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The nitty-gritty of the thin cap reforms

The Inland Revenue has released its much anticipated proposals to extend the scope of the thin cap regime and restrict the existing safe harbours.

The thin cap regime limits interest deductions claimed by foreign-owned New Zealand companies with debt to equity ratios exceeding certain thresholds.

Submissions can be made by 28 June 2013.

The changes were first proposed in January this year and the go-ahead was confirmed as part of the Budget Day announcements. It was announced in January that the changes would:

- widen the application of the regime to include:
  - groups of non-residents "acting together", and
  - more trusts with settlements made by non-residents.
- amend the rules for calculating the worldwide group debt percentage to exclude:
  - related-party debt, increased asset values resulting from internal sales, and
  - capitalised interest when a deduction has been taken in New Zealand.

This week's "official's note" responds to submissions made on the January paper and sets out the details of how the modified regime will work.

"Acting together"

The proposal to extend the reach of the thin cap rules to groups "acting together" had the potential to be wide-reaching and create significant uncertainty. The original proposal was that "acting together" would not be defined, but at least include groups explicitly co-operating through a written or tacit shareholder agreement and groups being effectively co-ordinated by a person or group.

Inland Revenue recognises that the "acting together" test could be uncertain and problematic. To address these concerns, a three-limb test is proposed to determine whether a group is "acting together" sufficiently. The thin cap regime will apply if:

1. 50% or more of the entity's shares are owned by a group of non-residents who (directly or indirectly) hold debt in the entity in proportion to their equity in the entity

2. the entity has fewer than 25 shareholders and the shareholders have a shareholders' agreement that sets out how the entity should be funded, and 50% or more of the shares are owned by non-residents, or
3. 50% or more of the entity's shares are held by non-residents that are effectively co-ordinated by a person or group of people, such as a private equity manager or managers.

Trusts

The three-limbed "acting together" test would not work in the context of trusts. Accordingly, the "acting together" test as originally outlined will be applicable. That is, the "acting together" test will include explicit co-operation and effective co-ordination of non-residents making settlements on the trust.

Related party debt

The change to exclude related-party debt from the worldwide group debt percentage is going ahead, with one minor exception. The rule will not apply to shareholder debt of a publicly listed company which is publicly traded debt owed to a shareholder owning less than 10% of the company.

Increased asset values resulting from internal sales

Inland Revenue is going ahead with the change to ignore increased asset values in debt percentage calculations where the increased value results from internal sales.

Capitalised interest

The change announced in January was to exclude capitalised interest from the value of a group's assets for the debt percentage calculations if a deduction for that interest has been taken in New Zealand. Inland Revenue is now considering limiting the exclusion for capitalised interest to assets that are not carried at fair value.

Submissions close on 28 June 2013.

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