the company paying the supplementary dividend;} \]

\[ SD = \text{the supplementary dividend paid to the non-resident shareholder; and} \]

\[ IC_{nr} = \text{the amount of imputation credits attached to dividends paid to non-resident shareholders who also receive a supplementary dividend.} \]

The tax credit arising under section LE2(2) is creditable against the tax payable by the company for the income year.\(^{102}\) If there is an excess of credits payable, the company can elect to apply the credit to the tax payable of another company,\(^{103}\) or it can carry the credit forward to a later income year.\(^{104}\)

There is also a special provision under section LE2(13) which provides that the payment of the supplementary dividend to non-resident shareholders shall not contravene any requirement of the Companies Act 1995 and/or 1993, or the company’s constitution, or any other provision of law.

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\(^{102}\) Section LE2(4).

\(^{103}\) Section LE2(5)(a).

\(^{104}\) Section LE2(5)(b). This carryforward is subject to a number of conditions set out in sections LE2(6), (7), (8), (9), and (10). There are also special rules for situations involving company groups and holding companies under section LE3.