New Zealand

Mathew McKay and Neelam Krishna of Bell Gully outline recent changes to tax legislation

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A number of significant changes have been made to the New Zealand tax system in the past year. Corporate tax rates have been lowered, a new limited liability partnership regime has been introduced and research and development (R&D) has been encouraged by the introduction of an R&D tax credit regime.

Significant reform is proposed for New Zealand's international tax rules in the coming years. The reform aims to improve the competitiveness of New Zealand's international tax rules by bringing them into line with those of our major global competitors. An active income exemption will be introduced in relation to outbound investment in controlled foreign companies (CFCs). Interest allocation rules, which have until now applied only to incoming foreign investment, are also proposed for outbound investment in CFCs.

A New Zealand government general election will be held before the end of 2008. In our view, any change of government as a result of the election would be unlikely to result in a significant change in international tax policy.

Corporate tax rate reduction

The New Zealand corporate tax rate was reduced from 33% to 30% from the beginning of the 2008 income year (March 31 for standard balance date taxpayers). The new 30% rate will also apply to most widely held investment vehicles (unit trusts, for example).

The key reason for the reduction of the rate was to make New Zealand more attractive for foreign investment, especially when, in comparison, Australia has a corporate rate of 30%.

Introduction of limited partnerships regime

The limited partnership rules

The recently enacted Limited Partnerships Act 2008 (LPA) replaces an outgoing special partnerships regime with the more globally understood limited partnership model. The limited partnership regime is intended to improve access to foreign investment capital.

A limited partnership is a separate legal entity. A limited partner's liability is limited to their contribution to the partnership provided that they do not take part in the management of the partnership business (certain "safe harbour" participation-type activities are prescribed by regulation). A general partner (or partners) will be liable for all the debts and obligations of the limited partnership.

A limited partnership can list on recognised exchanges. However, once listed, the limited partnership is deemed to be a company for tax purposes and will lose the benefit of look-through taxation.

New tax rules for general and limited partnerships

The LPA also introduces new rules for the tax-

ation of both general and limited partnerships. For tax purposes, general and limited partnerships are look-through entities. A limited partnership provides the benefit of limited liability for its limited partners while being treated as a flow-through entity for tax purposes.

All income, tax credits, rebates, gains, expenditure or loss are attributed to partners directly based on the partner's share in the partnership income. Consistent with the "look-through" approach, a partner, and not the partnership, is treated as:

- carrying on an activity carried on by the partnership, and having the status, intention and purpose of the partnership;
- holding property that the partnership holds, in proportion to the partner's partnership share; and
- being party to an arrangement to which the partnership is a party, in proportion to the partner's partnership share.

It is unclear how the provisions of many double taxation agreements entered into between New Zealand and other jurisdictions interact with the new partnership rules. In particular, it is unclear whether or not a non-resident limited partner could be deemed to have a permanent establishment in New Zealand by virtue of being deemed to carry on the activities of the partnership.

Income, tax credits, rebates, gains, expenditure or loss from a particular source or of a particular nature are required to be allocated to all partners according to the relevant partner's partnership share. For example, it is not possible under the new rules to stream foreign sourced income to non-resident partners, thereby eliminating New Zealand tax on such income.

A limited partner is subject to the loss limitation rule, which prevents the flow-through of any losses in excess of the actual amount of the limited partner at risk in the partnership. Unutilised loss can be carried forward for offset in future years when further investment is made by the limited partner.

Research and development expenditure

A new R&D tax credit of 15% of the amount of qualifying R&D expenditure is now available to New Zealand businesses that carry out R&D in New Zealand. The credit is refundable in cash so it also benefits companies in a loss position.

To qualify, a business's R&D activities must be systematic, investigative and experimental. The activities must either seek to resolve scientific or technological uncertainty or involve an appreciable element of novelty and be directed at acquiring new knowledge or creating new or improved products or processes. Other activities may also be eligible if they are required for or are integral to carrying out the core R&D activity. To qualify for the credit, the company must control the project, bear the financial and technical risks and own the results. Furthermore, the company must spend at least NZ$20,000 ($15,000) (unless the R&D is outsourced to a listed research provider) and carry out the R&D predominantly in New Zealand.

Stapled securities

In February 2008 the New Zealand government announced that amendments would be made to tax legislation in relation to the tax treatment of debt securities that are "stapled" to a share. Generally, a debt security and a share will be stapled when they cannot be transferred separately. Under the law as amended, a debt security that is stapled to a share will be treated as equity for New Zealand tax purposes. As a result, deductions for interest payments on the debt security will no longer be available.

When enacted, the proposed changes will apply from February 25 2008 (the date of the announcement). Companies that issued stapled securities before this date will continue to be able to deduct interest paid on the debt portion of the security.

Income Tax Act 2007

The Income Tax Act 2007 came into force on April 1 2008. It replaces the Income Tax Act 2004. The new Tax Act is part of a project that began several years ago to re-write the Tax Act in "plain English". It was not intended that the rewrite introduce any changes in tax policy (other than several changes that were specifically identified). However, some unintended policy changes have already been detected. It is expected that such changes will be corrected by amending legislation on a continuing basis.

International Tax Rules

Controlled foreign companies

A foreign company is a CFC if five or fewer New Zealand residents have total control interests greater than 50%, or where a single New Zealand resident holds control interests of 40% or more (with some exceptions).

Under current law, a New Zealand investor with an income interest of 10% or more in a CFC must pay tax on income attributed from the CFC on a branch equivalent basis unless the CFC is resident in a "grey-list" jurisdiction (Australia, Canada, Germany, Japan, the UK, the US, Norway and Spain).

Under the proposed rules, active income derived by New Zealand resident investors from offshore operations of CFCs will be exempt from New Zealand tax. Only passive income such as rent, royalties, and interest and dividends will continue to be taxed on an attributed basis. CFCs with less than 5% passive income will be able to meet the "active business" test. Only an Australian grey-list exemption will remain in place under the rules.

The proposed rules will also introduce an exemption from all dividends received by New Zealand investors from CFCs whether funded from active or passive income.

Outbound interest allocation rules

The current interest allocation rules (or thin capitalisation rules) apply solely to non-residents who control New Zealand companies. The thin capitalisation rules limit the deduction of interest on excessive levels of debt (debt in excess of 75% of the New Zealand debt: asset percentage or 110% of the worldwide group debt: asset percentage).

The proposed rules will extend the thin capitalisation rules to outbound CFC investments to limit interest deductions claimed in New Zealand for highly geared investments into CFCs applying the same debt percentage thresholds as apply under the current inbound rules. The rules will only operate where annual interest deductions exceed NZ$250,000.

The revised controlled foreign company regime and the outbound interest allocation rules are proposed to apply from the beginning of the 2009 income year.

Extension of the associated persons concept

The current definition of associated persons will be broadened. The proposed changes are driven by the perception that the current definition is deficient and allows, in particular, land dealers, developers and builders to circumvent the land sale tax rules by operating through closely connected entities.

A comprehensive set of tests to determine association will replace the existing rules. The general definition will be extended by the introduction of a number of new tests. In relation to trusts, a settlor and beneficiary, a trustee and beneficiary and trustees of trusts

with a common settlor will all be associated. A universal tripartite test is also proposed to associate any two persons who are associated with the same third person (with limited exception). The rules relating to the aggregation of interest held by associates will also be strengthened.

The revised associated persons rules are proposed to apply from the beginning of the 2009 income year.

GST discussion document

A discussion document has been released suggesting options for strengthening goods and services tax (GST) neutrality in business-to-business transactions. The thrust of the document is that the GST rules should provide effective and clear rules that ensure that GST does not unnecessarily hinder transactions between GST-registered persons.

In line with this theme, the discussion document considers the cashflow cost associated with collecting GST (which can arise if GST is paid but is not recoverable as input tax until a later date), the treatment of high-value one-off transactions (where neutrality is desirable) and the potential for over-taxation when nominees are involved in transactions.

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